

The hardest thing to understand is income tax. -- Einstein

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Daily Fool

[Tuesday, 23 February 1999]

Market Closed

FTSE 100	6155.20	+85.30	(+1.41%)
FTSE AS	2812.38	+32.41	(+1.17%)

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The Market Today

By David Stars ([TMF Stars](#))

Palmers Green, London -- Figures out today showed that the UK trade deficit has increased while gross domestic product growth has slowed. Of possibly more importance is the gap between strong growth in services and a contraction in manufacturing.

Some economic commentators are again postulating further easing of interest rates by the Bank of England in order to stimulate the economy. The data was given a positive spin by UK Trade Minister Brian Wilson, who waxed on about strong UK export figures but kept mum on the overall picture of an economy in danger of becoming seriously out of whack.

On our new politico-economic front, Tony Blair today outlined the plans for "if" Britain adopts the euro, although no plans for a scenario where Britain doesn't adopt the euro were mentioned. It all remains a mystery.

Bank of England Governor Eddie George was meanwhile admitting to a "potential for conflict" if the government asks the Old Lady to target a specific exchange rate for merging with the euro. He said that the conflict might be reduced as the British

pre tax loss of £1m from last year's £6.9m profit.

Fool's Eye View -- Self-Fulfilling Prophecies

An article in Monday's *FT*, written by Daniel Bogler, presented some new research by Professor Brad Barber and Professor Reuven Lehavy and two of their colleagues at the University of California.

The professors tracked 360,000 analyst recommendations by 4,000 equity analysts between 1985 and 1996 in the US. They classified recommendations into five gradations from the strongest "buy" to the strongest "sell." They found that the strongest "buy" recommendations made 18.8%, while the strongest "sells" made 5.8%.

Although the author of the article reveals a couple of real-life caveats that make the findings difficult to reduce to a trading strategy, with the final sentence the study is nevertheless declared as evidence that "The billions lavished on analysis seems a good investment after all."

But what inspired such a conclusion? Certainly, the returns on a portfolio composed of strongest "buy" recommendations is astonishing. This is one of those market anomalies the number crunchers offer us that proves the existence of what academics class as an "inefficiency." But while we can watch it accrue profit, we can never gain from it. It exists. It can make money. But not for you.

Basically, the theory is that a bunch of guys who wear green hats think that it's not possible to beat the market, and a bunch of guys in red hats think it is. This study proves that for eleven years, the strongest analyst recommendations have made a bundle on paper -- although the article did not dwell on the fact that the strongest "sell" recommendations performed extremely badly, with a loss of 5.8%. This is probably a function of a psychological preference for stock watchers to view the stock market asymmetrically. There is no index of strongest sells against which the analysts can have their negative musings trashed.

Of course, the professors point out that an arbitrage strategy wherein you could buy the strongest "buys" and sell the strongest "sells" for a return of 12.2% has a couple of practical difficulties. They reckon that to follow the recommendations religiously and buy all strong buys and sell the strongest sells would require that you churn your whole account four times a year. The transaction costs make this impossible for all but the largest institutions.

The other snag is that the study found "no reliable differences" between the "buy" and "sell" tips on the largest companies, which, the article points out, comprise 70% of the US market's capitalisation. This means that the gains are weighted heavily toward smaller companies.

"The abnormal returns are most pronounced among small- and medium-sized firms, which stands to reason since these are less well followed, giving analysts more scope to add value."

Well, they certainly add value alright. It's perpetual motion. It's alchemy. It's time travel and eternal life wrapped into one.

Market analysis is a self-propagating system. "More scope to add value." What this means is that the gains are accrued because the stock is recommended by analysts.

Who is analysing what for whom? Because of the possibility of low transaction costs, large institutions are the only ones who could ever gain from the professors' structuring of analyst recommendations. And who do analysts work for?

Therefore, "the billions lavished on analysis seems a good investment after all." This is a great boon to the analysis industry. They can only make money for you in a way that requires that all the money you make be eaten up by the industry that created the wealth in the first place in the form of analyst recommendations on smaller companies.

This kind of study also highlights the fundamental problem of applying even successful market analysis. It is not about being right; it is about making money.

And there's the rub. The very real self-fulfilling prophecies of the Wise keep their profit opportunities, fundamentally, to themselves. So while we can observe success, albeit born of the power of media-mantras, we can never share in it.

And Finally...

Get your 12-bores out and let's bag a few haggises! The *Wall Street Journal Europe* today reported a simmering battle taking place within the Scottish bagpipe industry.

Apparently, these Scots caterwaulers have been using sheepskins treated with honey and seal fat (though where do you buy seal fat and how do seals feel about this?) for 600 years, but a new Gore-Tex synthetic bag was used to win the world bagpipe championships last year.

The sheepskin-bagpipe-bag market is crashing, while the space age bag is gaining favour. The new bag uses a cat litter desiccant to control "moisture," and the most hairy-legged of bagpipers criticise the look of the new bag, which is said to resemble a plastic shower cap.

Could the new product not be given some cosmetic surgery to resemble its great granddad, or should all bagpipes be hunted down and killed like dogs? Tell us on the [boards](#).

It is also our pleasure to introduce a new message board on the web just for the Daily Fool. Questions or comments on today's Fool's Eye View? Post them [here](#).

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