

The Enigma of Financial Expertise: Superior and Reproducible Investment Performance in Efficient Markets

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Introduction

Are there financial “experts” with superior and reproducible stock selection skill? Attempts to measure the benefits of financial expertise indicate that markets are efficient—professionals do not make superior trades compared to those selected by chance (Fama, 1998). These findings together with demonstrations of professionals’ poor accuracy and biases suggest that financial “experts” may not exist (Shanteau & Stewart, 1992). Using the expert-performance approach we re-examine the evidence to reveal circumstances and sources of *superior and reproducible* stock selection expertise in open markets. A central theoretical question is whether evidence of expertise exists, regardless of the margin of profit.

Results and Discussion

As a result of the most comprehensive review to date, we conclude there is considerable evidence for financial expertise as demonstrated by the very small but reliable superiority of stock selection and forecasting performance of experts. As an example, the effect sizes for buy and sell recommendations as compared to benchmarks are $d = .1$ and $d = .2$ respectively. Through extended deliberate practice, specialization, and the development of complex mental representations, some experts are able to predict future changes in the market although they are rarely able to profit net of transaction costs.

Resolving the Enigma

We believe the enigma of financial expertise can be resolved by attributing the efficiency of the markets to the trading behavior of the financial experts with superior and reproducible stock selection skill. While

the private investors’ transactions are on average associated with losses, expert investors are constantly searching for promising trades and their trading activities make all stocks more closely approximate their efficient values. The identification of extraordinarily profitable stocks therefore is very rare, just as are scientific discoveries that revolutionize disciplines. However, the value of expertise remains clear: The cumulative knowledge and actions of expert investors produce small and consistent contributions that maintain and create market efficiency.

Conclusions

Theoretically, our results suggest that behavioral studies to date have yielded only limited benefits because it is not possible to extrapolate mechanisms of unskilled participants found in typical experiments to those of experts with extended knowledge and practice. Only by developing representative tasks and a deeper understanding of the full range of expert behavior can we create comprehensive economic and decision-making models (Ericsson, Andersson & Cokely, in prep).

References

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