❖ Contrarian Views and Ideas ❖

"Can a Bad Portfolio Manager beat the S&P 500?"

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The answer to this question is decidedly affirmative. Let us first define terms. A so-called bad portfolio manager is one whose stock selections consistently earn an average rate of return of 8.8% per annum while it is assumed that the S&P 500 will continue to earn its historical annual rate of return of 10%. Let us also assume that the 8.8% average return is generated in the following manner. An average return of 6% per year is generated by 80% of the stock selections and an average return of 20% per year is generated by 20% of the stock selections. This equals an average expected return of 8.8% (.2 x 20% + .8 x 6%).

This hypothetical portfolio manager realizes that this circumstance will always be true and hence begins to regard trading as a futile activity and therefore practices a buy and hold strategy. If one assumes the existence of a $10,000 portfolio divided initially in an 80-20 ratio between the outperforming and underperforming stocks, the portfolio will generate the following results:

Hypothetical Portfolio

Year	Portfolio Value	Compound Annual Return	Year	Portfolio Value	Compound Annual Return
1	10,880	8.8%	7	19,195	9.76%
2	11,868	8.94%	8	21,349	9.94%
3	12,984	9.09%	9	23,834	10.13%
4	14,246	9.25%	10	26,709	10.32%
5	15,681	9.41%			
6	17,319	9.59%	20	102,332	12.33%

It is obvious that the superior stock selections will increasingly influence and even dominate returns if the portfolio is left undisturbed for a sufficiently long period of time. The fifth year is the first year that the portfolio earns a rate of return in excess of the presumed market return. The ninth year represents the point at which the portfolio outperforms the market on a cumulative basis.

The 20th year is particularly intriguing. The influence of the successful investments is now so powerful that this portfolio would generate an above market return even if 80% of the portfolio earned no return at all rather than 6% per year. In fact, if 80% of the portfolio did not earn 6% per year but ultimately became worthless, the portfolio would still earn 10.72 per year. Patience is a remedy for many things, including poor stock selection.