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In Picking Facebook Shares, Repeating the Mistakes of the Past

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Since the implosion of the dot-com bubble in 2000, retail investors have been rightfully wary of the stock market. Facebook was going to change it all, bringing the ordinary investor back.

Instead, Facebook was a massacre for retail investors, highlighting yet again why stock picking is a loser's game. The hype around Facebook was enormous as retail investors salivated at the chance to buy what they hoped would be the next Apple. Yet, after initially trading above $40 a share, the stock is now down nearly 43 percent from the initial offering price.

The Facebook example is one more confirmation of studies that have shown that, on average, individual investors lose out consistently when they buy and trade individual stocks. They're better off investing in passive index funds.

Professors Brad M. Barber and Terrance Odean recently released a paper surveying the evidence. Studies of individual investor trading found that "many investors earn poor returns even before costs." These investors trade badly and tend to lose more money than they would using a simple buy-and-hold strategy in passive funds that match indexes like the Standard & Poor's 500-stock index.

How big is the loss? The same authors in another study of 65,000 investors found that the 20 percent who traded most actively earned 7 percentage points a year less than the buy-and-hold investors, the 20 percent who traded least actively. For the individual investor, that can add up to hundreds of thousands of dollars over a lifetime.

This is not surprising. Even mutual fund managers have trouble beating the market. Last year, according to S.& P. Indices, 84 percent of actively managed funds did not beat the Standard & Poor's index representing that fund's sector. Going back over five years, 61 percent of funds underperformed. Even so, most mutual funds beat individual investors who try to do it themselves.

If the professionals have such problems, individual investors don't have a chance. They are not as knowledgeable and not as disciplined. Study after study has found that individual investors have a disposition effect - that is, they tend to sell winners too soon and hold on to the losers by refusing to recognize their failure.

Individual investors are also heavily influenced by their mind-set and their environment.

For one, they are strongly influenced by media reports and buy stocks that are promoted. And, yes, there are studies of Jim Cramer's show, "Mad Money," and this effect. One recent study found that the higher the viewership of the show, the bigger the market reaction to stock recommendations. The authors also found that Mr. Cramer's buy recommendations had more influence than sell recommendations, reflecting people's desire to bet on winners. But didn't we know that already from the tech bubble? More than a decade ago, stocks of companies with little or no profits were wildly hyped. It all ended badly, with retail investors losing the most.

In full disclosure, I'm still a little bitter about that. In 1999, I bought Ask Jeeves stock at about $120 a share, eventually selling at below a dollar before shares went up 28-fold and the company was sold to IAC/InterActiveCorp. I'm unfortunately a great example of how retail investors can time things perfectly wrong as they become part of the herd. The Facebook affair was but a sad repeat.

These inherent flaws put us off on the wrong foot when we pick and trade stocks. We don't diversify enough, don't do enough research and tend to sell on emotion rather than logic.

If this weren't hindrance enough for even the most educated individual investor, the Facebook debacle shows that the market is rapidly changing in ways to make it even harder for individual investors to profit.

In the case of Facebook, the profits from investing were largely taken from individual investors before the I.P.O., by trades in the private market where most individual investors could not trade. Goldman Sachs, for example, led a private investment round at a $50 billion valuation only a year ago, selling a third of the stock in the offering at about double the price. By the time Facebook came to market, there was little left for average investors.

The losses in Facebook show that Wall Street doesn't seem to care much about the individual investor. Companies are increasingly going public with structures that disenfranchise stockholders, or they are looking to cash out and go private just before things get good. Investment banks furiously peddled Chinese issuers to a public that didn't seem to care much about the companies' problems.

Instead, the markets have become the domain of hedge funds, where high-frequency trading peels off short-term profits. In the longer term, the severe underperformance of mutual fund managers last year was attributed by Horizon Advisors to the volatility in the markets and the increasing correlation of stocks. As stocks move together, or become correlated, picking winners that offer returns higher than the market average becomes more difficult.

Beyond all of these barriers, individual investors are also faced with a stock market that has remained stagnant for the last decade.

So what can be done?

One thing to consider is whether to further educate individual investors on the problems of investing on their own. The studies show that in general, investors are better off in passively managed index funds. But even here, investors tend to defeat themselves. At least one study has found that investors who engage in passive exchange-traded funds eat away the gains in performance by using this as an excuse to trade more. The problem again occurs when investors try to trade on their own.

In light of this, more disclosure and education would be nice. Perhaps Mr. Cramer's show could begin each segment with a note spelling out how much investors lose when they trade on their own. The warning could be given to all investors when they sign up for brokerage accounts. And because not everyone will heed this disclosure, the government might take steps to limit the ability of people to trade in their retirement accounts, where the bulk of Americans hold their invested wealth.

But the bottom line is that more needs to be done to educate and help individual investors. It should become common knowledge that investing in an individual stock and trading may be fun, but it may also be dangerous to their wealth. Perhaps the warnings could start with a confessed Facebook I.P.O. investor.

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