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Reflections on AAII National Conference

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Classroom or Bazar?

Investing in general is usually an endeavor of trying to impose order, predictability and gains in the face of unpredictable markets and economic environments. We naturally search for truths and trustworthy resources in a world of uncertainty and all the unsavory characters of the financial services industry. I have on occasion mistakenly referred to AAII as the American Association of Independent Investors, and no one has ever corrected me or probably even noticed. My point is that probably the most important thing for AAII to teach its members is how to be an appropriate skeptic. We need to learn to not swallow whole what we are fed, but rather to chew things up a bit and perhaps spit some out. What are the signs of being too gullible or too skeptical? (A session in itself?)

In this context, learning is not a matter of stuffing facts into our head so much as a matter of finding what is relevant and trustworthy, and then integrating it into our investing framework. Sitting in an effective classroom usually involves some lecture or stimulating facts-in-context and ideas, asking the presenter for clarification and elaboration, and then having the opportunity to evaluate and explore the material with other participants. In effective educational settings there is stimulation followed by critical discussion between learners and explorers.

I liked the periods between sessions to have some of these discussions and was generally impressed by the quality of the reflections with people I found waiting for what was next. I think more could be done to structure and facilitate the reflective process. In the larger AAII setting, the provision for online comments to Journal articles is good, but could be given more prominence such as Point Counterpoint articles. In investing, there are very few assertions for which someone cannot make a useful counter argument or at least exception.

In contrast to a classroom, going to a bazar and listening to a sales person is a slightly different experience. To be persuaded of the value of a service or product is different than being provoked to consider an idea or concept.

Obviously, the conference was a mix of the two. The intent of each session was more clearly identified for me than what I deciphered in the previous AAII conference I attended. Yet, it is not easy to make the shift between an academic and a marketplace context. A request for elaboration or even a challenge is handled differently by a good teacher than by a good salesperson. I felt that some of the presenters discounted participants. While some of us are getting senile (I missed the entire first day because my airline ticket said p.m. when I thought it was a.m.) and some of us are naïve, some of us are sharp and experienced investors. I would say in general that AAII could give more credence to the membership, such as inviting papers, speakers and panel members from within the membership and structuring more critical review of material presented.

Let me proceed with thoughts about what I thought was missing, recognizing that time at such a conference is limited, as may be the general interest level.

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Missing

I would appreciate more academic representatives such as economists or business school professors. The presentations by Patrick O'Shaughnessy, Larry Swedroe and Craig Israelsen were exemplary in this direction. In addition to presentation of research results, it would be helpful to have sessions giving guidance on how to do different kinds of financial research, whether quantitative or qualitative such as Douglas Gerlach exemplified in his use of judgment and intuition. How does one use numbers, or not use numbers, to evaluate and make predictive conclusions? How do we emulate the people running the massive casinos rather than their patrons? Exactly how do we numerically explore what might be profitable without falling victim to curve fitting? What are the implications of markets being fractal? How do we balance the search for eternal truths, such as we see in science and academia, with a search for what works now and in the foreseeable future, such as we see in business? When are we in error to search in one direction or the other? More generally, why do so few investors do their own research? How should one go about doing investment research?

Let me continue with some specifics suggestions of things that I thought were missing in total or in part.

- Price
    - To what extent do prices drive price? Does price have an independent cause such as earnings, or is price the dependent and the independent variable as George Soros claims in his book about reflexivity? Is the dog chasing its tail?
    - Technical analysis was missing. Do technical analysis and price patterns have any credence? Sometimes technical analysis is thought of as charts and visual pattern recognition. Is quantitative pattern recognition using statistical tools not also technical analysis? Is there really fundamental analysis that ignores price patterns? Even those using fundamentals have things such as price/earnings or price/sales.
- Timing
    - What are the data on prudent and dysfunctional timing endeavors?
    - Is volatility as measured by the Black Scholes formula a valuable timing tool? Is there not persistence in a stock's volatility pattern?
    - How do I reconcile that even if I'm opposed to timing, for every position I have to choose a time to buy and at some point a time to sell.
    - Are there trends or other patterns that give some useful indication of when to buy or sell?
- Market mechanisms
    - How do markets work? What is going on inside the black box when we make a trade?
    - What is the role of brokers and market makers?
    - Do what extent are markets cyclical?
    - If markets do not behave with a normal distribution, why do we still use standard deviations in much of market analysis?
    - Is High Frequency Trading a threat to the individual investor?
    - If I go to any auction, such as e-Bay, an estate sale or a cattle sale, and a third of the bidders buy everything in sight regardless of price, that will affect the auction, will it not? So how does index buying impact the market, and what aspects of the market?

