

# PERFORMANCE COMPONENTS:

## INVESTMENT POLICY IS KEY

By Mark Hulbert

A portfolio's performance is a function of three factors: investment policy, market timing, and security selection. Most investors focus on market timing and stock selection, but a study of newsletter performance indicates that these factors contribute the least to a portfolio's bottom line.

Most investors are barking up the wrong tree. That's the inescapable conclusion to emerge from my analysis of those newsletters that engage in asset allocation. The factors that most investors think are important for performance are in fact relatively inconsequential.

A portfolio's performance is a function of three different factors. The first is investment policy, which sets your default allocation to each of the major asset classes, such as equities, fixed income, gold, cash, and so forth. For example, a financial planner is setting investment policy when she recommends a 100% equity exposure to a 35-year-old client investing for his retirement. The key characteristics of an investment policy are its long-term focus and the fact that it changes allocations rarely and very modestly when it does.

The second major determinant in portfolio performance is market timing, which leads to deviations from the default allocations dictated by one's investment policy. Your investment policy might call for you to be fully invested in stocks, for example, but you also might believe that stocks are extremely overvalued right now and decide to be only 50% invested in equities. This deviation from policy would be market timing.

The last major determinant of performance is security selection. Do the particular securities you own do better or worse than their asset class as a whole? For example, on average, being fully invested in stocks was very profitable during the decade of the 1990s. But it would have been a lot less profitable if your entire stock portfolio was invested in only a few particularly poor-performing small-cap value stocks. This lowered return would be attributed to security selection.

These three factors' relative roles have been studied extensively in the pension fund arena, but less so among investment newsletters. For this article, I examine investment newsletters' performances during the decade of the 1990s.

### THE DATA

The newsletters I chose to examine for this article were those that explicitly engage in asset allocation and that also had been monitored by the Hulbert Financial Digest for at least 10 years. Surprisingly, only eight newsletters were eligible. This is because most investment newsletters focus on only one investment class (such as equities), making it impossible in their cases to determine the relative importance of the three factors.

To determine the relative role of these factors, for each newsletter I constructed two hypothetical portfolios, one that was a pure reflection of the newsletter's market timing and another that was a pure reflection of its investment policy. I then compared the newsletter's actual performance with that of these two hypothetical portfolios.

The hypothetical pure-timing portfolio was an exact replica of the

---

*Mark Hulbert is editor of the Hulbert Financial Digest, a newsletter that ranks the performance of investment advisory newsletters. It is published monthly and is located at 5051-B Backlick Rd., Annandale, Va. 22003; 703/750-9060; [www.hulbertdigest.com](http://www.hulbertdigest.com). This column appears quarterly and is copyrighted by HFD and AAI.*

newsletter's actual model portfolio except that a market index was substituted for each non-cash position. Any allocation to a U.S. stock fund, for example, was replaced by a similar allocation to the Wilshire 5000 index, and any amounts invested in domestic bonds were replaced by the Shearson Lehman Treasury index. The two indexes chosen for international investments were Morgan Stanley Capital International's EAFE index (for equities) and J.P. Morgan's non-U.S. government bond index (for bonds). Any investments in gold shares or funds were replaced by gold bullion. Any cash positions were invested in 90-day U.S. T-bills.

I derived each newsletter's investment policy portfolio from this hypothetical market-timing portfolio. Specifically, I assumed its investment policy allocation to be the time-weighted average of its market-timing portfolio. Consider, therefore, what it would mean if a newsletter's market timing portfolio outperformed its investment policy

portfolio—that would mean that its market timing added value. Similarly, if its actual portfolio outperformed its market timing portfolio, it would mean that its security selection added value.

Let me illustrate. Imagine a newsletter whose U.S. stock allocation deviated during the 1990s between 0% and 100%, and whose average allocation to U.S. stocks over the entire decade was 50%. I assumed its investment policy was to be 50% invested in U.S. equities, and credited market timing decisions with any deviations from this 50% level. If its hypothetical timing-only portfolio performed no better or worse than its hypothetical investment policy portfolio, then that would mean that this newsletter's market timing decisions added no value. That is, its deviations from its policy level of 50% U.S. equities added nothing.

