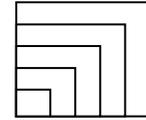


Picking Stocks with a Rifle, Shotgun or Net

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Examining the scope of the stock selection process sheds light on the active versus passive debate.

The investor delving deep into the unique fundamentals, story or even technical patterns of each stock, and then picking one or a very few stocks, is using a very selective and targeted approach. I will compare it to using a rifle. The success is dependent upon the person shooting; the aim may or may not be consistent and is not easily replicated. Were the results random?

The investor buying an index product is using a net to garner returns from a large number of stocks expected over a long period of time to have a slight edge. Indexes using factors such as valuation or size often comprise thirty percent of all stocks. Such aggregates might beat or trail the market by a few percentage points.

One approach I use is a quantitative methodology between these two extremes that can be compared to using a shotgun. Like the factored index, statistical tools are used to find criteria and screens for excess returns. However I'm looking for criteria to select maybe eight to twenty stocks to fit a profile that will exceed market returns by a considerable margin. I may have several such profiles or portfolios. The probabilities of missing the target go up as do the chances of far exceeding market averages. Yet, there is a replicable system and set of rules that can be tested.

Because the scope is so different, typical factor-based research may have relatively little relevance for the shotgun approach. Factor-based research is usually based on a single factor such as beta, valuation, size or momentum. Studies of the correlations between these variables might be used to create an allocation that limits overall volatility. The end result is that stocks going into one index and therefore into the end allocation meet one criterion but not multiple criteria. The interaction effect is measured as correlations between factors. This is very different than the interaction effect of what stocks meet multiple criteria, which is the foundation for a shotgun approach. Two criteria, each separately pointing to excess returns, when taken together may have even greater returns or may have inferior returns. Picture a very complex web of overlapping Venn diagrams, whereas with single factor indexes the circles do not overlap.

Active mutual fund managers might use rifles, shotguns or nets. However because predictability is so important to their survival, and because of the need to invest relatively large amounts of capital, they often gravitate to the net approach as a way to approximate their benchmarks.

Academicians also gravitate to the net approach in their search for universal laws and truths. This is in contrast to the business person or investor who is less concerned with what always works than with what is working now in this unique time and environment.

From these perspectives, what do you have to add, subtract, multiply (branch out) or divide (dig deeper)?

An alternative to mutual funds.

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