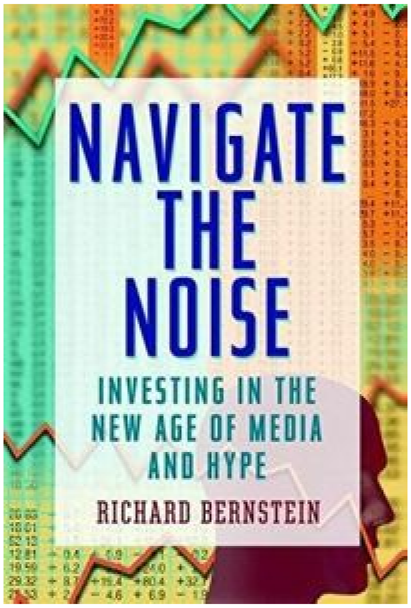

Book Navigate the Noise

Investing with One of Wall Street's Top Investment Strategists

Richard Bernstein
Wiley, 2001

Recommendation

The more information a market provides the more efficiently it will operate, right? Well, in theory that's so. In fact, market transparency has been a top goal of financial regulators in the U.S. for decades. But is it possible to have too much information? Richard Bernstein makes a compelling argument that not all information is good information. Noise - the deluge of 24-hour news coverage, constant cable TV market-chatter, continuous Internet feeds and barrages of electronic updates - is a danger to most investors, who lack the resources to separate the accurate from the spurious. This book is a Godsend for investors who think - usually mistakenly - they can make sense of it all. Bernstein tells you how to cut through the noise by focusing on long-term investment plans, diversifying and clearly assessing risk. *BooksInShort* recommends this informative book for its crisp, personal style, and for its practical approach to bringing some peace and quiet to your portfolio.

Take-Aways

- A noisy market provides more information without better information.
- The information explosion creates noise that interferes with good decision making.
- The media plays up exciting news rather than the most accurate information.
- When markets are volatile, noise levels go up.
- Thinking that you can make sense of noise with your own investment analysis is dangerous.
- Listening to noise can provoke excessive trading, more errors and costs.
- The most popular investments are not necessarily the best investments; popular investments often subsequently under-perform.
- Look for good stocks, not good companies, since good companies actually under-perform the market.
- Listening to the noise disrupts effective long-term planning.
- Rely on strategic planning, fundamental research and risk analysis, all within a disciplined investment approach.

Summary

The Information Explosion

Because there is so much information available today, the key to knowledge is not content, but the ability to sift through a huge amount of data. Investors encounter mountains of information daily and must discern just which information is really relevant. The explosion of information can cause bad investment decisions. Whether you get informed through rumor, gossip, chat rooms, notions about stock price momentum or other sources, you are more likely to be swayed by such information than you are to truly understand what is happening. You are better off with traditional, more accurate investment methods, such as strategic planning, fundamental research or risk analysis, all within a disciplined investment approach.

> "An increased number of bad investment decisions are being made because of the increased availability of information."

Increasingly, people are getting sucked in by all of the noise, much of it due to the new technology. However, if you examine the actual performance of investment portfolios, you will discover that present results are no better than the results produced before these technologies. In many cases, the later results are even worse. In fact, it is dangerous to think that you can invest on your own and make sense of all of today's investment hype. You are more likely to fail, especially if you seek higher returns with less risk or trade frequently. The reality is that if you seek higher returns, you will have greater risks and more trading will often just run up extra costs.

> "Rumor, innuendo, chat rooms, whisper numbers and stock price momentum have replaced strategic planning, fundamental research, disciplined investment approaches and risk analysis."

Many investors also make the big mistake of seeking good companies with good management, products and growth prospects. Instead, look for good stocks, not good companies, because if everyone agrees a company is good, its stock price will probably reflect that. An undiscovered bad company will actually be a better investment.

Recognizing Noise

The media and the information age make it easier for everyone to obtain information, not just professional investors. However, as more information becomes available, it takes longer to search for the best information and to understand what is worthwhile. An increasing number of people think they don't need professional advice because of all this available information, but they need more help than ever, just to sort through it. An increasing number of investors - apparently thinking that they know more than mutual fund managers - have turned to trading individual stocks, a common mistake.