## RESULTS

Table 1 reports the performance between the beginning of 1990

through the end of 1999 of these three portfolios for each of the eight newsletters.

The third column reports the net value of these newsletters' market timing decisions. Though seven of the eight newsletters added value through their market timing, the magnitude of added value was quite modest. On average, these eight newsletters' market timing decisions added just 41 basis points per year to what was produced by their investment policy alone.

The last column reports the net contribution of security selection decisions. While the results are more mixed, the magnitude of the contributions was again quite small. On average over the decade of the 1990s, security selection added an average of just 29 basis points per year. Furthermore, keep in mind that these results do not take taxes into account. If you were following these newsletters in a taxable account, the net cost of their market timing and security selection decisions very well could have erased these modest gains. (By the way, these results are similar to the

**TABLE 1. THE COMPONENTS OF NEWSLETTER PERFORMANCE: WHAT REALLY COUNTS**

Telephone Number	NEWSLETTER (Portfolio)	Investment Policy Portfolio (%)	Market Timing Portfolio (%)	Net Value of Mkt Timing (%)	Net Value Actual Portfolio (%)	Net Value of Security Selection (%)
(800) 392-0992	FXC Newsletter	13.11	13.15	0.04	10.75	-2.40
(800) 955-8500	InvesTech Mutual Fund Advisor	6.21	6.72	0.51	6.75	0.03
(800) 890-9670	Moneyletter (Venturesome Portfolio)	11.94	13.22	1.28	15.22	2.00
(800) 326-6941	Mutual Fund Letter (All Weather Portfolio)	9.80	9.83	0.03	12.51	2.68
(800) 252-2042	No-Load Fund Investor (Wealth Builder Portfolio)	14.57	15.15	0.58	14.05	-1.10
(800) 800-6563	No-Load Mutual Fund Selections & Timing (Asset Alloc. Port.)	10.50	11.18	0.67	12.79	1.61
(800) 852-1641	S&P Outlook	12.04	11.89	-0.15	11.27	-0.62
(800) 833-2782	Peter Dag Portfolio Strategy (Model Vanguard Portfolio)	7.67	7.95	0.29	8.03	0.08
				<b>Average:</b>	<b>0.41</b>	<b>Average: 0.29</b>
Wilshire 5000 Value Weighted Total Return Index		17.59				
Shearson Lehman Treasury Index		7.45				
Gold Bullion		-3.18				
MSCI's Europe, Australia, Far East Index		5.33				
J.P. Morgan's Non-U.S. Government Bond Index		8.34				

conclusions emerging from other studies of asset allocation.)

Regardless of whether the net contributions of these newsletters' market timing and security selection decisions was positive or negative, the most important result to emerge from Table 1 is that neither decision is all that important. The overwhelming determinant of long-term performance is investment policy. Ironically, however, most investors pay little attention to it, instead focusing most or all of their energies on market timing or security selection.

Psychological factors probably count as much as anything for why investors have this misplaced focus. On the one

hand, investment policy is not very exciting. It doesn't change very often—rarely no more than once every five or 10 years. And when it does change, it doesn't change by very much. Furthermore, we don't have a lot of control over the factors that make an investment policy more or less appropriate—such as age, risk aversion, family circumstances, etc. In contrast, market timing and security selection are exciting pursuits. No wonder investors gravitate toward them.

### **BOWING TO REALITY**

Recognizing these psychological

realities, it may make sense for you to divide your portfolio into two pieces.

One portfolio—with the bulk of your investable assets—will faithfully pursue your investment policy without deviation, a long-term buy-and-hold strategy.

The other will be one at which you try your hand at market timing and security selection.

This second portfolio will allow you to indulge your psychological need for fun, excitement and action. But don't forget that the chances are high that your two portfolios over time will perform quite similarly. ♦