OPINION

Why stock picking really does work

GEORGE ATHANASSAKOS >
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED 3 HOURS AGO
UPDATED 1 HOUR AGO

I am a firm believer in stock picking. I think stock picking with the right process and the right temperament works.

Moreover, I believe that portfolio managers do poorly not because they lack stock-picking abilities but rather because institutional factors force them to overdiversify.

There is no doubt many investors would beg to disagree. For the first time, passively managed funds last year controlled more assets than did their actively managed competitors.

Needless to say, my views conflict with those of other academics who believe that markets are efficient, namely that stock prices reflect all available information correctly, and that value and price are always the same.

Naturally, if this is the case, stock picking does not work. But are markets efficient? Some finance academics and all psychology academics disagree. A big requirement for market efficiency to work is that investors are rational. That is, they are dispassionate calculating machines that gather all information, they analyze it and make the correct decision.

But psychologists such as Nobel Prize winner Daniel Kahneman beg to differ. They argue that theories which assume that humans are rational are to be treated with skepticism. Humans are more anxious, irrational and unpredictable than market efficiency advocates assume. Dr. Kahneman, in fact, demonstrated that humans are not symmetric when they make decisions. They tend to become risk-averse when they win and risk-takers when they lose. Others showed that humans tend to naively extrapolate past performance, they are overoptimistic about their abilities and they herd.

Moreover, market efficiency assumes that higher risk will lead to higher returns. But recent research by finance academics has shown that over the past 50 years, stocks with lower risk outperformed those with higher risk. Market efficiency cannot reconcile this and yet finance academics continue to believe that the Earth is flat.

And it is hard not to quote the late Berkshire Hathaway vice-chairman Charlie Munger here. This is what he said following a Q&A after the 2017 Daily Journal annual meeting: “Warren and I have had some effect on investing and thinking, but they are still teaching the Efficient Market Theory at business schools. The old ideas die hard. [Business professors] think that market efficiency is inevitable like physics. Now what kind of nut would want to make stock markets like physics? It ain’t like physics.”

Additional evidence, more closely related to the article’s topic, has in recent years emerged against market efficiency and supports the view that stock picking may work. For example, academic studies using aggregated data show that funds that invest in concentrated portfolios and/or deviate significantly from benchmarks tend to outperform, not every year, but on average in the long run. They also show that prices do not reflect the most recent accounting statements and so one can earn risk-adjusted returns using fundamental analysis and taking advantage of market inefficiencies.

While the above studies alluded to the fact that stock picking may work, they did so indirectly. But up to recently, there had not been much direct academic evidence showing that stock picking works. This

changed at the end of 2024. Two academic researchers from France's ESSEC Business School recently wrote a paper in which they demonstrate that "mutual fund managers collectively possess stock-picking abilities that outperform passive benchmarks and consensus-based strategies from analyst recommendations."

And not only that, but they also find that investors can learn and profit from the stock-picking ability of professional portfolio managers by analyzing their historical portfolio holdings using machine-learning models. They argue that if portfolio managers' performance was driven by just luck, a strategy that relied on their portfolio holdings would not consistently outperform the market.

This direct academic evidence corroborates individual value investor data compiled by Scott Reardon of Dakota Value Funds, which show that more than 50 high-profile value investors have outperformed their benchmarks and/or the markets before and after fees over their lifetime (or over a time during which they were active money managers), from John Maynard Keynes (over 24 years) and Prem Watsa (over 30 years) to Walter Schloss (over 49 years) and Peter Cundill (over 35 years) and from Seth Klarman (over 25 years) and Howard Marks (over 22 years) to Charlie Munger and Warren Buffett (over 60 years).

The key characteristics of all those investors were patience, discipline and long-term perspective. It cannot be just luck as academics tend to argue, dismissing stock-by-stock analysis as a wasted effort, and focusing only on diversification. It is stock picking based on bottom-up analysis and careful due diligence.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, Western University. He is the author of the recent book Value Investing: From Theory to Practice.

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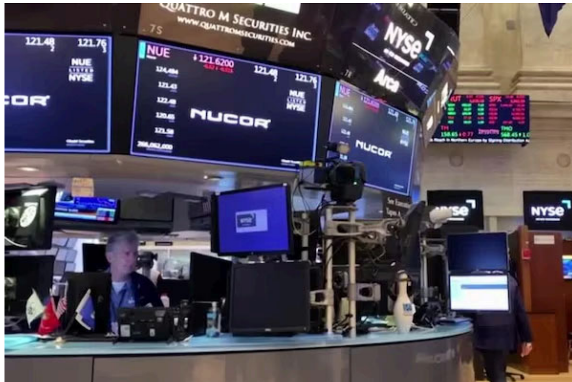

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