

## OUTSIDE THE FLAGS

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November 2014

# Starting with Prices

Stock picking makes sense if you believe investing is all about spotting successful companies. But identifying good businesses is one thing. Predicting that those companies' securities will beat the prices set by the market is another.

The media is full of analysts' views about the merits of one stock over another. This multiplicity of opinions takes in management quality, competitive advantage, product differentiation, balance sheet strength, industry margins, and on and on.

The implication in the media coverage is that individual investors should sift through all the opinions to come up with their own views about which companies are the best businesses with the best prospects—and build their portfolios from that information.

It's a daunting task, and it's entirely unnecessary. That's because the market, collectively, has already integrated the views of thousands of highly informed and highly expert investors about each company's prospects.

All that information and analysis is reflected every day in prices. And every day, those prices change as *new*

information comes into the market. So even if you assemble a highly considered, deeply thought-out analysis of a company's worth, you can easily get it wrong.

Of course, you can get lucky basing an investment strategy around perceived mispricing and forecasts about the economy and market conditions. But that approach rests on a couple of big assumptions—that the market collectively will eventually come around to your way of thinking and that the economy and the particular industry will pan out as you imagine.

Still, this view remains a popular approach in fund management around the world. You gather together a few good ideas about individual stocks and concentrate your portfolio around those “bargains.”

The problem: There is little evidence that trying to outguess the market prices adds value in the long term. And even if

the individual stock ideas do pan out, there's no evidence that traditional managers can do this well enough to cover their costs.

Keep in mind, also, that building concentrated portfolios around perceived mispricing can lead to missing out on the best performers. So it's not just about which stocks managers pick, it's also about which ones they leave out.

An alternative approach is to accept current market prices as a fair reflection of the combined views of participants in a highly competitive marketplace. If you start with the prices, you can begin to identify the securities with higher expected returns.

Diversifying broadly and rebalancing as prices and circumstances change mean you are not requiring just

a handful of stocks to do all the work, and you are less at risk from stock-specific or industry-specific factors that can blow a big hole in your strategy.

Ultimately, investing is about the future, not the past. Prices are forward-looking and are determined by the expectations of thousands of highly skilled, highly motivated, well-informed experts.

So rather than trying to outguess the market, you start by using today's prices to identify differences in expected returns. Put another way, instead of deciding on desired outcomes and betting against prices, you use the information in prices to help improve expected outcomes.



*"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognized by Australia's corporate regulator in its own investor education program.*

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