Pokémon Investing!

Have you noticed the surge recently in people wandering aimlessly and staring at their smartphones? Chances are they're playing Pokémon GO, the latest craze. It's an activity eerily close to how some folk see investing.

From Tokyo to Frankfurt and from New York to Sydney, tens of millions of people have become obsessed with finding tiny virtual creatures called Pokémon, using their smartphones' camera and global positioning systems.

Such is the addictive nature of Pokémon GO that some people have been caught playing the game while driving. Two men in the US were reported to have fallen off a cliff in their search for Pokémon. Others have been hit by cars. [1]

The blinkered and single-minded behaviour evident in those hunting Pokémon can also be seen in people who build portfolios around individual securities. And while you won't get run over, you can still do yourself a lot of damage this way.

Stock pickers tend to concentrate their portfolios around what they see as their best ideas. They will focus on stocks which they believe the market has mispriced and buy them in the hope the market will come around to their view eventually.

Of course, there are a few problems with this approach. Like Pokémon players so focused on their phones that they miss a spectacular sunset (or worse lose their jobs!), stock pickers can be so intent on finding the right stock that they overlook the opportunity cost of missing out on the market return.

A narrow focus also leaves the stock hunter open to idiosyncratic risks associated with single companies or sectors, risks that can be offset by keeping your portfolio broadly diversified.

The Pokémon addict who walks in front of a truck is like the stock picker who stakes everything on a security that crashes his portfolio. The risk isn't just that his stock bets fail to pay off, but that he fails to earn the market returns owed to him and falls short of his medium-term and long-term financial goals.

Another issue is cost. It may be diverting to spend your lunch hour chasing after digital "creatures", but you could also have spent that time reading or catching up with friends or going to the gym to get healthy. Likewise, stock pickers have to factor in the costs of brokerage, time and stress related to betting against the market.

The question you have to ask is whether the considerable risks you are taking are worth the possible benefit. Keep in mind that surveys consistently show that over time only a small fraction of stock picking managers outperform the market after fees. And even then, it is very difficult to identify the winners in advance. [2]

As for individual stock recommendations, you don't have to go far to find examples of investor guidance that turn out to be the share market equivalent of someone following an imagined Pokémon over a cliff.

In March, 2015, one Australian media outlet noted that consumer electronics retailer Dick Smith Holdings Ltd had "jumped to the top of a number of analysts' buy lists" after it reported strong first half earnings and flagged buoyant sales. [3]

At that point, the stock was trading at around $2 a share. By the end of that year, it had fallen to 35 cents. In January 2016, the company collapsed and was placed in receivership. All of its 363 stores in Australia and New Zealand were closed and more than two thousand people lost their jobs.

Now, the analyst calls on Dick Smith at the time might have seemed perfectly reasonable given the information to hand. Their perceived "right price" for the security was well above $2 and this would have been a profitable trade had they been right.

But the analysts turned out to be wrong. Basing investment performance on identifying a "mispriced" security did not work in this case.

In other cases, of course, analysts will have got it right. But a lot of things have to fall into place for this to be a consistently winning strategy. Not only does the market have to come around to your price, you have to ensure that costs don't outweigh the premium you earn. And even if you meet those requirements, some new piece of information might still move the price in the opposite direction of your forecast.

The fact is prices change as information changes. Unless you have a crystal ball, it seems highly unlikely that you'll find all the market Pokémon without doing yourself some damage in the process.

A better approach is to work on the basis that current prices are fair. Instead of second guessing prices, you use the information they contain to build highly diversified portfolios that pursue higher expected returns while minimising idiosyncratic risks and avoiding unnecessary costs.

Of course, using this approach does not eliminate risk. And there will be times when you won't be compensated. But you can be confident that there is a sensible explanation for this way of investing, that the desired premiums are persistent and pervasive and that you can capture them cost effectively.

Pokémon Go is not all bad. But to borrow its slogan, "you gotta catch 'em all".

1. ‘Ten Unimaginable Things Happening Because of Pokémon Go’, *Time* 18 July 2016
2. SPIVA Australia Scorecard, Mid-Year 2015, *Standard & Poor’s*
3. ‘Should You Buy Dick Smith Holdings Ltd?’, *Motley Fool*, 20 March 2015

Do not act on this information alone! Always seek independent financial advice before taking any action.

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