



A Quantitative Look at Stock Picking Lists

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I have always had something of an issue with stock pick lists that are published in various old and new media channels. The gist of these articles is typically that a business publication wants to publish a list of the best stocks for the coming year. The publication polls a series of experts— typically money managers. Forbes is no exception, and they have just come out with a series of stock picks for 2007 from a set of professional money managers:

http://biz.yahoo.com/special/invest120406_article1.html

I do not have a problem with this type of exercise in general, but I always wonder what the publishers expect people to do with these picks. The problem with stock picking lists is that there are some perverse incentives for the experts who participate in the activity. Specifically, if someone asks you for a ‘stock pick’ and you know that you will be ranked as either a winner or an ‘also ran,’ you have a real incentive to pick a very volatile stock. Think of it like this. You know that a year from now you will get some positive attention if you pick a stock that shows enormous appreciation. If you pick a real dog, you can bet that the publication won’t be advertising the fact that they listed a big loser as a stock pick. If you pick a solid company that generates high returns relative to risk but still is not in the top performers, you won’t get much attention either. The way you get some good press in this type of exercise is to make a swing for the fences.

I admit that I like to peruse these lists for ideas—there are plenty of very smart analysts and money managers who come up with great ideas. To account for the tendency of stock pickers to make highly volatile picks, I take these lists and see how they look from a quantitative perspective. I expect the picks to be volatile—more volatile than any index, in general. The Forbes list includes both stock picks that the experts expect to have large gains as well as some that are expected to be big losers. When I ran a series of the ‘buy’ choices through *Quantext Portfolio Planner* (QPP), I found a number of interesting results. I started with a portfolio of the ‘buy’ picks from the Forbes article linked above:

Ticker	Company
INTC	Intel
GLW	Corning
SGMS	Scientific Games Corp.
MSFT	Microsoft
DECK	Deckers Outdoor Corp.
TIF	Tiffany and Co.
PLMD	PolyMedica Corp.

Forbes 2007 Guru Picks (http://biz.yahoo.com/special/invest120406_article1.html)

The article linked above says that Forbes invites twelve experts to give their picks, but only seven are listed in this article—so this is what I have gone with. This is a fairly broad selection in terms of sector, which makes it interesting. *Quantext Portfolio Planner* analyzes historical data and makes projections as to the future average return and risk for stocks and funds. When I ran these stocks through QPP using default settings, I found a number of interesting things. First, as expected, these stocks are uniformly volatile. Over the three years through the end of November 2006, every one of these was more volatile than major domestic and foreign equity indices (as represented by SPY, QQQQ, EFA, and EEM)—with the exception of Microsoft (MSFT) which was less volatile than the emerging markets ETF (EEM).

Ticker	Annualized Standard Deviation in Return
SPY	7.2%
QQQQ	14.7%
EFA	9.9%
EEM	19.4%
INTC	25.7%
GLW	39.0%
SGMS	30.5%
MSFT	17.3%
DECK	52.8%
TIF	23.0%
PLMD	23.9%

Trailing 3-Year Annualized Standard Deviation in Return for Stock Picks and for Index ETF's

What does it mean that these have such high volatility? Stocks with high volatility have a high degree of uncertainty in the future earnings that are expected by the market. This also means that these companies have high potential for above-average returns. QPP generates volatility forecasts for each stock or fund in a portfolio. These projections have been benchmarked against options markets. QPP then uses long-term historical data on capital markets and more recent statistics for each stock or fund to generate an expected future return that is consistent with the projected volatility. *Using QPP, we can look at whether the projected return on a stock (consistent with volatility) is greater than the trailing annual return.* When I analyzed this list in QPP, The projected future returns for all of these stocks except DECK is markedly greater than the average returns from the trailing three years.

In the case of DECK, the projected (long-term) average annual return is 40%---certainly high enough for a big win. That said, the projected (long term) standard deviation in annual return is almost 80%. These long-term projections assume that the overall volatility of the stock market will return to long-term historical average levels—much higher than they are now. Any stock with historical and projected volatility as high as DECK is tricky to predict. What we can say is that the future potential for DECK is very high---but so is the downside. This is a classic ‘swing for the fences’ stock pick. The options prices of DECK reflect this. The fact that there is no listed options on DECK beyond June of 2007 is a testament to a high level of uncertainty. Options on Microsoft (MSFT) are liquid out in 2009.

QPP is telling us that the other stocks in this selection (INTC, GLW, SGMS, MSFT, TIF, and PLMD) have been under-performing on a risk-adjusted basis. QPP projects high returns for all of these stocks—particularly if these equilibrate to the long-term projected average return. In other words, QPP implies that these stocks will out-perform in order to get up to their projected average return because they have been lagging their risk-adjusted average expected returns. High volatility stocks should have high expected returns and these stocks will generate higher average returns in the future if / when the stock market’s

overall volatility returns to historical levels. This is not necessarily true for any individual stock, of course. We are talking in statistical terms.

So, we have a group of stocks that all have high volatility and have been under-performing the levels of average return that are expected of stocks with these levels of volatility. The exception is DECK which has been generating high levels of return already---but has a good potential to continue based on its status as a high risk / high return stock.

As I noted earlier, if you are going to be a stock picking expert, you have very different incentives than someone who might actually buy a stock. As a stock picking expert, you are going to pick high volatility stocks. Once you have narrowed the universe to high volatility stocks, you might then look for companies that have been under-performing on a risk-adjusted basis. TIF and INTC actually have negative average annual returns over the last three years. At some point they should recover and generate some decent returns. Purely from an ‘odds making’ standpoint, I’d say that these are good bets for a stock picking list. Microsoft (MSFT) has been generating reasonable returns, but still pretty anemic given its volatility level. MSFT has pretty limited upside given its size and maturity. It is a stock that I might buy but it probably won’t bring kudos to the guy who puts it in for a stock picking list. Corning (GLW), somewhat like DECK, has generated some very high returns over recent years as well as having enormous volatility. Scientific Games (SGMS) and Polymedica (PLMD) have both performed well over the past several years and are poised to generate even higher average returns in the future (according to QPP’s risk-return balancing). In the case of these two stocks, you have both momentum and the high risk / high return factors on your side—and both of these can be important—especially in the near-term:

<http://seekingalpha.com/article/15291>

Overall, the experts who have chosen the stocks on Forbes’ list have made some smart choices from a statistical standpoint. I have not looked at the fundamentals of most of these firms, so I can’t speak to that side of the analysis. The statistics show us that these

are very volatile stocks and are projected (on that basis) to generate higher returns in the future than they have over the past several years—all except for DECK, but DECK is projected to generate very high future returns, too. My personal appetite for the levels of volatility that these stocks expose me to is constrained by my total risk tolerance. The portfolio impacts of these stocks will be a function of what else is in your portfolio. I have some ‘swing for the fences’ picks in my own portfolio, but I manage these positions carefully.

Disclosure: the author owns shares in INTC

Quantext Portfolio Planner is a Monte Carlo portfolio management tool. Extensive case studies, as well as access to a free extended trial, are available at <http://www.quantext.com/gpage3.html>