

## ‘Practical Speculation’ Book Review

*Practical Speculation*: Victor Niederhoffer and Laurel Kenner, Wiley, NJ 2003.

When a hedge fund manager who lost all in the 1997 Asian meltdown and a financial journalist get together and write a book about speculation, you would expect an informative, entertaining, and interesting book. Victor Niederhoffer and Laurel Kenner combined their talents with ‘Practical Speculation’. The book lives up to expectation plus some, with provocative ideas and a shaking some of the myths that surround the investment world.

Whether we like to acknowledge it or not, every ‘investment’ is indeed a speculation about an uncertain therefore risky future. Niederhoffer and Kenner take what they believe is a scientific approach to equity investment by putting ideas and conventional wisdoms to statistical tests. They rely heavily on statistical scatter diagrams with the consequent correlations and regressions. This doesn’t detract from the readability of the book but we do have to rely on their integrity for their analysis and conclusions. So the authors believe that they can get at the truth about investment and this truth is the basis for practical speculation.

Before their practical speculation ideas are presented in Part Two of the book, the authors debunk conventional ideas in Part One entitled ‘Mumbo Jumbo and Moonshine’. The authors disparage the reliability of those with a vested interest in the finance world. Not only do brokers, fund managers and biased press receive a serve but also officials like Alan Greenspan and investment gurus such as Benjamin Graham are in the firing line.

Two particular sacred cows are given short shrift. Firstly the authors believe they show that there is a negative correlation between earnings and future stock prices. In other words if earnings on the S&P 500 rise in a year, the S&P 500 is likely to perform worse than average the next year. And vice versa. Secondly they argue that technical analysis is unscientific and thus useless for practical speculation. They claim ‘the trend is definitely not your friend’.

After destroying, the authors outline what they consider constructive investment ideas in the second part of the book.

Within the framework that markets work through ever changing cycles here are some of their speculation precepts as summarised on pages 219 and 315:

- Small companies tend to perform better than big companies
- Risk can be reduced by diversification. However risk reduction decreases as the number of stocks in the portfolio increases
- Certain kinds of stock do better at certain times of the year than at other times
- Companies that innovate and research tend to be rewarded
- Companies that have monopolies fixed by government tend to do better over time
- Company stock buy back announcements precede superior performance
- Companies paying dividends have superior long-term performance

Decreases in inventory and accounts receivable lead to good performance  
Tax payments by companies indicate that earnings are real and reliable.

The authors rely heavily on a 2002 study by the London Business School titled “Triumph of the Optimists: 101 years of Global Investment Returns”. These authors show that \$1 invested at the start of the 20<sup>th</sup> century with reinvestment of dividends would have accrued to \$15000 at the end of the period: a return of 1,500,000 %. The basic argument is since this statistical result was achieved last century the practical speculator today can rely on this outcome in the future. Investors should be optimistic despite the market volatility. Buy on the dips is their recommendation.

The second part of the book is somewhat disappointing. Its theme is to keep the faith: shares do go up over time. To assist credibility Part two draws on metaphors from science. They allude to the Periodic Table of Elements and the First and Second Laws of Thermodynamics but don’t really clarify how these ideas assist investment. Perhaps they are trying to dazzle us with science or perhaps muddy the waters to make it seem that their ideas do have scientific merit. Metaphors and generalisations are borrowed from tennis, chess and fishing to illustrate market maneuvers. Again it’s up to readers to make what they will of that information. One practical hint offered is the recommended the use of limit rather than market orders to provide a ‘negotiation’ advantage.

The returns on shares last century as outlined in the book were amazing. Is what happened last century indicative to the overall outcome this century? These optimistic authors say yes, certainly. This is indeed a bold speculation.

Secular bear markets last century form 1902 to 21, 1929 to 49, and 1966 to 82 did not detract form the overall result. But as a practical matter can an investor wait out lengthy periods for shares to recover? If you could live on for another century it would be ok, if the authors’ speculation were correct. If an investor is not able to reinvest dividends or has to draw down capital to live on then the volatility that Niederhoffer and Kenner say will pass is a killer.

This book will interest if not enthrall those who like to look at the stock investment big picture. However the book should be read with the same skeptical attitude the authors employ to identify the mumbo jumbo and moonshine of ‘Practical Speculation’.

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