> "The users of such news flow should understand equities dominate the news not because of their importance in the financial markets, but rather because the providers of information realize equities are better entertainment."

Unfortunately, many people were misled by the ease of making money in 1999, because the stock market, particularly tech stocks, did so well. About 70% of the technology stocks in the S&P 500 Index beat the index, so investing in almost anything resulted in success, leading investors to think they could do better than the professionals. However, many of these positive returns turned negative in 2000, whereas the mutual fund managers did much better, illustrating the danger of ignoring fundamental investment principles.

Does More Data Mean More Smarts?

The big error is thinking that you know more just because you have more information. You can waste a lot of time and make poor decisions when confronted by noise, which is more information without better information. Likewise, more timely information is not necessarily better, although some investors use daily information to trade based on the latest news. Dangerously, this is often the most exciting news, which is played up by the media.

> "One's focus should probably be on 'good' stocks rather than 'good' companies. After all, if you know it's a 'good' company, and I know it is a 'good' company, most other investors probably know as well. The odds are the current stock price already reflects the company's quality."

More reasoned, less timely data is generally more accurate. For instance, a tested stock selection model (used by the author since 1989) based on analysts' earnings estimates, has a much better performance result. The model is based on month-end earnings estimates and does not incorporate frequently shifting, intra-month estimate revisions. The model's long or "buy" portfolios have consistently done better than the overall market, while its short or "sell" portfolios have consistently done more poorly.

> "The probability of short-term market forecasts being consistently correct is probably no higher than is that associated with Monday's forecast for Saturday's weather."

The media tends to pay too much attention to stocks and less to bonds and other financial markets because equities are better entertainment. Given this, heed a few cautionary tips:

- Be wary of information directly from companies, since many companies have their own investor relations departments that are hired to spin every company event positively or to create frequent positive surprises to keep their company in the news.
- Be wary of noise from uncertain sources, such as from investor chat rooms. You really don't know who is putting out this information. It could even be a person trying to manipulate a stock or a teenager just having fun.
- Avoid excess trading due to noise. Investors who listen to noise tend to trade more often, which opens the door to making more mistakes on bad information. You pay more for making extra trades, as well as for the various publications and services that provide this noise. It may be fun and entertaining to keep up with this noise, but that really turns investing into a hobby. To succeed with serious investing, ignore the allure of the noise.

DIY Investors

The do-it-yourself (DIY) movement may be fine for tasks you can do with little professional help, such as painting a house or growing a garden. But mostly, DIY projects don't meet professional standards - particularly in the case of investment decisions.

> "In my opinion, investing by oneself and attempting to decipher and digest all the investment noise and hype is a plan for failure or at least for sub-par results."

You may take the big risk of following an irrational or volatile strategy, which performs well for a time, but then fails because it is based on noise. For example, a data-mining strategy that worked in the past may not succeed in the future. All data-mining strategies eventually blow up, because they are not based on solid fundamentals. For instance, the author of a popular strategy proposed that seeking stocks with low price-to-sales ratios was the best strategy, while another advised looking for stocks with a low P/E-to-growth. However, in both cases, the strategies significantly under-performed soon after the books were published. Authors tend to promote strategies that have worked in the past, but these are not necessarily strategies that will continue to work. Investment 'how to' books tend to look backward rather than forward. Be skeptical of claims of a superior strategy, especially when the author lacks an economic theory to support his strategy.

> "Noise traders can indeed achieve higher returns, but typically must do so while incurring higher risks."

To choose an effective investment strategy, test it first. Examine such factors as returns, risk and turnover. Define the correct benchmark to measure your strategy, such as using a broad index. Be a disciplined investor who follows a strategy with a long-term history of out-performance regardless of how it performs in the short-term. Having a well-understood investment discipline is the best way to filter noise from today's huge amount of investment information.

