Beating the markets means knowing something others don’t and Forbes Magazine’s Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher highlights the only three questions investors need to answer in order to gain the upper hand

The three questions that count

When it comes to beating the market there are only three questions that count. It is basic to finance that being smarter or wiser doesn’t win although sheer luck may briefly. However, beating markets means knowing something others don’t, which is damned difficult. Better stockpicking, market timing or whatever can only win in the long term if based on knowledge others don’t possess. How might you gain that upper hand? What three questions?

First up is “What do you believe is true that’s actually false?” We know little about markets and much we believe is actually nonsense. So what you believe that’s wrong is probably widespread mythology leading to massive losers’ bets. You learn to bet against them. Years ago I wrote here about how statistics show overwhelmingly that no buy/sell rule based on overall market price/earnings (P/E) ratios beats a buy and hold strategy.

Statistically all possible permutations fail. It’s a stunning statement but true. Yet, driven by stone-age fear of heights and confirmation bias, investors overwhelmingly believe high P/E market years fare worse than low P/E times.

Some times like 2000/02 reinforce the mythology as investors ignore soaring high P/E times like 1998, 1999 and 2003. Correct bearishness requires something bad others don’t know. So when you see investors freaked by high P/E markets you know not to be – knowing something they don’t. There are lots of examples. Like August, when I showed that the price of oil has no stock-market effect.

The next question is “Can you fathom the unfathomable?” If no one knows what drives X, can you? Study patterns for correlations. When you find a correlation, seek basic economics and finance for causality. Sometimes you hit non-intuitive pay-dirt.

For example, the driver behind growth versus value cycles in stocks is time-lagged shifts in the US’s yield curve. The world correlates to the US and, nine to 12 months after its yield curve flattens, growth stocks start outshining value – until the curve next gets very steep. The correlation is high. Why? Value stocks are bank-financing dependent and flat yield curves make US banks less eager to lend to lower-quality borrowers – simple, measurable economics and finance. But no one knows – although you do now.

Question three is “How is my brain blinding me now?” The best thing you can know that others don’t is how your brain works. It makes you almost unique! I’ve written about behavioural self-blinding traits for years. Like August’s column on oil with “confirmation bias” and “reframing” – and more. Everyone does.

Learning from this makes your brain take years but helps in and outside investing. Here are some stocks I like and think I know in ways others don’t.

Operating from the Netherlands but all over the world, CNH Global lags only Deere & Company in agricultural equipment. The stock is less than 15% of its 1997 level. Very cyclical, it bled badly for years. A turnaround has come and I expect a boom ahead and higher prices. It has lots of upside potential, selling at only 20% of annual turnover, 60% of book value and three times cashflow.

Metso, from Finland, is further along. It dominates the market for paper and rock processing automation process control equipment. From here, expect 10%-plus growth rates in turnover plus improving profit margins. It, too, is very cheap at 70% of turnover and 14 times next year’s earnings. It has a small but growing 1.8% dividend yield.

In the aftermath of America’s Gulf Coast disaster, Kirby Corp should shine. Its barges and towing vessels comprise a third of America’s Gulf in-shore coastal shipping capacity. Hurricane Katrina did it little damage. Kirby was already a small growth business with a big future shipping most basic materials before the disaster – and one much bigger than its 1.6 times annual revenue and 16 times 2005 earnings.

Canada’s Enbridge not only runs the world’s longest crude oil pipeline – all 8,500 miles of it – it also controls the key lines from Canada’s oil sands, a key incremental energy supply source for the future. As long as energy prices are firm, so will be Enbridge’s earnings. Barriers to entry are huge and that makes Enbridge much more precious than its 18 times 2005 earnings and 2.6% dividend yield.

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