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The 5 Worst Ideas in Managing Money

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1 Short Selling

The Dow has risen from 1,000 in 1982 to over 27,000 as of this writing. On average, the stock market rises 6 of every 10 days. Investors can find better odds in Las Vegas than trying to short the market or shorting specific stocks even though this idea offers great intellectual appeal. Want proof? Equities hedge funds have generated a cumulative return of 58% versus 257% for the S&P 500 during 2010-2019, or 22% of the S&P return. Long only mutual funds according to the Lipper Survey have provided a cumulative return of 182%, more than 3x the hedge fund return. Worse yet, investors pay higher fees to have their money managed in a hedge fund.

2 Using P/Es to evaluate stocks

Merrill Lynch recently reported that 80% of investors use P/Es as their primary investment tool. SPIVA reported that 84% of all types of equities funds failed to beat the S&P 500 over the past 10 years. The general perception on P/Es is that lower P/E stocks offer greater value. This viewpoint runs counter to the evidence at hand. William O'Neil of IBD studied P/Es and found that stocks selling at a P/E of 35 or higher returned on average 120% during 1996-1997. Target QR studied the top 10 stocks during the period of 2006-2015 which achieved cumulative price gains of 845%- 5,354%. We found that these stocks started their runs at an average P/E of 64x. Our research demonstrates that profits growth trumps P/Es in evaluating stocks.

3 Focusing on positive earnings surprises

Wall street is fixated on earnings surprises, both positive and negative. Quarterly earnings reports are almost always discussed in the context of a positive or negative surprise with no mention of earnings growth. Consider two stocks, one reporting a lesser loss of 4 cents a share versus the estimate of a 5 cents for a 20% surprise. Another company reports $2 a share versus $1 a year ago, but falls short of the estimate by 20%. Our research shows that earnings growth is far more important than a quarterly surprise in stock evaluation, and that conventional reporting on surprises has no relevance to the trajectory of growth.

4 Ignoring Money Losing Companies

Most investors shy away from money losing companies. Moreover, Wall Street often comes to a wrong conclusion in rating a stock because of their reliance on EPS which can give a distorted view of profitability. In looking at the biggest winning stocks during the period of 2010-2019, 4 of the top 10 performers did not make money during that period. Wall Street rates stocks based on EPS, which is one of several ways to evaluate profits growth. The EPS methodology makes no adjustments for capital expenditures such as R&D in the income statement. Enterprising investors who are willing to roll up their sleeves and take a hard look at deficit companies can sometimes be rewarded by finding a diamond in the rough.

5 Being Less than 100% Invested

Morningstar tracks standard portfolios which hold a mix of 60% in stocks, 30% in bonds, and 10% in cash. It recently reported that only 12% were overweighted in equities, well after the new bull market started six months ago. Tampering with asset allocation in most instances backfires by reducing returns. The jury is out on market timing and the results are dismal, as supported by many studies. Consider that we have just come through one of the strongest rebounds ever from a bear market low and one in which the S&P 500 is up 50% from its bottom. All this while, a lot of money designated for investment in stocks has been sitting on the sidelines. This is yet one more example why investors should remain fully invested at all times. The NASDAQ is at an all-time high and up 23% on the year. Curiously, the words “new bull market” have yet to be mentioned or put into print.

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