In and Out of Love (with stocks)

Expectations contribute to noise and cause investors to fall in and out of love with stocks later than they should. For example, the equity market often discounts future events based on perception rather than reality, a practice that contributes to volatility and risk. All stocks go through an Earnings Expectations Life Cycle, where they are affected by various developments, such as positive and negative earnings surprises that contribute to earnings momentum or to declines that are out of step with true performance. In some cases, this process leads to an inflated bubble that eventually deflates, as happened with the technology sector. Distinguish between popular investments and the best performing investments, since they are not the same. Often, popular investments subsequently under-perform.

> "'Bad' companies significantly outperform 'good' companies over the long-term."

Growth investors tend to be high-expectation investors, who often find it difficult to sell, while value investors tend to have low expectations and often buy too early. In both cases, positive or negative noise can lead these investors respectively to hold too long or act too soon. The best investors buy when there is no noise and sell when there is a lot.

Turn a Deaf Ear

To be a successful long-term investor, don't listen to the noise, because noise disrupts effective long-term planning. Noise can disrupt your propensity to diversify and reduce risk. It undermines goal setting and can lead to a tendency to take too much risk and to concentrate on the short term over the long term. Noise will undermine your discipline, since it makes you more likely to abandon your set strategy in the face of unexpected events.

> "One of the simplest methods for filtering noise is to extend one's time horizon."

Adopt a deliberate counter-strategy of screening out noise by reviewing your long-term strategies at timed intervals - once a year, or better, once every two or three years - rather than based on events. This makes you a more disciplined investor, reduces the propensity to trade during noise and focuses you on your investment goals and strategy. A long-term strategy and plan assures that you have assessed your own risk tolerance more effectively, and thus won't worry as much about the financial markets' daily, weekly, and monthly gyrations.

> "The more information available to us, the more we must necessarily understand to make the information worthwhile. The more numerous the sources of information, the longer we must search for one having the best answer to our inquiry."

Particularly avoid being influenced by the noise during times of higher volatility in the market, when the level of noise goes up. If you really have a long-term horizon, the daily news, financial television and rolling assessments of your portfolio's daily value are relatively unimportant. Screen them out, because investment noise generally focuses on short-term events and can persuade you that unimportant events are much more important than they are. For instance, risk tends to be short-term, but noise tends to focus on risk and short-term events, whereas over the long-term, risk dissipates.

Good Companies, Good Analysts

To do well as an investor, seek good stocks rather than good companies. For example, there are relatively few A-plus companies - only about 60 out of 1600 major companies - based on return on equity, sales growth, earnings growth and other factors. But, relative to the performance of the equal-weighted S&P 500, these stocks have slightly under-performed the overall market on a long-term basis (about 15 years). Many investors, unaware of this performance record, think these companies will do well and invest in them. Then, too, the performance of A-plus companies tends to be cyclical, so owning a diversified portfolio of A-plus stocks is like owning an expensive index fund. Further, the valuation of these stocks tend to be high and their overall performance as stocks tends to be low, because other investors are aware that these are good companies, which keeps the price up.

By contrast, bad companies, characterized as C & D stocks, not only do better than the A-plus stocks over time, but they perform the best of any category over the long-term because most investors underrate their performance. This keeps their value low, but they do better over time, and their stocks rise.

Finally, get solid help. To assess a good analyst, skip those who are the most visible and go to those who are really providing value. Often the most visible analysts are simply providing noise. The line between reporting and analyzing has diminished. Reporters discuss what has already happened, whereas good analysts can help you understand why it happened or predict what might happen in the future. A good analyst conducts proprietary research rather than accepting company spin and realizes that valuable investment information comes from deriving informed decisions, whether others agree or not.

About the Author

Richard Bernstein is a quantitative analyst at a major Wall Street firm. He developed a stock selection model based on analysts' earning estimates, which he has been running since 1989, and back-tested it to early 1986, to provide a very effective model for selecting stocks. Using data that is updated monthly, it has produced long or buy portfolios that have consistently out-performed the overall market, while its short or sell portfolios have consistently under-performed the market.