  - How and when is tragedy of the commons relevant for investors? Are indexed products prudent for the individual but destructive for the market and efficient allocation of capital, since the productive and unproductive companies get the same buying and selling pressures? Are bubbles an example of tragedy of the commons?
  - What are the dynamics and issues associated with liquidity, especially if we minnows are only safe and thrive in shallow water?
  - Has Sarbanes Oxley damaged the micro-cap market?

- Family issues
  - There was nothing on estate planning. At our chapter meetings, we usually have about 80 attendees, but have had 160 at estate planning presentations.
  - For couples, what are the issues related to who manages the investing or how the responsibility is shared? If one is interested and experienced in investing and one is not, how should they think ahead for succession planning?
  - How should charitable giving be structured and when?
  - Why are so few of our grown children interested in investing? What should we do about it, either as an organization or within our families?
  - Why do most people not financially prepare for their future and/or expected unexpected events? Does the human brain have faulty wiring? With a dynamic so prevalent, what makes some of us think that we are immune? Are we not all in denial about a very uncertain future just in order to function? Is there a similarity between not saving and preparing for retirement or other financial needs, and sitting at a slot machine, taking what chance delivers?
  - How is age an appropriate variable in allocation and investment decisions? Most investors at retirement have either far more than they need for living expenses or far less. Do not both situations point to higher risk portfolios? If most of ones assets will not be used for living expenses but will rather go to heirs, charities or taxes, does age have anything to do with optimal investment strategies and allocation?

- Macro issues
  - To what extent are price variations driven by macro economic and political events, thus deserving our attention, and to what extent by metrics specific to a security?
  - Should the investment implications of climate change be front and center in our awareness? Are we like being in 1939 and ignoring the investment implications of impending war.
  - There were casual comments, but nothing focused on commodity cycles and variations in the price of oil.
  - How does one balance a relevant macro analysis and weighing individual investments?
  - Would you expect investors with diametrically opposing political opinions to choose the same investments? How do political opinions inappropriately skew good investment analysis?

- Off-market investments
    - If markets are a loser's game, as Larry Swedroe announced, it appears that our options are to invest in passive funds, try to find a backwater part of the market, or find non-publically traded investments. How about an independent, non-sales look at non-publically traded investments, such as apartment buildings, small businesses, partnerships or peer-to peer equities or loans?
    - Funding Circle is an example of newer investment opportunities facilitating direct purchase of small business loans in fractional amounts. I've had both an SEP-IRA and a Roth account for almost a year and it appears to be working smoothly. The one account nets about 14% and the other 13%. If we get a severe recession will a lot of them default? Maybe and maybe not, as they are incredibly diverse. Nothing is guaranteed in any investment.
    - What are the opportunities and threats in similar purchase arrangements for equity?
- Assumptions without empirical support
    - Several speakers identified momentum as improving returns, along with other factors such as value and smaller market cap stocks.
    - If documented at all, it is with a reference to an author or piece of research. However, the specifics enough to be actionable are lacking. When does it work? What are the risks of a reversal or reversion to the mean? Are momentum stocks more likely to gap down? What defines momentum? Is it how fast the price is rising? Is it how consistently it is rising? Is it the length of the trend?
    - I'm in the process of analyzing weekly percent price change over twenty-five weeks for the 3,000 largest stocks since 2009. The stocks with the highest standard deviation over the 25 periods had the highest returns. In other words, they were the least trending. The stocks with the lowest simple moving averages (SMA) had returns going forward (1 week, 2 weeks, 3 weeks, 4 weeks, 8 weeks and 12 weeks) double those of the stocks with the highest moving averages. Both the highest and lowest SMA had much better returns than the majority of stocks in the middle. So betting on a reversal would have been a better bet than betting on a continuance of trend.

      It is easier to prove something not true, such as in this case momentum, than to prove something true.

      I mentioned this to Patrick O'Shaughnessy and his perspective was that it was only a six year period and only through a basically bull market. True, but if my research is not flawed and it works for six years, is it worth a try or should I believe the common wisdom about momentum? Would I use a basically short-term strategy for six years if it wasn't working?

      This kind of a dialogue is what I would like to see more often in our AAII media and meetings.
- Professionals
    - When and how should one use professionals? As individual investors, are we not also very independent?
    - How do you find trustworthy professionals in a sea of sharks?