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When Investing, Be Mindful of 'Knowledge' Limitations

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We practice asset allocation, disciplined diversification and rebalancing. We do not buy individual securities looking for the proverbial "pop." We do not trade. Not that it can't ever work out, only that it doesn't reliably or predictably do so. Success (after transaction costs and taxes) in trading seems to come slightly less often than 'luck' or the bell curve suggests it should.

In the last 12 years, I have routinely and repeatedly counseled clients (for reasons below) against this behavior. And yet, almost predictably, it starts to show up when Shiller's CAPE ratio gets high.

Up until last week, over the last 4-5 years I can count these conversations on one hand. However, in the last ten days, I have had four conversations about individual stock trades that a variety of clients has wanted to place.

One gentleman wanted to buy Alibaba on the day after it opened at 68 and jumped to 93ish (I mean, look at the size of their customer base). One woman thought we should buy Apple (because the 6 & 6 plus launch went so fabulously). One gentleman thought Tesla would be a good trade after it fell so viciously from its early September highs (obviously, it has to recover, right?). And finally, a client thought that Facebook would be a good buy here (won't they soon start charging for things they used to give away for free?).

These might sound like stories about individuals and investing, but it is far more an issue of mindfulness and the limitations of knowledge.

The story arc in a movie swings from bad to good to bad to good and back again. Hollywood has mastered the art of using light and sound to move us emotionally, to grab our attention and to make us feel. The economic commentators and market punditry are no different; they use the ebb and flow of market tides to keep us glued to their voices and commercials. Do. Not. Get. Sucked. In.

All the information about every company is available to every investor. The price you see on the CNBC ticker is the result of all that information being understood by the market. When you buy a stock to trade, you are betting on the next piece of information -- one that neither you nor anyone else has yet considered. Individual stock trading is NOT a game that small investors can win as they (we) do not have any new or unknown information upon which we can trade. When my clients come to me with these ideas, I offer three thoughts:

1. What we read about in the media is "old news" -- Every portfolio manager out there already knows this information, and it is already factored into the stock's price. If you are ever in a position to KNOW something that others don't know and you use that information to make buy/sell decisions, it is likely called "insider information," and you go to jail for trading on it. The rules of the game make it so that, if you know it... so does everyone else. There can be no information advantage gleaned from public media sources and those gained from private sources, if they are accurate, may not be legal.

2. We are always better off in the long run owning many different companies in similar categories. In the Facebook example, we are better off owning a portfolio of rapidly growing technology/social media companies instead of just owning Facebook. ALL the research tells us that individual stock picking, while exciting, doesn't enhance returns the way we think it does (even for the professionals that do it every single day). Again, we don't (can't) know the next piece of information that could destroy the company we are considering.

3. The question is, do we pick that portfolio ourselves (hold a bunch of individual equities), or do we hire a manager, or just buy an index? In my opinion, it makes a lot of sense for the retail investor to buy an index or hire management for the different sleeves of their asset allocation. With the size of most individual's portfolios, diversification can be tough to come by with individual securities. And, things like trading costs and taxes would wipe away any benefits -- even if you did achieve higher returns (which is incredibly unlikely over the long term).

We have no information advantage. The research tells us that no one can successfully select securities and time the market consistently. By trying, we increase our costs and decrease our diversification (which adds to our long-term risk, increases the likelihood of our making mistakes out of fear and leads to reduced performance).

If you have a well-diversified portfolio of indices and managers, you probably already own (in a far more appropriate amount) the company you are considering. If you don't, there are probably reasons you shouldn't.

The more you hear the stories of big wins being had in individual securities, the more you should hold on to your beautifully diversified portfolio. Sooner or later, those telling you stories of their winnings will wish they were right there with you.

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