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6 lessons you need to know about stock picking

March 2023



WS Global CIO Office

The background of the entire page is a dark, blurred image of a person's hands typing on a laptop keyboard. Overlaid on this is a semi-transparent financial candlestick chart with blue and red bars and a yellow trend line. The text is positioned in the upper left quadrant.

Stock picking has always been one of the frequently discussed topics in investment, and picking stocks like Warren Buffett perhaps is an inspiration for many of us. While it is not a dream of the impossible, it might not be the right path to build wealth for everyone.

Here are the 6 lessons about stock picking an average investor should know before considering it for their investment portfolio.

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Lesson 1

Bad pick or good pick, chances are you will lose some money

Stock prices go up.
And they go down.
The fluctuation in price movement can be drastic and irrational.
There's nothing you can do about it. If it bothers you, stock investing probably is not for you.

When you purchase a company share, you are making a bet on both future fundamentals (such as revenue, earnings, profits and free cash flow) of a company and the future perceptions (valuation multiples) of that company. To find a good stock to invest, you will need to spend time researching and then make a forecast on what revenues and profit a particular management team in a particular market can generate against their competitors. This task alone is hard and demanding. Yet, being a good forecaster does not guarantee you to be a good stock picker. Instead, more importantly, you need to be a good psychologist. To select stocks successfully, you need to be able to forecast how markets value the fundamentals you forecast. For this reason, even with best-in-class companies and stocks, investors need to be ready for material losses over time when the forecast on the market's perception of company fundamentals is wrong.

To demonstrate this point, in the table below, we categorise a universe of more than 1,500 stocks globally by CFRA Star Ranking (a professional ranking system to classify whether a stock is a good or bad buy based on its fundamentals, valuation and other factors). The higher ranking the stock has, the better stock pick it should be. We then calculate performance of all stocks in each category on absolute term and relative to global equity benchmark. Results show that:

1. We certainly do not recommend investors to give their money to “monkey throwing darts” (as Warren Buffett suggested). However, based on analysis of one well-resourced and rigorous research provider, the probability any 5-star rated (or Strong Buy-recommended) stock outperforming global equities over 3 years is 62%. While this is actually quite an impressive performance in our minds, for an average investor, with much more limited time and resources, it is likely that this percentage will be markedly lower.
2. There is no differentiation in short-term performance between good stock (5-star ranking) and bad stock (1-star ranking).
3. Similarly, short term, good stocks suffer similar downside risks as bad stocks.
4. However, while we see a better longer-term average (3-year) performance of good stocks, the probability of an individual good stock outperforming the global equity benchmark drops significantly (when compared with those of bad stocks).

No clear differences in performance between 5-star and 1-star stock picks in the short term

Average, min. and max. returns of different star ranking categories of stocks over 1 year and 3 years

	1-year return			3-year return (annualised)		
	Average	Min.	Max.	Average	Min.	Max.
★	-3.3	-68.2	63.1	0.2	-36.3	23.5
★★	1.5	-54.4	131.9	7.2	-46.9	93.5
★★★	-1.6	-91.8	103.1	7.3	-47.0	103.8
★★★★	0.2	-83.5	220.3	9.0	-48.4	92.9
★★★★★	-1.2	-70.4	70.2	10.1	-24.9	67.2

Source: CFRA, Bloomberg, Standard Chartered

Lesson 2

Higher risk does not always equate to higher return

In theory, higher risk should reward investors with higher return.

