PANEL DISCUSSION ON OPEN DAY - FIRST PORTFOLIO MANAGEMENT SEMINAR, MACQUARIE UNIVERSITY

Edited by R.G. Lander

The following is an edited summary of questions and answers during The Panel Discussion on Open Day, February 21, 1973 at the First Portfolio Management Seminar conducted by the N.S.W. Branch of the Australian Society of Security Analysts at Macquarie University. It has been necessary to edit the transcript of the tape recording of this session. Although the wording is not necessarily verbatim, it conveys the inherent arguments and views put forward by members of the Panel.

Professor Philip Brown chaired the group which was comprised of Professor Ray Ball, Mr. James Cowan, Mr. Austin Donnelly and Mr. Jack Treynor.

The Panel considered four topics posed from the floor:

"Is short selling a necessity in the achievement of an efficient market? If so, what action should be taken to legalise it?"

"When does specialist investment knowledge become insider knowledge?"

"The Security Analyst has never justified the cost of his existence."

"The market index is no good - everybody always beats it."

Chairman: I'll pass the first question over to Austin Donnelly to start the ball rolling.

Donnelly: This question raises another namely whether we have an efficient market or not. I feel that from a practical point of view we do not have an efficient market. Had the market been efficient we would not have seen the meteoric rises in 1969 and the slumps from thereon. The market's movements would have been smoother. That's from the practical viewpoint and I know that there are theoretical arguments against this. I believe that short selling does make a market more efficient if done properly. In the U.S.A. you can only sell short under certain conditions when prices are on the uptick. If you believe a stock is going up, you back your judgement by buying; if you believe a stock is going down, you should be able to back your judgement by selling even if you haven't got the stock, provided you can borrow the scrip. Properly controlled, short selling has a part to play in an efficient market.

Chairman: Jack, perhaps you would like to discuss the efficient market point first, and then perhaps somebody else might like to take up whether or not short selling is necessary for an efficient market and should be legalised.

Treynor: This is a tricky question. I suspect the answer is that market prices would be the same with or without legal short selling. Perhaps the more interesting question is price response over the time period in which information is propagating through the market. The evidence suggests that information travels very fast; the figure of 15 minutes is often cited in the U.S.A. which would seem to be fast enough. There is very little short selling the way it is now in the U.S.A. with institutions accounting for 70 per cent of trading on the New York Stock Exchange and only a tiny handful of institutions having it within their charters to sell short. I think this is very unfortunate because the
generation of research advice is a process of comparison. On average, you expect to find, in a comprehensive research process, half the shares in a market under-valued and the other half, by definition, overvalued. If you're not permitted to sell short then half your research information is of no value to you.

Chairman: If this is the problem, that, if you uncover information which leads you to suspect that a stock is over-valued, what would be the mechanism then for that bad information being reflected in share prices? Ray?

Ball: We know from evidence to be presented to the Seminar tomorrow that the Exchanges are very, very rapid indeed in reflecting the news as contained in an earnings report by a firm. And that includes earnings news that is bad news. If you pick up an income number from a firm two days after the telex report to the market and it says that income went down, you can forget about making any money out of looking at that report. You guys are doing such a good job that the market responds rather well. From the evidence it would seem that as far as the profit report is concerned the market does not need short selling in order to impound the bad news concerning the firm. This does not mean, however, that there should be legislation against short selling.

Chairman: Thank you, Ray. Jim, what's your view on whether or not short selling ought to be legalised?

Cowan: I haven't much to add to what Austin said at the beginning. There is room for short selling in this market but there should be the same sort of restrictions on it as apply in New York. There must be an upward sale beforehand and the scrip factor is particularly important. I would advocate its re-introduction.

Chairman: Why should we only permit short selling on an uptick? Austin?

Donnelly: If short selling is limited to an uptick, that overcomes one of the great arguments against short selling, that it accentuates the swings.

