A stock picker's market

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One claim which often surfaces is "**it is a stock picker's market**". This is particularly true when the level of uncertainty of the investment market outlook rises, or the volatility in the returns experienced increases, or there appears to be a number of major global challenges, which is virtually all of the time.

The claim is normally made by "active" investment managers. Such managers warn about the dangers of being "passive" and being exposed to the risk of blindly following the market down. They argue that the "environment" is unique and needs specialist approach to protect your savings.

The reality is, "it is always a stock picker's market"; shares have to be picked. The times of greater uncertainty are no different to the times of less uncertainty.

Given that it is always a stock picker's market; the real question is "how should you pick stocks?" There are three main choices. Do you:

A. Pick the stocks, so you get the market-return? Some call this "index" management.

B. Pick the stocks to try and get a return above the market-return? Some call this "active" management.

   The consequence of this approach is that you might also get less than the market-return. History shows that more than half (typically 70%) end up with a return lower than the market, when costs are taken into account.

C. Pick stocks on some other basis for some other purpose? This may be based on the nature of the return you are after over a particular time horizon, taking into account your needs for liquidity, income and growth/inflation protection. This approach will target the shares with the particular characteristics that are consistent with the required pattern of the returns to achieve the investment objectives.

   If you go down route C you may get more or less than the general market-return over a particular period, but under this approach, the market-return is less important to the return that you are looking to achieve and the risk profile of the share selections.

Within the main choices there is a range of approaches based on combinations of each approach. Remember that each approach can work, but if you are looking to build wealth over the long-term (e.g. you are saving for retirement), the evidence is that choice A (and/or C) is better than B. In fact most studies show that while in any individual year, active stock picking management (i.e. B) may be successful, it is not consistently so over the long-term and the average return you get is the market-return less fees and other costs. It is therefore lower than average (i.e. A), because the costs are typically significantly higher than under A.

Alternatively, if you are looking to spend your wealth and you need income (e.g. you are in retirement), the evidence is that choice C (and/or A) is better than B. This is because it is more important to target a particular pattern of returns (income), than to try and chase returns that are better than average. The problem is that if you chase high returns in retirement and are one of the 70% that are unsuccessful, the financial consequences can be significant. It is often better not to be greedy, when you cannot afford the risk that either you or your investment manager gets it wrong.

Shares have to be picked

Whatever the market environment, shares have to be picked. That is, you must make a decision to buy, hold or sell shares and how you do that.

The questions when you are picking them are “what outcome are you after?” and “what you are willing to accept, if it does not quite work out as planned?” The better outcomes are more likely to arise when there is greater alignment between how the shares are picked (philosophy and process) and what you are trying to achieve. In addition it helps to keep all fees (management and transaction costs) low.