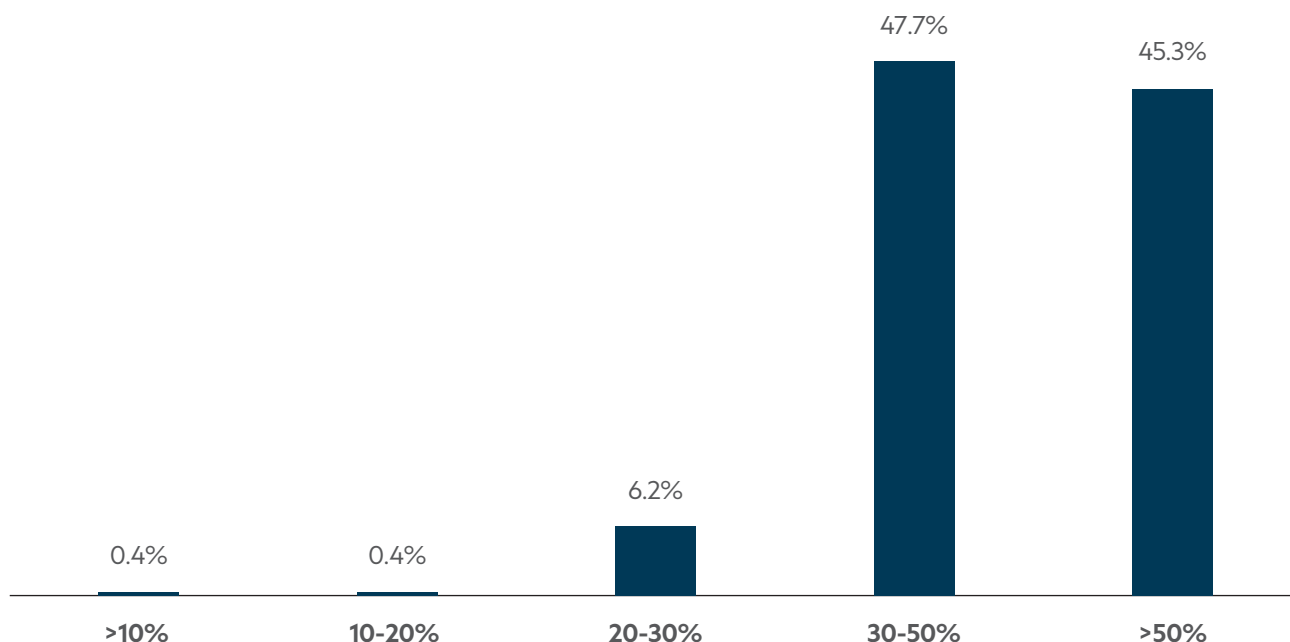
In reality, especially in stock investing, the risk of “catastrophic” failure among individual stocks tends to be much higher than most investors are prepared to take and, in some cases, outweigh any potential rewards.

To understand the asymmetry in the risk and return trade-off in the stock market better, we looked at the past 5 years of total returns (reward) and maximum drawdown (risk) of all individual stocks in the S&P 500 index. Results show that:

1. Over the past 5 years, 80% of the stocks reported total returns ranging from 0% to 30%, and less than 5% of stocks showed superior performance with total returns exceeding 30%.
2. However, more than 90% of S&P 500 members suffered a maximum drawdown of 30% and greater over the same period of time.

More than 90% of S&P 500 members saw pullback of at least 30% over the past 5 years

Distribution of S&P 500 index stocks across different max. drawdown thresholds (2018-2023)



Source: Bloomberg, Standard Chartered

Lesson 3

Owning more and more stocks do not make investors immune to sharp market losses

Diversification applies to all aspects of investment, stock investing included.