Treynor: The usual arguments against short selling are mis-stated, I think. I don't think short selling is necessarily any riskier than buying long, if it's properly practised. The great danger in short selling is failing to redress your exposure to the stock on the way down.

Chairman: How about a vote? How many are in favour of short selling in the audience here today? (Audience overwhelmingly in favour.) Thank you. Jim, would you like to take the second question?

Cowan: Well frankly I don't think I can answer it because, unless one has been told something that would be virtually a secret of the board and which no board had the right to disseminate one would not really have "insider knowledge". I think it would be awfully hard to make rules about this sort of thing.

Chairman: So it's a question of terminology, I suppose, in some ways.

Cowan: Very largely, I think, yes.

Chairman: I suppose one definition of insider information then would be "that which is not public".

Cowan: Yes, but there is a lot of things probably that aren't published that depend on somebody's opinion of their degree of importance. There might be something not published which a board does not regard as important but which an analyst could find most useful because of his closer market
Chairman: Ray, would you like to clarify the terms from your point of view?

Ball: I think you have a legal concept that defines it more or less in terms of privileges in the sense that a management of a firm might be privy to information which other people are not privy to. In terms of the stockmarket, inside information would be that knowledge which is not available to the participants in the market. Yet it is quite possible that the participants might have access by non-direct routes to some of the information which management feel they are privy to. For example, we may know that a large component of the change in a firm's income is due to the change in the profitability of the economy as a whole. And so knowledge as to what is happening to, say, industrial production can give a hint as to the sort of information which the directors of a corporation might regard as exclusive to themselves. So it need not be obvious that a person has inside knowledge.

Chairman: Austin, what is your view on this?

Donnelly: I believe the market acts on hunches and prejudices. If a security analyst is ahead of the market in this perception of information, he may have insider knowledge in Ray's concept in the sense of having information not available to the market. But this would not be insider knowledge such as might be gathered by going through the managing director's waste paper basket. In a bit of extra mural activity last night, we worked out a formula on this:

Superior Financial Information equals Real Information minus Perceived Information. And the name of security analysis in my view is to look beyond the financial statements, look through the notes, find out all the accounting fiddling that's gone on - permissive accounting - to get the real facts. This is intelligent analysis but it's not inside information. It's better perception and it's closer to the real information rather than what the market thinks the information is.

Chairman: Jack, to what extent does rumour, prejudice and similar things constitute information?

Treynor: There's an interesting question legally, of course, in the States whether that kind of knowledge constitutes inside information. Up until now it hasn't been considered such but it's about to be. When we talk about inside information we have in mind information that somehow is unfairly applied to a securities transaction. Apart from liquidity motivated transactions, the only reason people buy and sell securities is to obtain an unfair advantage over the person they're trading with. And so it's not quite clear to me why we get so concerned about inside information. There are two appeals to social interest advanced in defence of laws against the use of inside information; firstly that it's simply unfair and secondly that it could have a significant impact on the price of a stock if fully appreciated by long term investors. I'm not sure it would be an exaggeration to say that in a typical public company the single most important function of management is the overseeing of the information system within the company which distills meaning out of thousands of seemingly unrelated events. This job is being carried out on behalf of stockholders and it shouldn't be used by somebody who takes advantage of this information to trade against a
shareholder who doesn't have it. This argument would not
apply to outside knowledge which is information emanating from
within a company but known by such people as employees,
suppliers and customers. As the law now stands in the States
there is no legal prohibition on using outside information,
and of course, it's just as valuable as some inside information.

Chairman: Thank you Jack. The distinction appears to be in terms of
opportunities for profit, I suppose, between those which are
unfairly gained from people within the firm and those which
you may well gain because you are a Superior Financial
Analyst. Let us look at the question: "The market index is
no good. Everybody always beats it." Austin?

