A Matter of Opinion

You can't beat the market without taking on more risk, so if that is your goal, you must give more attention to return than to risk.

The Chance to Beat the Market Comes During Good Times, Not Bad

By James B. Cloonan

With valuations, price-earnings ratios, and dividend yields at levels that encourage bearish thinking, it is certainly possible we will be in a market correction by the time you read this. However, I tend to go along with the law of physics that hold that things in motion stay in motion in the same direction. Clearly, at the time of this writing, we are in an incredibly prolonged bull market, and this encourages me to provide a few thoughts that are particularly important during up markets.

The first is based on two earlier Matter of Opinion columns, "Make Hay While It's Sunny" (March 1986 *AAII Journal*) and, "When Things Get Tough" (January 1983 *AAII Journal*). Both of these columns expressed the belief that if you want to beat the averages, you must beat them substantially in strong up periods. It is too easy to get complacent when you get 25% returns, even when the market is getting 30%. But don't. It is virtually impossible to beat the market when the Dow is down because the stocks that aggressive investors own tend to be more volatile than the market, with betas greater than 1.0 (they are up more in bull markets and down more in bear markets). Bull markets are the real opportunity, and if you cannot beat the market in strong up years, perhaps you should consider an index fund.

A second consideration, particularly important in up market periods, is that risk means volatility. Stocks with higher risk have not only a chance of greater loss, but a chance of greater gain. Most of the theories you read regarding risk reduction bring about not only a reduction in the chance of below-average performance, but also a reduction in the chance of above-average performance.

This is true of diversification. The more you diversify, the more you reduce your chance for exceptional gains. Of course you also reduce you chance for losses. But an investor who wants to outperform the market must give more attention to returns than to risk. Although I would never suggest owning only one to three stocks in your portfolio, overdiversification substantially reduces the chance to outperform. This is particularly true for individual investors who have limited time and are probably better off devoting their analysis time to fewer stocks so they can be thorough. Personally, I would never put more than 20% of my portfolio value in any one stock. But I will only buy stocks that I really want; I would not buy additional stocks just to diversify.

We have talked about the reductions in risk (as measured by chance of loss rather than statistical measurements) that takes place by holding stocks over a longer period of time. For instance, in *Journal* articles and elsewhere, it has been pointed out that if you bought stocks and held them for one year during the last 70 years, you would have had a loss 29% of the time, but if you held for five years, you only would have had a loss 11% of the time, and if you held for 15 years, you would never have had a loss.

It is interesting to note that if you were shooting for a 25% annual return (twice the average), you could have attained it 27% of the time if you invested in the S&P 500 for a one-year holding period at any time over the past 70 years; you would have attained it 7% of the time if you held it over two-year periods, 3% of the time with three-year holding periods and you never would have achieved it with an investment horizon of four years or more. Of course, this is the S&P 500 and our individual portfolios would do better (I hope).

Now, don't misunderstand—I am for longer holding periods for your overall portfolio, although not necessarily for any individual stock. Long-term holding periods allow investors to place more emphasis on return and less on risk, which primarily exists over the short term. I only point out the above holding period statistics to illustrate the point that risk and return are tied together.

I believe firmly in the two points I have made here. First, you must work harder during up periods in the market and second, successful investors don't ignore risk, but they emphasize potential high returns much more.

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