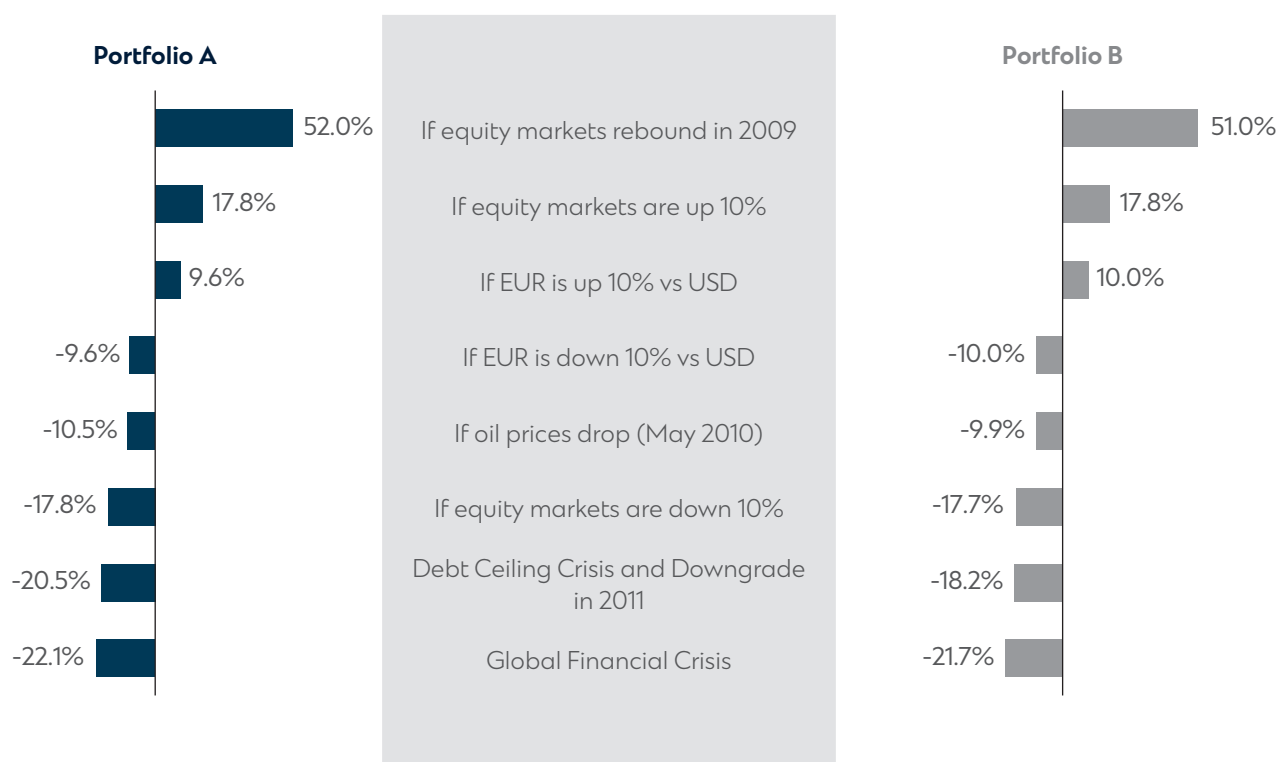
The idea is to select stocks that are uncorrelated to each other so that a portfolio of all differently behaving stocks can be more resilient against individual company-specific events of risk. One simple yet effective way to achieve this is by owning stocks in different sectors and/or geographical regions.



That said, historically, no diversified stock portfolios are immune to major markets events, especially the one that has a large impact on broad equity markets. In the chart below, we compared stress test results on two US stock portfolios diversified across different sectors – portfolio A has 10 stocks and portfolio B has 50 stocks. Our analysis showed that despite significantly higher number of stocks invested, portfolio B suffered a very similar drawdown to portfolio A in different crisis and risk-off scenarios.

Essentially it also means stock pickers can enjoy very limited benefits from diversification, especially when it comes to downside protection. For any investing journey over the long-time horizon, the type of diversification that can help investors reduce portfolio volatility and increase the stability in investment returns is the diversification across different asset classes (bonds, alternatives, commodities, etc.).

Stress testing performance of portfolio A of 10 stocks and portfolio B of 50 stocks diversified across different US equity sectors



Source: Bloomberg, Standard Chartered

Never try to time the market (and trade around quarters)

Quarterly earnings season has always been an important time of the year to any stock investors.

During this time, companies release their earnings results and market volatility picks up as market perceptions of company fundamentals are being evaluated. As a result, it is often believed that the quarterly earnings season is the exciting time to trade stocks. To assess the validity of this strategy, we examined short-term performance of various members in the S&P 500 index after their earning releases in Q4 2021. Results in the chart below showed that:

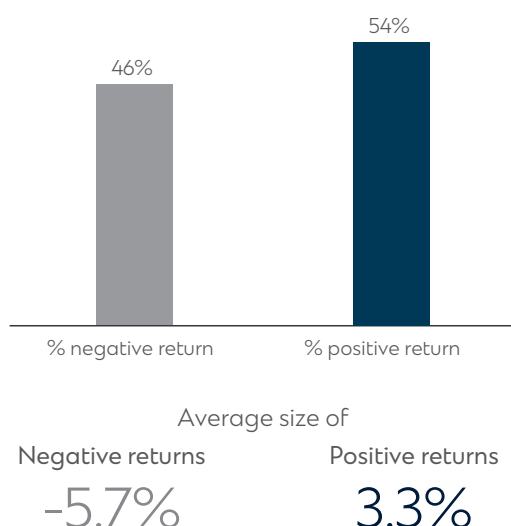
1. Whether a company's earnings results beat or miss market expectations, it does not have a clear influence on the short-term performance of all stocks.
2. While probabilities of having positive returns are slightly higher than those of having negative returns (in both beat and miss market expectation cases), the magnitude of potential losses (proxied by the average size of negative returns) seems to be larger than that of potential gains (proxied by the average size of positive returns).

Trading around quarters can be extremely challenging and misleading because stock price fluctuations are often more dominated by the assessment of near-term expectations rather than by fundamentals (such as earnings, revenue, profitability and free cash flow).

Probabilities and average size of positive/negative returns of S&P 500 members post earnings release in Q4 2021

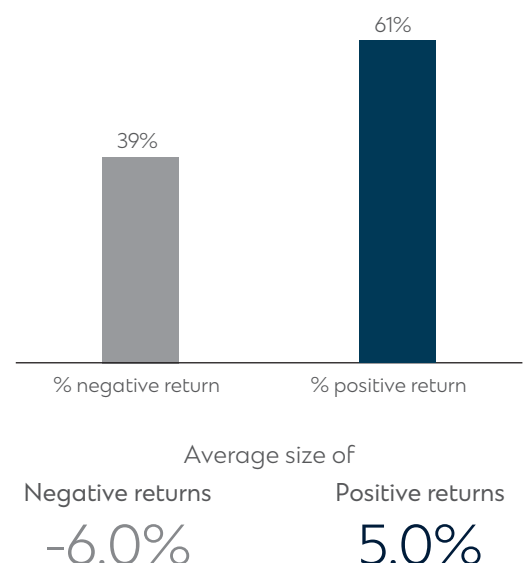
When earnings results beat market expectation

Probabilities of positive/negative 1-month return post earnings result



When earnings results miss market expectation

Probabilities of positive/negative 1-month return post earnings result



Source: Bloomberg, Standard Chartered

Lesson 5

Earnings still matter over the long run

In *One Up on Wall Street*, Peter Lynch advised investors to focus on three key financial metrics: earnings, earnings and earnings.

And we agree with that. We believe that over the long term, fundamentals move stocks, and earnings is one of the key drivers to watch. Companies that can consistently deliver positive earnings growth, generate positive free cash flow and (importantly) beat market expectations can potentially provide good stock returns.

To demonstrate this point, we calculated the number of times that members of the S&P 500 index beat/miss earnings expectation and their performance over the past 5 years. Our study showed that:

1. The gap in the 5-year stock return (cumulatively) between companies that have consistently delivered and beaten market expectations and those that have consistently missed estimates increases exponentially when frequencies of such instances are above 70%.
2. For those companies whose earnings results have disappointed the market more than 90% of the time over the past 5 years, their stocks posted negative returns, on average.

Stocks of companies that have delivered and beaten market estimates have consistently outperformed

5-year cumulative returns of members of the S&P 500 index categorised by how often their earnings beat/miss market expectations (2017-2022)

	of the time (2017-2022)			
When earnings results beat market expectation	60%	70%	80%	90%
Average 5-year return (cumulative)	63.9%	72.6%	84.1%	82.3%
When earnings results miss market expectation	60%	70%	80%	90%
Average 5-year return (cumulative)	65.1%	60.3%	3.5%	-47.4%
Gap in 5-year return (cumulative)	-1.2%	12.3%	80.6%	129.6%