Donnelly: Some of you may remember an article I wrote a few years ago
entitled "The Boom that Never Was" which pointed out that the
All Ordinaries Index became distorted in 1968 because of a
situation where four or five stocks represented 48% of this
index and these were the stocks which were moving up very
rapidly. We got the situation where, of the ten largest
Australian stocks, eight or nine were high risk high Beta
stocks because they were mining oriented. There is no longer
an Australian sharemarket; there are two markets - industrials
and mining. The industrial market at present appears to be
going into a slide and if it goes down 10%, it's about 99%
sure that it's a cyclical downturn. The industrial market
has never dropped 10% in the last six years without going into
a cyclical downtrend. On the other hand the mining market
still hasn't reversed its downtrend from 1970. I believe
what is needed is not an adjusted index but a new one.

Chairman: Well, it's somewhat pleasing to learn that there have been
cyclical downturns and I suppose we can look forward to more.

Donnelly: No, I think you'll see the continuation of the one we
predicted six months ago.

Chairman: Jim, would you like to add to this?

Cowan: Everybody beats the index because it's easy to beat it if you
pick a point when it happens to suit your particular case.
There must be some time when everybody has beaten the index
over a period. People tend to quote the period that suits
them. We have 19 indexes in Sydney and about another 14 in
Melbourne but, because a lot of them are industry indexes, it's
very hard to pick one index which is truly representative of the
Australian market. There are two markets and we must recognise
this. Whether the industrial market is about to go into a
slide as Austin predicts is or is not a fact we shall see, but
it's probably a time when investors are going to have to cull
out special situations not affected by export problems and
perhaps by the Labor Party's introducing a Prices Justification
Tribunal etc.

Chairman: You mean we're rather like fishermen; we remember the large
catches but forget the others.

Cowan: Yes, but we're also like sportsmen, I suppose. We like to
back a winner and we like to make sure we adjust things so
that we do back the winner by working on the index figures
backwards.

Chairman: Jack, suppose somebody came along and said to you: "In the
Australian stockmarket there are two separate markets", how
would you go about finding if that was correct?

Treynor: Well, Phil, that's what you fellows call an empirical
question, or rather it's what they call an econometric or
statistical question. It seems to me you might proceed
as follows. Take the return series rather than the price series and perform a conventional principal components or factor analysis on each stock in the market. The first so-called principal factor to emerge from this kind of analysis typically behaves very much like a stockmarket index, although the question then becomes the behaviour of the residuals, one residual series being associated of course with each of the original issues. Now is there any commonality in these residuals? Are they pretty much varying one from another or can we repeat this process of identifying a common factor all over again with the residuals? And it seems to me the empirical question is if you can, you have some grounds for suspecting that maybe one market index is not adequate for the Australian market. Now that's a dangerous answer because, as Fisher Black would say, that doesn't show anything at all about interdependence of mining versus industrials. What it shows is merely that there's no riskless asset in Australia and that lending and borrowing on it aren't at the same interest rate.

Chairman: I am sure there is one person on my right who would dispute that the past sequence of share prices could be used to predict a cyclical downturn.

Ball: Of course there are cycles if you define a cycle to be a period when you have a sequence of increases followed by a series of decreases in the market index, begging questions as to how you want to calculate the market index. I might note that Eliot Janeway had a column in the Chicago Tribune for something like 20 years and in almost every single week of those 20 years he's predicted a downturn. And by God, he's got every one of them because he's predicted every week there'd be a downturn. I don't think whether or not a person predicts a downturn is in any way a test of whether or not there are cyclical downturns as distinct from non-cyclical downturns. And if you were to take Janeway's forecasting record and ask yourself how many upturns he got, you'd find there would be very few. What's more if the Dow Jones industrial average stood at say 800 and he said, as he occasionally said, it's going to get below 500 by the end of the year; if you took the number of times in which the index rose above 800 relative to falling below 800 you'd find that this predictive accuracy would be a little bit different when you measure it this way.

