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Harder Than It Looks

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The longer a bull market lasts—and this one now counts as one of history's longest and strongest—the more money investors make. But there's a funny thing about making money: It goes to our heads. We assume our fattened portfolios are because of our own brilliance and we start imagining we can get even better results—by actively picking individual stocks.

But finding winning stocks is, of course, utterly maddening: It seems so easy—and yet so many investors, both amateurs and professionals, fail miserably. For proof, consider the performance of actively managed U.S. stock funds. Depending on which investment category you look at, just 1% to 14% of funds outpaced their investment style's benchmark index over the past 15 years, according to S&P Dow Jones Indices.

Why does the apparently easy money so often prove elusive? To succeed as a stock picker, eight obstacles stand in our way.

1. Fierce competition. I am loath to describe investing as a game, because the goals we fund with our investments are so critical. Nonetheless, there's no denying it: To many, investing is an enthralling game—made more enthralling by the chance to get absurdly rich. The upshot: The markets attract the best and the brightest, all scouring the globe for winning investments. If there are bargains to be had, they don't stay that way for long.

2. Trading costs. Whenever investors buy and sell stocks, they incur transaction costs. Those costs mean that investors, as a group, must inevitably earn less than the market averages.

As brokerage firm advertisements regularly remind us, commissions these days are tiny and sometimes zero. But remember, investors also get nicked for the bid-ask spread, the gap between the lower price at which we can currently sell a stock and the higher price at which we can buy. The difference is pocketed by Wall Street's market makers.

But even after factoring in the bid-ask spread, trading costs have come down sharply in recent decades. Ironically, however, that's a mixed blessing for investors with market-beating aspirations. Because it's cheaper to trade, it's also cheaper to take advantage of investment opportunities. Result: Investors now scoop up undervalued shares that they might previously have ignored, when transaction costs were higher.

3. Skewness. The most a stock can lose is 100% of its value, but its potential gain is unlimited—200%, 500% and perhaps far more. Every year, a minority of stocks with spectacular performance drive the market averages higher, so most stocks end up lagging behind the averages, a phenomenon known as skewness.

This was highlighted in a recent study by Arizona State University professor Hendrik Bessembinder. He found that the stock market's entire gain during the past 90 years, over and above Treasury bills, could be explained by less than 4% of stocks.

Like stories of winning lottery tickets, these huge stock market winners capture our imagination and make

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beating the market seem easy. But, of course, just the opposite is true: Only a small minority of stocks score these huge gains.

4. Disposition effect. Let's suppose we get lucky and buy one of the market's huge winners. We watch in delight as the shares double and then triple. Is this a stock that will one day rival Amazon and Apple—or will the company's heady stock-market gains come to a sudden, inglorious end?

This agonizing conundrum is made more agonizing by the stakes involved: If we are indeed holding one of the market's great winners, and that's a big "if," selling would be a terrible mistake. After all, this could be one of those rare stocks that delivers the gains needed to offset all the duds we'll buy over our lifetime.

Yet behavioral finance tells us many investors will indeed sell, a phenomenon known as the disposition effect. We're inclined to sell our winners quickly, so we can turn our paper gains into cash profits, while hanging onto our losers, in hopes of recouping our losses and avoiding the emotional pain of selling for less than we paid.

5. Overconfidence. Even if we sell a big winner too soon, we could guarantee that we'll remain lifetime market winners—by immediately investing our portfolio in broad market index funds. Thanks to our big winner, we're potentially ahead of the market averages for our investing career to date—and, by buying broad market index funds, we'll be assured of owning all future big winners (as well as a whole lot of duds), thereby cementing our status as market winners.

But very few successful stock-pickers give up the game like this. Why not? In a word: overconfidence. Thanks to our big winner, we're confident we can pick future winners.

6. House money effect. After our initial success, we might decide not just to continue hunting for big winners, but to take it up a notch—by allocating more of our portfolio to stocks and perhaps making even bigger bets on each stock we take a fancy to.

Why this increased aggressiveness? At issue is a phenomenon known as the house money effect. Like casino gamblers who get lucky early in the evening, we may feel we're ahead of the game financially and can afford to take even more risk.

7. Skewness redux. How does this story end? Our continuing bets on individual stocks will, more than likely, be our undoing and our lifetime results will eventually fall below the market averages.

For that, we can—once again—blame both investment costs and the market's skewness. Unless we're extraordinarily skillful or unusually lucky, probability suggests that most of the stocks we pick will turn out to be market laggards—and the few winners we buy won't, after costs, be enough to offset the lackluster performers we end up owning.

8. Pascal's Wager. It isn't simply that the odds of stock-picking success are slim. We also need to heed the lesson of Pascal's Wager. As the 17th century French philosopher and mathematician Blaise Pascal saw it, it's rational to believe in God. If we believe and it turns out God doesn't exist, the price is modest: a lifetime of worship and a little less immorality. But if we don't believe and God does exist, the price is considerably higher: an eternity roasting in hell.

The implication: We should think not only about the probability of different outcomes, but also the consequences of each. If we spend a lifetime betting on individual stocks and we emerge as winners, our retirement would be more comfortable. But if we fail badly, there may be no retirement at all.

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In other words, the benefits of stock-picking success pale next to the consequences of failure. We simply cannot afford to fail when it comes to saving and investing for retirement—which is why prudent folks not only sock away money regularly, but also they diversify broadly, preferably through low-cost broad market index funds.

We appreciate your confidence in us and welcome introductions to friends, family, and colleagues.

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