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History Repeats Itself ... Or Does It?

You've read in history about the financial disaster of 1929: The Great Crash that started in October of that year, in which the Dow Jones Industrial Average fell 13 percent through October 26, when it dropped another 13 percent—and then fell an additional 12 percent on October 29. Fortunes were wiped out overnight; people who were wealthy when they went to bed woke up as paupers. The financial cataclysm was so severe that it was one of the triggers of the Great Depression of the 1930s, in which millions were unemployed, banks closed all across America, and an entire generation learned what true hardship means.

One man, at least, saw it coming. Karl G. Karsten, the proprietor of Karsten Statistical Laboratory in New Haven, Connecticut, demonstrated mathematically that the stock market was overvalued by as much as 25 percent, early in 1929. Later, eminent economist Irving Fisher would praise Karsten's analysis, asserting that the mathematician's numbers clearly foretold the coming crash.

But Karsten himself, it seems, was less impressed with his own brilliance. A couple of years later, in 1931, he wrote a book titled *Scientific Forecasting*, in which he essentially poked holes in his own methods. Specifically with regard to the Crash of 1929, he noted two fatal flaws in his system. First, though he had analyzed stock data back to 1886, the huge rise in stock prices in the late 1920s was completely unprecedented, making the road signs of the past almost irrelevant. Second, he pointed out, his method failed to take into consideration the effect of market psychology, “a potent factor and one which no statistical series could be found to reflect in advance,” he wrote. Ever the careful scientist, Karsten went on to offer numerous warnings about placing too much dependence on statistical forecasting—including his own!

So, what might we learn from this? Are predictions always wrong? Should we give up on financial analysis and just throw darts at a stock chart? Or is there a principle of sound investing that depends less on using the past as a way to guess which way the market is headed in the future—or even trying to outguess the market at all?

There are a couple of scientific principles that I have found to be very helpful for my clients. One is the principle of “efficient market theory” (EMT), which holds that in the aggregate, the financial markets possess all the available information on a given stock or even a given sector, and that information is efficiently transmitted into the pricing of the securities. One way of thinking about EMT is by visualizing the world financial markets as a huge brain, and each individual transaction taking place as a single brain cell. Individually, a single transaction carries relatively little information. But when considered in the aggregate—with millions of transactions occurring in any given minute—the overall effect is that the markets appropriate, evaluate, and reflect the available data almost instantaneously.

Especially now, in the age of computer-assisted trading, we know that information can ripple through the system in milliseconds. Another visual that helps with this concept is one heard recently from Dr. Apollo Lupescu, who works with the Investment Strategies Group at Dimensional Fund Advisors (DFA). Dr. Lupescu says that when he tries to explain to his mother-in-law what he does, he goes back to a recent trip to Florida. “I was swimming in the ocean, and I realized I was above a school of fish. If I tried to focus on a particular fish and predict which way it would go, it was very difficult. But after a while, I began to see a pattern in the movements of the school as a whole.” Dr. Lupescu’s comments point to the importance of seeing the really, really big picture: using massive amounts of data in order to take into consideration the megatrends that drive the markets—and the individual investments that make up the markets.

Speaking of DFA, the second principle that I find helpful is related to the foregoing. If we allow the markets to do what they do best—incorporate all the available information into prices—then, instead of trying to guess which way the markets are going, we can focus on interpreting what the markets are telling us and thus make better decisions over time. Empirical research has shown that securities offering higher than expected returns in a given environment share certain characteristics, or dimensions. If those dimensions can be quantified scientifically and captured in a cost-effective manner, they can be used to construct a portfolio that can be expected to outperform over time. This scientifically driven approach to investing, when coupled with robust diversification and blended carefully into a given client's goals and timeframes, can provide not only better overall return, but can also work to limit volatility in unpredictable markets. Rather than trying to tell our clients which stock is ripe for an upside breakout or when the next correction is coming, we focus our efforts on positioning them dimensionally, using good diversification, driven by an accurate understanding of their needs, risk tolerance, and objectives.

We should also re-emphasize that this science-driven approach focuses on investment characteristics that can be captured cost-effectively. We have all known people who approach the stock markets like the crap tables in Las Vegas: always chasing the latest "hot tip"; always looking for the next short sell or option play. Most of the time, folks like this will burn more of their assets in trade commissions than they will realize in profits. It is essential that any investment strategy carefully consider transaction and other costs. After all, money you pay in commissions and fees isn't going to be available to help you fund your retirement or your child's college education.

So, the next time you hear one of the media pundits making noise about the "coming crash" or the "huge upside breakout" that you can't afford to ignore, remember Karl G. Karsten, the careful statistician from Connecticut. This is not to say that there won't be a downside correction at some point—such downward movements are an inevitable part of the financial markets. But it's also worth remembering that even the man who predicted the Great Crash of 1929 believed that history can't always be depended on to repeat itself.

Stay Diversified, Stay Your Course!

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