The evidence we've put together indicates that high rates of return on average are not followed by high rates of return in subsequent periods but rather average rates of return. If there is cyclical behaviour in an index you'd expect high rates of return in a given month to be associated with low rates of return in subsequent months and conversely. I don't think there is anybody in Australia or the USA who has given any convincing evidence of the existence of cycles in the stockmarket.

Chairman: The gentleman on my left is restive.

Donnelly: I just want to mention in terms of evidence the index we keep on industrial shares. If a line were plotted through the peaks of 1964 and 1969, it would have suggested that the market would have peaked at between 510 and 520. In fact the Index hit 531 in December and now it's 478 which seems to me to be pretty reasonable evidence of cycles in the stockmarket. I think we're talking in different terms, Ray, because you're using monthly rates of return while I'm talking only of share prices, excluding income which distorts. Some 95% of the trading in the last 15 years has been within a clearly defined channel and it seems to me that this is a factor you can't ignore.
Ball: I'd say that the channel is not all that clear to me. Looking back you can see trends or sequences in any sort of stock price. The question is whether you can use these to extrapolate into the future. I suggest the only way to test these sorts of notions that Austin is suggesting is to go out and collect the evidence in as systematic way as possible. You can always find one instance in a market in which prices fly around a lot; you can always find one instance that's going to justify any theory that you want to put up. The question is does the theory work on average - that's the only way to do it. I say you might be right, Austin, but let's have a joint call to look at the evidence.

Chairman: We've already had one vote. Let me ask all of you to pause for three seconds, don't look at the people around you and answer the question: "Which way is the industrial market headed over the next year?" That is to say, will the return adjusted for dividends over the next year be greater or less than 12½% p.a. which has been the average over the past 13 years? Three to one against! Excuse me, I'm just going out to place an order. Let's get selling short in quickly.

Jim, perhaps you might like to lead off on the last subject "The Security Analyst has never justified the cost of his existence".

Cowan: Well, I dispute the statement strongly, although I think it's probably true to say that a lot of security analysis is fairly valueless. During the mining boom we, I did at any rate, allowed the normal measures which we'd grown to recognise over the years to be swept aside in the mood of the moment. And people who live in Singapore and Hong Kong are seeing a lot of the same thing at the present time. The Singapore index has gone up from 200 at the end of September to 610 the other day. If you try to tell people there that they should sell at the moment and that you've seen it all before, they just look at you and say "but it's different up here." That's just exactly what we said, you might remember, when the mining boom was on. This doesn't mean that analysts are never worth what they're paid or what it costs to support them. I dispute this very strongly; I think that the upsurge we've seen in financial analysis in this country over the past twelve years speaks for itself. There have been some major advances over this period only because security analysts have come to the fore and done a good job.

Ball: This question boils down to saying that very little has been done by way of performance measurement which is one of the themes of this Seminar. Let me cite an example that Philip Brown was connected with in the USA. He once had to evaluate analysts in a large bank who specialised by industries. A poor guy working in Utilities tended to show a low return on his recommendations because he happened to be picking a very low risk industry and one of the hot shots who specialised in one of the more risky industries appeared to do well. Yet, adjusting their returns via portfolio measurement techniques for the risk they were bearing showed some rather surprising sorts of things as to who was earning his money and who was not. The other interpretation is that, it seems to me, if people survive then they're justifying their existence.

Chairman: Well you look a very healthy bunch! Austin?
Donnelly: I think the operative word here is "never". There have probably been times when security analysts haven't justified their existence but there's certainly no way of measuring that. Furthermore, to the extent that analysts are advisors but good advice is not taken by the portfolio manager, this can't be laid at the door of the analyst. The measures that Jack spoke about today certainly help and I hope that as time goes by that the practitioners and the academics will get closer together on this.

Chairman: Jack would you like to add something?

