In the News

SANTA BARBARA NEWS-PRESS

Sunday, January 30, 2005

Is investing an art or a science?

EXCLUSIVE OUTLOOK

Paul Orfalea, Lance Helfert and Atticus Lowe

Occasionally, someone asks whether we believe that investing is an art or a science. This presents a tricky situation because the question suggests a desire for the definitive and a low tolerance for paradox. Thus, our answer of "Yes!" usually proves unsatisfactory and confounding.

WHAT IS THE REAL QUESTION?

That answer is mostly flippancy, but it's close to the truth. People asking the question usually intend "art" and "science" to represent "intuition" and "knowledge." They are really asking the following: Is there some sort of unified field theory that explains everything, such that if we only studied hard enough we could always make money; or does investing require high levels of sensitivity and intuition, at the level of some rarified natural talent, such that only a gifted few can prosper?

These really are terrible questions, but many in our industry persist in perpetuating the illusion that investing is indeed a science, so we feel the subject is worthy of further discussion. Let us begin by plainly stating that investing is not a science, although investors should behave like scientists in their methodology. Further, investing is not an art per se, but certain artistic sensibilities improve one's chance of success. In fact, the traits common to great artists and great scientists — keen observation, active imagination, courage to experiment and openness to change — make great investors.

DIFFERENCE OF OBJECTIVE

Although we share traits with scientists, the point at which we must differentiate ourselves from our scientific counterparts lies in their objective: to achieve a consistently replicable finding.

Consider this further: Science depends on the replication of results. By quoting the words that appear on nearly every piece of literature issued by the investment community, "Past performance is no guarantee of future results," we may dispense with the notion that investing is a science. To simplify in the form of a logical syllogism: Science depends on replication of results; the only certainty in investing is an uncertain outcome; therefore, investing is not a science.

OBSESSION DOES NOT MAKE A SCIENCE

Many brokers, analysts and other professionals believe investing is a science because they rely heavily on statistical analyses and tools like Monte Carlo simulators (a highly sophisticated spreadsheet that accounts for thousands of variables to predict the future value of a portfolio). Despite these obsessive forms of measurement and projection, they still must concede: Past performance is no guarantee of future results.

It's silly to hear investors talk about trading "rules" they have discovered by sorting through historical data and hypothetical forecasts. We study charts and conduct extensive research, but we would never base an investment decision on technical analysis alone, much less some supposed immutable laws of investing.

REPLACEMENTS FOR MANAGEMENT

There's an old joke that you can always tell a Harvard man, but you can't tell him much. No offense intended to our readers who claim Harvard as their alma mater, but this joke is a good metaphor for a type of arrogance that fuels elaborate investment decision mechanisms. Some people feel they must have a concrete answer for everything, and cannot bear ambiguity.

These people attempt to reduce investing to a science, and because they are in fact very intelligent people, laymen often believe them. Some preach market timing (the ability to buy low and sell high based on trend calculation); others preach the efficient market theory, which maintains that the market responds so quickly and perfectly to conditions that one can only achieve superior results through insider information or very good luck. Many install mechanical trading rules and stop/loss orders, for example automatically selling a stock if the value drops by a certain percent.

All have reams of data and powerful computer models to support their beliefs, which are of course presented as facts. Like mandatory sentencing laws and overcomplicated sales incentive programs, these "scientific" approaches are designed to minimize management bias and human error, but they also serve to reduce individual accountability. And yet their biggest flaw remains: They rarely achieve their goals.

Neither of these approaches, on their own, make sense to us. We believe in people and their good judgment — such is the premise of an open market. An investor must weigh all available information, determine whether a stock is a good buy or not, and then manage the investment.

For example, if we buy a stock at 80 because we believe its intrinsic value is really 140, we do so knowing that that stock might drop to 30 before it goes up. If it does drop to 30, we buy more because it is an even better deal. Someone with an automatic sell rule would simply take the loss and miss the long-term gains.

In their effort to build a perfect investing machine, the academic minded brokers and managers lose objectivity; they cannot distinguish between observation and interpretation. Much as college English students hunt for symbolism until they cannot follow the well-told narrative before them, mechanistic investors constantly try to force events to fit their models; they lose the ability to see things as they are. Ironic, since objective observation is the first step in the scientific method.

AS EINSTEIN WOULD SAY, "IT'S ALL RELATIVE"

We do not understand the theory of relativity, but then, Albert Einstein did not understand the income tax.

We do understand that the stock market is a complex system, so like a painter making sense of a boating party or an astrophysicist making sense of dark matter, we look for patterns.

For example, we observe that in the short-term, the market responds to human emotions: reacting to news stories, pop culture fads and other ephemera. But in the long-term, the market rewards earnings. These observations can influence our actions in the short- and long-term.

We also accept that the stock market is a massive interconnection of causes and effects; it's all related. Not all of the connections are apparent, so we must use our imagination to predict how certain events might play out. Most of Wall Street is very focused on profit-to-earnings ratios (P/E) and future growth estimates. They rarely give debt and tangible assets enough consideration.

For example, a company with a P/E of 20 and no tangible asset value (value of real assets that can be sold, such as real estate and cash) is much riskier than a company with a P/E of 20 and net tangible assets worth 70 percent of the company's current share price, all other things being equal. The funny thing about this is that the company with real estate will probably have significantly understated earnings due to the depreciation of their real estate assets, so the P/E figure itself becomes less meaningful. Scientists applying formulas might miss this connection.

Everything must be taken in context, and with the context constantly shifting, it is impossible to have a "rule" for picking winning stocks. A low P/E means little until one takes everything else into consideration, such as the balance sheet, growth prospects, competitive advantage, management quality, etc.

Everything is literally relative, because every ratio, statistic and metric is intricately tied to hundreds of other factors. Computer models may help us get a better view of the data, but the only computer that can accommodate the high level of ambiguity in the stock market is the human brain. Consider that Einstein, the quintessential scientist, said, "Imagination is more important than knowledge."

ARTISTS, SCIENTISTS AND BUSINESSPEOPLE

As the saying goes, "Data is not information, information is not knowledge, and knowledge is not wisdom." However much research one does, experience refines one's judgment beyond the mere weighing of facts. To improve our investment results, we behave like scientists and artists, using tools and traits refined over years of practice. But are we practicing an art or science?

Perhaps neither. Investing is business, a noble discipline unto itself, with its own set of conventions and aesthetics. But if forced to choose between the two, we say business is clearly more art than science. Confronted with a pitchman's latest scientific formula for guaranteed market success, we remember that attempts to reduce art to a science are like Dr. Frankenstein's attempt to create life through mechanical rather than human means: doomed to only create monsters.

Paul Orfalea is the founder of Kinko's and co-founder of West Coast Asset Management. Lance Helfert is WCAM's president and Atticus Lowe is vice president. They can be reached at info@wcaminc.com. The principals of West Coast Asset Management, or its clients, may own shares in the companies written about in this column.