Source: Bloomberg, Standard Chartered

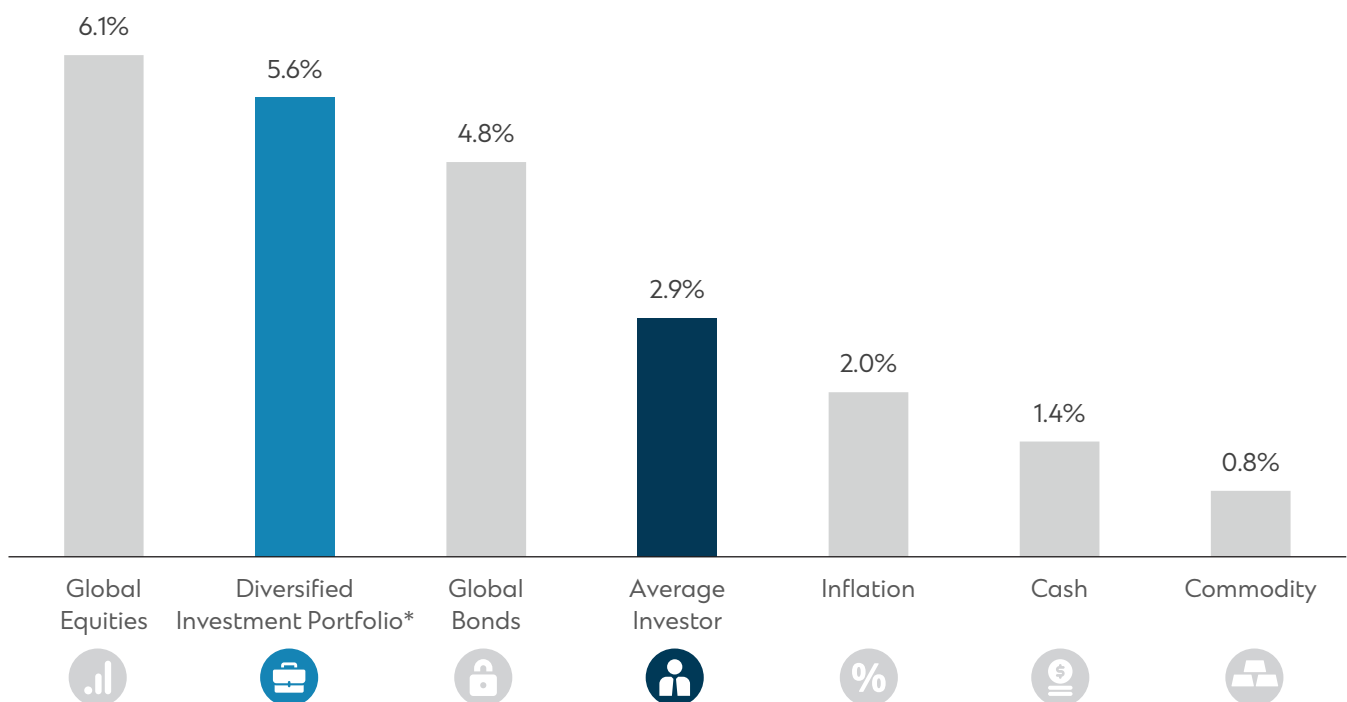
Stock picking may not be the most rewarding path to build wealth for most investors

Stock picking can be exciting and thrilling to many eager investors, but it is a risky process, financially and emotionally.

This is not only due to the highly volatile characteristics of this investment (as discussed above), but also because stock picking can be emotional. All too many investors impulsively pick and sell stocks because they are excited and scared. Never mind that stock picking typically entails an attachment to a company in which you have invested, especially if you have invested both time and resources researching it. That said, in returns, history shows that most individual investors do not beat the markets with stock picking. Data in the chart below shows that over the past 20 years, an average investor can only produce, on average, a 2.9% annual return, underperforming most financial markets' performances, including global equity, posting an annual return of 6.1%, or global bonds delivering close to 5% annually. Instead, we believe that a diversified investment portfolio with more consistent performance can be more beneficial for investors to achieve their long-term goals.

Average investor performance vs various financial market performance

20-year annualised return by different investments (2001-2020)



Source: Standard Chartered, Bloomberg, J.P. Morgan Asset Management, DALBAR Inc

*A diversified investment asset allocation is proxied by 40% Global Bonds and 60% Global Equities

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