Treynor: Based on the evidence in the States, analysts are doing an excellent job of justifying their existence. The evidence is that professionally managed portfolios do just about as well as the market, risk adjusted. Now, if we acknowledge trading costs of about 10% for the round trip, and when you recognise the rate at which many of these portfolios are traded, it's clear that the gross contribution of security analysis to these portfolios is very substantial. The next step would be the bean-jar example. The notion is this - many of us remember, perhaps from our childhoods more than any recent experience, seeing a jar full of beans in the storekeeper's window. And there's a kind of contest - guess how many beans there are in the jar. If ten-thousand people make a guess on how many beans are in the jar, how close will the average of their guesses be to the true number of beans in the jar? Now this may seem a little far afield from the question of security analysis, but of course, the point is this. If the point of professional security analysis is to achieve an advantage trading against the unwashed, the unsophisticated, the emotional man-in-the-street investor, then he is playing the role of the ten-thousand, only multiply in the States, for example, by a fairly generous number because there are now estimated to be thirty-million men in the street investors in the United States. The question is, "If the market is, as has been alleged by somebody, a voting machine rather than a weighing machine, then market price at any point in time is an average of the opinions of these thirty million investors, different weights for different investors, obviously. How good is that market price as an estimate of true investment value, if for the sake of argument, we assume that all thirty million of these people are utter fools? And the answer, it seems to me is that the concensus, is a very good estimate of investment value, with one qualification only. It's a very good estimate of investment value unless you can identify some systematic bias in the way these thirty million lay investors are arriving at their judgments of investment value. Now, there are lots of ways that they could be biassed. For example, one corollary of this conclusion is the following: if you have thirty million people operating in virtual utter ignorance in arriving at judgments about the value of a particular company, the previous conclusion suggests that in the absence of bias that the market price will be a good estimate of value. Now inject a broker's report into this population. Of course, it's possible the broker's report will take a view of the security that agrees with the market concensus, but I think we'd all quickly concede that's highly unlikely. If it doesn't agree with the market concensus, then it introduces a systematic bias and to the extent that the broker's report is successfully distributed through the population of investors, it's obviously going to move opinions pretty much all in the same direction. To be sure, there'll be some people who will react against the prejudices of the analyst but I think plausibly, we can say that this will tend to be the effect.
JASSA

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Treynor: Well, this leads us to a very peculiar conclusion, and certainly one that one would want to distrust until we thought about it for a while - any research effort, no matter how careful, how conscientious, how balanced, how responsible will tend to move market price away from true investment value.

The session was closed by the Chairman following brief comments by the panel on two questions from the floor.

REVIEWS AND NOTICES

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STRATEGIC INVESTING

By Austin Donnelly (C.C.H. Australia) 1973

A new textbook by an author who is a member of both the Institute and the Society - and of their joint editorial committee - must command attention. Wide in its coverage and written in general terms with an almost total avoidance of mathematics, it must prove to be helpful to everyone interested in the practice of investment in Australia.

The major components of strategic investing are given as:
1. An appropriate policy,
2. Market realities including market cycles,
3. Strategy based on internal policy and external market realities,
4. Balanced security analysis, and
5. Overall effect on the portfolio,

and the text of 400 pages is in essence an elaboration of them.

The approach is invariably that of the pragmatic practitioner rather than the academic, and this is particularly illustrated by the treatment of risk. Some of the views expressed by the author are already known from his other writings but the many facets are brought together into a consistent theme.

This will not be universally accepted - not only by the academic but by chartists as a whole and by many who have expressed disagreement on particular topics, from intrinsic values to a coming property depression. These areas of difference in opinion will hopefully lead to further public discussion; the new work should help to define the issues and encourage more students and practitioners to consider critically just what investing is all about.

SUNRISE, SUNSET

By A.J. Briloff (Barron's) 14 May 73

This article by a Professor of Accounting is sub-titled "A Hard Look at Kaufman & Brood's Accounting", and the attention of members is drawn to it as a fine piece of security analysis - or security detective work.

The company under the microscope is one of the three principal operators in the homebuilding industry in the U.S.A. Its accounting methods in this field could be