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Figuring out the right answer: Busting some popular myths about investing

A lot of propaganda in personal finance contradicts the fundamental law that there are no free lunches ever

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Illustration: Binay Sinha

The first step in figuring out the right answer to a problem is to eliminate all the clearly wrong ones. In finance, many of the wrong answers are provided, and even gain popularity, because of ignorance of theory and empirical research (for brevity, we shall use the word 'theory'). Practitioners in every field of finance often make misleading claims that contradict theory. For example, listed companies try to talk up their share prices by making irrelevant announcements, such as bonus issue. Equity research analysts argue that a stock is cheap by using meaningless valuation multiples like Enterprise Value to Earnings Before Interest Tax Depreciation and Amortisation (Ebitda) (which assumes that depreciation is not a real cost).

Such misleading claims that contradict theory are rampant in personal finance also. Let's look at ten claims starting with the most obviously wrong ones and ending with those that even well-intentioned practitioners get wrong. Various academic papers and empirical studies have discredited these claims and hence this article does not go into the details.

- There is the claim that "You can beat the relevant index using technical analysis." Eugene Fama disproved this claim half-a-century back and won a Nobel prize for it.

- “Back-testing shows that a particular strategy is likely to outperform the index in the future.” This is almost always because simplistic analysis came across a random pattern in the data and assumed that the same pattern will repeat itself in the future. It usually does not. This is the fallacy in almost all quantitative investment strategies. If the analysis of 20 years of data led to the discovery of an investment strategy, then data from further back in history should be used to test it. And ideally, data from other countries should also be used to test it. But even rigorous testing does not mean that the strategy is highly likely to outperform the index in the future.
- “It is easy to beat the relevant Indian stock market index. And it is easy to identify above-average equity mutual funds (MF).” S&P has proved that the average Indian active equity MF’s returns are roughly equal to the relevant stock market index over the last 15 years. Moreover, the last five years of data do not help you predict which MF will beat the index over the next five years. Warren Buffett pointed out the elementary mathematics that if there are 1,000 MF schemes making random investments, then it’s very likely that at least one lucky MF scheme would beat the index every single year for nine consecutive years. Nobel prize winner Paul Samuelson explained that you would have to be a genius to figure out which MF manager is a genius who is highly likely to beat the index over the long term.
- “High fee of an MF does not matter if its past performance has been good.” As described earlier, past high returns of a particular MF could be because of luck. And hence it is not a good predictor of the future. A high fee is one of the best predictors of poor future returns relative to the index.
- “If 10-year yields rise, then a 10-year bond will drop in value. But if you hold it to maturity, you will not make a loss.” The reality is that you will make a permanent loss if rates rise and make a permanent gain if they fall. Let’s assume that X buys a 10-year bond at a yield of 6 per cent and holds it to maturity. A month later, 10-year yields rise to 7 per cent. Now Y buys a 10-year bond and holds it to maturity. Over the next 10 years, Y would have earned 1 percentage point more per annum compared to X. So, X was eventually worse off compared to Y. This is true for long-duration debt MFs as well.
- “Since long-duration bonds are not risky if you hold them till maturity, you should invest in 10-year bonds for goals that are 10 years away and in 3-year bonds for goals that are 3-years away.” Actually, since long-duration bonds are riskier than low-duration bonds, even if you are investing for retirement which is 10 years away, you could choose to invest a significant proportion in low-duration debt MFs.
- “India’s rate of growth in GDP is higher than that of the US and hence Indian equity should significantly outperform US equity over the next 20 years.” To compare, we should use a common currency, for example, we should compare the US Dollar returns of both the indices. And ideally, the comparison should be on a risk-adjusted basis. There is semi-reliable data for India only for the last 34 years and during that period, this claim does not hold true.
- “Smart beta or factor investing (example, momentum, low-volatility, etc) allows you to beat the index on a risk-adjusted basis.” Nobel prize winner Eugene Fama, who is the brain behind the smart-beta strategy, has himself said that any additional expected return from a smart-beta strategy comes from higher expected risk.
- “Even if rebalancing does not increase returns, it reduces risk.” For simplicity, let’s assume that you had a portfolio that was equally split between a Nifty 50 index fund and physical cash (let’s ignore taxes and fees). During the worst part of 2008, the portfolio would have fallen in value by 29.7 per cent. If you had rebalanced the portfolio once halfway through the crash, then your portfolio would have fallen in value by a total of 33.1 per cent. To clarify, in some other cases rebalancing would have reduced the loss. Several low-quality studies recommend rebalancing. But a tiny number of high-quality studies show that rebalancing has equal positives and negatives.
- “Over the long-term of 5-10 years, equity is guaranteed to outperform inflation.” In reality, over 5-10 years or even 20-30 years, there is a higher probability that equity will at least match inflation, but there is also a material probability that it will generate returns that are lower than inflation. Hence, unless you are very rich, allocating more than 60 per cent of your net worth to equity may be risky.

All these fallacies contradict the law of no free lunch which is the most fundamental law in finance. There are an infinite number of such fallacies that contradict this law. While there are no free lunches, there are an infinite number of overpriced lunches. You should avoid these overpriced lunches (such as almost all insurance-cum-investment products). So, stop hunting for the fictitious free lunches and instead focus on avoiding the real overpriced ones.

DON'T FALL FOR THESE FALSE CLAIMS

- **Back-testing proves** that an investment strategy will work
- **Smart-beta strategies** allow you to beat the index
- **Long-duration bonds** are not risky if you hold them till maturity
- **Rebalancing** reduces risk
- **Equity is safe** in the long-term

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