

## **Good News! Smoking Reduces Your Risk of Cancer** (published November 2008)

— *By Steve Tepper*

I read a story recently that neatly summed up, as an easy-to-follow allegory, the futility of using historical performance to pick a mutual fund or portfolio manager.

The story comes from Michael Edesess, PhD in his book “The Big Investment Lie.” To paraphrase (and at times embellish), he describes the fictional country of Fumaria. 99% of Fumaria’s 80 million citizens smoke on average 4 packs of cigarettes a day, while the remaining 800,000 citizens don’t smoke. Because of the huge demand for cigarettes, there are 10,000 brands to choose from.

Fumarians know of the cancer risk associated with cigarette smoking, so naturally they’d like to find a brand of cigarettes that isn’t carcinogenic. Cigarette companies are aware of the tremendous marketing advantage they would have if they created a brand of cigarettes that doesn’t cause cancer, so they meticulously study the cancer rates of their customers compared to the cancer rate of the 800,000 non-smoking Fumarians.

Now here’s where it gets interesting. If studies are conducted for each of the 10,000 cigarette brands, you would expect that a large majority of the studies would show higher cancer rates among the smokers. But would you expect that result for **all 10,000 studies**? No, you would expect over any given period, a few anomalies, study groups where the cancer rate among smokers is the same as, or even less than the cancer rate among the non-smoking population.

Let’s say that over a given period of time, one brand had a cancer incidence rate lower than the non-smokers’ rate. We’ll call that cigarette **Brand X**. You don’t have to have a degree in statistics (or oncology) to conclude that Brand X’s results were most probably random, rare, and unlikely to be repeated (i.e., over another study period, a different brand will likely beat the non-smoker cancer rate).

But you can be sure the makers of Brand X had a different interpretation. They published the results and proudly advertised that **smoking Brand X reduces the risk of cancer!** And the smokers of Fumaria, desperate for a cancer-beating alternative, switched to Brand X. Other brands, whose own studies didn’t beat the non-smoker cancer rate for that period of time, changed their formula to emulate Brand X, and then advertised that they have the same ingredients (therefore implying that their brand will also reduce the risk of cancer).

All of this has a parallel in the world of investment management. The vast majority of investors are looking for a return in excess of the market return, even though it is widely accepted that the combined efforts of all investment managers to beat the market has

historically resulted in lower-than-market results. But investors cling to the hope that they can identify individual fund managers who can beat the market.

Because of the tremendous amount of money involved (trillions of dollars), there are thousands of investment alternatives, and all would like to be identified as the investment that beats the market. So they study their historical results and compare them to the market rate of return.

Over any given period, many alternatives will beat the market. The managers of those investments will publish their results and allow investors to infer that their funds will continue to beat the market in the future.

As with Brand X in Fumaria, we concede that over a given period, some funds will beat the market, but the funds that will beat the market in the next period can not be predicted by any past period's results. Therefore, chasing after high returns by investing in funds which have good historical returns can prove to be as futile a strategy as smoking to reduce your cancer risk.