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ECONOTE No. 68: Do not believe in headline investment gains! 29/1/2018

Summary

The start of every year in the financial advisory sector begins with the usual outlook for 2018, and then goes on where to make money and how much money is to be made. Econotes is different inasmuch as it will tell you to discount a rough average of 50% of what is promised by anyone (present company excepted, of course!), not because it is lies but it is full of "terminological inexactitudes". We stress here that we do not criticize the forecasts or methodologies but we do criticize the fundamental calculations underlying all claims of investment returns, including those which will make 1,000% in 2018 (yes you heard that right, I have the evidence on file and it is not about cryptos !).

Investment Conclusions

1.All claims on investment returns are based on the assumption that buyers enter at the bottom and exit at the top. Written and attested records of any investors buying right at the bottom and selling right at the top of any market are scarce if non-existent. Econotes will be delighted to be proved humiliatingly wrong if such evidence is made public.

2.Half of the investors will always be on the wrong side of any deal, hence the claim above in (1) is at least 50% right!

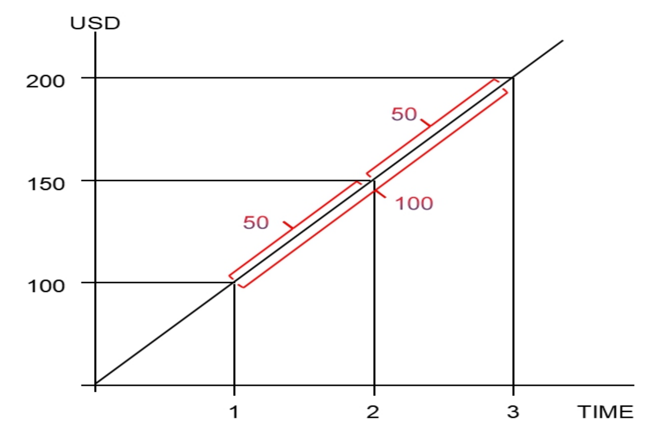
3.Assuming that (1) is broadly right, then any "bottom to top" return will be always, **on average**, much smaller than the "headline" expected and advertised gains.

Boring but essential: Why half of investors are always wrong

The Fig.1 shows a very simple example of a market doubling over three periods, be it days, weeks, months or years.The trajectory is straight to make the example easier, but it does not have to be.The market is assumed to have bottomed at 100, and any investor who had bought and held it till the market peaked at an assumed 200, would have made a 100% return. (NB. No one talks about taxes which can wipe 30% off capital gains.All the averages shown in the is report are very crude measures, and for illustration only, as they leave out compounded measures and Total Returns estimates). Observe the following simple "facts":

(1)Claims that this market made 100% gain are true only if an investor bought at 100 and sold at 200, a rare or non-existent occurance given the impossibility of perfect timing of markets (2)For any investor who bought at 100 there was another poor fool who sold at 100, and similarly for any investor who sold at 200 there was another poor fool who bought at 200.Conclusion: at any stage of any "deal" half the market will be on the wrong side of the deal, buying high or selling low. (3) Ah yes, but what if the fools who sold at 100 re-entered at 101 and then held till 200. Well and good, but they will not have made the 100% return but 98.0%, not bad but not the 100% claimed Now multiply that with thousands if not millions of deals of buyers , as the chart and its red intervals shows, of buying at 100 and then selling at 150, then buying at 151 and selling at 200.Is it not true then that EVERYONE makes a profit, albeit not 100%, in a bull market ? Yes and No.Not every investor who sold at 100 re-entered the market, and some of those who bought at 200 were caught at the peak as the prices fell.The rest of the investors would have made profits of anything from, say 0.001% to 99.9% but few, if any, would have made 100%. In this simple example the **average** gain will be no more than 50.0%. As the chart shows the average price between the bottom 100 and top 200 is 150.For deals done in the intervals of 100-150 and 151-200 etc the average gain will be about 42.0%.

Fig.1: The best chart ever in financial history (well, perhaps!)



Source: Econotes

Some more details: Forecasts and best selling books

We have shown that the average gain in any bull, or boom or bubble market will be much less of what is advertised to be.So people feeling sorry for themselves or berating their investment advisors for not having put them “early in and late out” of markets, are actually missing an important point, actually about 50.0% of the point, pun intended! In that context , Fig. 2 shows the trajectory of two current “boom and bubble markets”, the S&P500 since 2009 and Bitcoin since 2013. Observe that the S&P500 has risen almost continuously since 2009 from about 676 to currently 2,872 or a gain of over roughly 9 years of 325.0%, or an annual average of 36.0%, but always assuming a perfect buy and hold from 2009 to date ! Cryptos are a case on their own and we have dealt with them extensively in Econotes Nos 66 and 67.Their rise (and fall) is based on people simply expecting that other people will carry on buying them, as cryptos are backed by nothing and reflect no real asset value of any kind.Bitcoin rose to a peak by 142,753% from 2013 to Dec. 2017, or a yearly average of 28,550% with wild volatility.Before getting too excited, see above as to who, if any, really gained, and by how much, in all this fantastic journey.The 142,753 % rise is purely imaginary for reasons explained and the true average will be much lower although still very high.This brings us to forecasts and the sale of advice of “How to make millions in the market following my example and advice”.Both topics are interlinked and both contain a large amount of bogus stuff and claims.Not illegal, just misleading and basically illogically wrong.

Fact Box: Who’s a wealthy boy/girl then?

Forbes’ 400 billionaires for 2017 lists 7 who made their billions by buying and selling financial assets out of the top 50, or about 14.0%, and a total of about 35 out of the 400 or about 9.0%. These small numbers can vary a little by adopting a more or less elastic definition as to how the money was made .The overwhelming majority of billionaires made their fortunes through mundane activities such as making real goods including electronics and related, in I.T services, in drilling for oil, and in telecoms, property and various services. The reason why we bring up Forbes here is just to show in the real world the path to serious riches is not via the stock market. No doubt there are millionaires out there who made their fortunes in the stock market, but very few billionaires!

Fig.2: S&P 500 (red) and Bitcoin (blue) (index level and USD price), 2008 to date.

Source:Bloomberg

Don’t follow that forecast and don’t buy that book

Forecasts to have any value must be freqeuntly wrong.Any forecast which is all the time right is useless. Consider the “forecast” that tomorrow markets may go up, down or stay the flat. This will be right all the time and hence useless.All forecasts have three components.Direction (up, down, same), Quantity (X% up or down or no move) and Time (tomorrow, next week, next month etc).The old joke is that no wise forecaster will give all three components, as giving any two will allow a perfect leaway to explain away a wrong forecast.Any forecast correctly predicting gains will be eventually proven useless. In the markets any action on the forecast which turns out right, will be instanlty acted on by most if not all participants and, hence, the forecast will stop predicting right. If a forecast that the price of gold will always go up on Mondays is known only to a few investors, and if the forecast proves right, then these investors will make a killing.After a few Mondays of action, the markets will catch on.The result could be investors going long on Fridays in order to sell on Mondays, or more sellers on Mondays willing to sell on an expected rising market than buyers willing to buy. Prices may fall on Mondays (while rising on Fridays !) thus proving the forecast wrong.Which brings us to books claiming to give you the secret of how to make millions.Why buy a secret which a lot of other punters will be buying ?And what if they all act on the advice? See the forecasts section above ! And why the author is so philanthropic as to share his secret with thousand others?One way to make a million is to write a bestseller on how to make a million! Happy investing in 2018 ! Keep in mind that you will always be 50% wrong! Andrew Freris (writing completed on 29/1/2018)