Why day traders who do well are more than likely just lucky

Differing approaches to analysing role of luck in investing come to the same sobering conclusion

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A few months ago, analysts noticed strange stock-price movements that could only be explained as motivated by retail investors with a not-so-nuanced understanding of the companies
and situations they’re holding a position on. There was a speculative fever taking hold, the experts said, as cheap money and low-cost trading encouraged people to place bets in the investment space.

That means while some of those trades might very well pay off, the people who go into them because of a newsletter tip shouldn’t automatically take it as proof of a well-reasoned commentary. As borne out by several statistical analyses, it was more likely a lucky call.

In a piece published in the Wall Street Journal, columnist Mark Hulbert shared the results of statistical tests that, despite having different approaches, point to remarkably similar conclusions about the relative contributions of luck and skill to investment success.

One test, devised by UCLA finance professor emeritus Bradford Cornell, compares the greater dispersion of short-term versus long-term returns for a given group of portfolio managers. When one concentrates on a specific group, he reckons, the bigger range of their short-term returns should be due wholly to luck.

Applying the test to several hundred investment newsletters, including many that pursue strategies popular among day traders, he found a disparity of 81 percentage points between the past 12-month returns of the best and worst newsletters, while the corresponding range at the 15-year horizon is just 11 annualized percentage points. The upshot, Hulbert said, is that 92% of the difference in newsletters’ annual returns is attributable to luck.

“When [Cornell] applied the same formula to a sample of large-cap U.S. equity mutual funds, he reached the almost-identical conclusion,” Hulbert said.

Another test was proposed by Michael Mauboussin, a managing director at Counterpoint Global, in his book titled The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing. As Hulbert explained, Mauboussin concentrated on the speed at which a manager goes from being top-ranked to just middle-of-the-pack. Conducting that test on four decades’ worth of investment-newsletter returns, Hulbert said, showed that newsletters that occupied the top decile positions in one year descended to the 51st percentile by the next.

A third test, suggested by Professor Campbell Harvey of Duke University and Yan Liu of Purdue University, involves isolating the portion of a given manager’s return that’s explained by skill, which they measure as “noise-reduced alpha.”
The test, Harvey said, is able to identify managers with a genuine ability to generate alpha. But when applied to the small subset of managers that have outdone the market according to traditional performance evaluations, more than 90% did so because of luck. That means skill definitely exists, but its role in the investment industry is so minute that most individual investors should behave as if it's not a factor at all.

“For most investors, deviations from an index fund are essentially all luck,” Cornell said. “They may just not know it.”

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