Dimensional

OUTSIDE THE FLAGS

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The Perfect Storm of Picking Stocks

When tropical cyclone 'Debbie' ravaged the Australian state of Queensland in March 2017, the price paid for steelmaking coal surged 15% as the storm disrupted exports from the region. It was an illustration about how quickly prices can change.

The most powerful storm to hit the commodity-intensive state in six years also affected the share prices of major miners like BHP Billiton and freight operators like Aurizon, who warned the market of severe disruptions to supplies.

This shows just how difficult it is to build an investment strategy around finding prices "better" than the ones provided by the market. Even if you can somehow decode the countless forces driving a particular stock's price, new information can come along out of the blue (literally) and blow apart your assumptions.

HOW PRICES WORK

Market prices are always changing, based on the information to hand. This can be firm-specific information, like the appointment of a new CEO or a credit downgrade. Or it can be external news, like a downturn in global demand or a weather event.

As an investor, you can either try to second-guess the market or understand that current prices are a fair reflection of market participants' aggregate views about each security's characteristics and expected cash flows.

The problem with the first approach is there's no evidence anyone can reliably and consistently outguess market prices, which already incorporate the varied views of millions of intelligent and highly motivated investors. This means that to succeed, you have to know something that the market isn't already aware of.

Now, that's a tough hurdle due to the market's competitive nature. Participants, often with deep pockets, are ready to deploy huge resources to find that ever-elusive "mispricing". This in turn drives up the cost of finding such information.

So not only do you have to beat the combined wisdom of all other participants in the market, you have to do it in such a way that it doesn't drive up your costs beyond any additional return you might hope to make.

Even if you do correctly assess the prospects of a company at any one time, you have to *keep* doing that—

month after month and year after year. And you have to repeat that both for every stock in your portfolio and for the market as a whole.

Think how many variables you have to get right—changing technology, changing management, competitive pressures, commodity prices, interest rates, changing consumer demand, regulatory issues, political uncertainties and even the weather.

THE CASE OF QANTAS

A perfect storm of a different kind hit Australian national flag carrier Qantas Airlines in late 2013. Shares in the airline hit a record low below 97c a share and its credit rating was lowered to 'junk' status after it warned of a half-year net loss.

Qantas was being hit by a combination of a domestic price war, falling yields and rising fuel costs. Desperate for a capital injection, the airline pleaded with the Australian government to scrap the rule limiting its foreign ownership to 49%.

There were calls around this time by corporate governance experts for the company's CEO and entire board to be sacked and for the airline's entire recovery strategy to be reassessed[1].

But just two years later, Qantas shares had more than quadrupled to above $4. The fare war had eased, fuel prices had fallen, passenger yields had improved, its restructuring program was bearing fruit and its management remained in place. Many of the analysts who had written the airline off were looking rather sheepish.

Another 18 months later to the time of writing, Qantas shares are at their highest levels since the global financial crisis, or nearly five times above the lows reached during the perfect storm the company faced in 2013.

LESSONS LEARNED

This isn't to predict that Qantas will continue on its upward trajectory. But it's reminder that the prices market participants are prepared to pay for a stock are forever changing. These prices reflect known information.

Instead of trying to second-guess those prices, we can use the information in them to draw conclusions about the dimensions of expected returns. And we can use those dimensions to form portfolios designed to deliver outperformance.

We can improve the reliability of those outcomes by diversifying across stocks, sectors and countries to limit idiosyncratic risks and we can maintain a long-term focus so that short-term noise doesn't blow us off course.

This is a far more efficient and reliable approach than trying to predict the next perfect storm.

1. 'The 5000 Job Losses Should Include Alan Joyce', Professor Sinclair Davidson, RMIT, 24 February 2014

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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