CAN INVESTMENT NEWSLETTERS SUCCESSFULLY TIME THE MARKET?

By Mark Hulbert

Historical data indicate that most market timers do reduce stock market risk, although often the expense is lower returns. A smaller, but not insignificant, number of market timing newsletters was able to beat the market on a risk-adjusted basis over the long term.

Protagonists in the market timing debate are so committed to their beliefs that I doubt any amount of contrary historical data would lead them to alter their beliefs. In fact, the debate has all the makings of a theological dispute.

On one side of the debate are the "atheists" who believe successful market timing over the long term is impossible, and who explain away any evidence to the contrary.

On the other side are the "true believers" who fervently trust that it is possible to time the market, and who adhere to this position on faith even when empirical evidence for their belief proves elusive.

Nevertheless, I believe part of the debate's intractability is less theological than it is semantic: Both sides use the same words to mean different things. Consider the crucial question: Are investors better off by employing a market timer?

The atheists reply in the negative, arguing that the majority of investors would have made more money had they fired their market timer and instead bought and held an index fund. And they have an enormous amount of historical data to back them up.

But the true believers mean something different when they reply to this question in the affirmative. To them, the alternative to market timing isn't the same as it is for the atheists. They believe that if investors don't employ a market timer, they're likely to reduce or eliminate their equity exposure. The real-world impact of following a market timer is thus to increase equity exposure over what it would have been otherwise. And since most investment newsletter market timers have done better than a money market fund, believers in market timing thus can point to the fact that a not-insignificant number of investors are better off for following a market timer.

Being an agnostic myself, I therefore propose to present the data and let you decide how to resolve this debate for yourself. I'll rely on the investment newsletter performance database compiled by the Hulbert Financial Digest over the last two decades.

DESCRIPTIVE DATA

Before reviewing that data, however, I want to provide some descriptive data about market timing newsletters generally. I am indebted to Alok Kumar of Yale's School of Management, who has exhaustively studied the HFD's database of market timers (and whose findings are available at http://papers.ssrn.com under Abstract & Author, look for the title: Behavior of Momentum Following and Contrarian Market Timers.)

One of Professor Kumar's major findings is that there are only a few different types of market timers. This no doubt will come as a shock to the hundreds of timers out there, each one of whom is trying to differentiate himself by claiming an entirely unique approach and never-seen-before proprietary timing model. But in fact, according to Professor Kumar, almost

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all of the market timing newsletters tracked by the HFD fall into two broad categories—they either are contrarians or momentum players.

The difference between these two types has to do with their reaction to the market's recent performance. A momentum-based timer increases market exposure as the market goes up, while decreasing it as the market declines. A contrarian timer, in contrast, does just the opposite, reducing exposure as the market is bid upward and buying when the blood is running in the streets.

A prominent example of a momentum-oriented market timing newsletter is Fabian Premium Investment Resource. This service bases its timing signals on the 39-week moving average. If the market is trading above its average level of the previous 39 weeks, then this newsletter is on a buy signal. If not, it's on a sell signal.

A good example of a contrarian-based market timing newsletter is Investors Intelligence. This service bases its advice on its calculation of the consensus market forecast among all investment newsletters. As that consensus becomes more bullish, Investors Intelligence becomes more bearish, and vice versa.

An even more noteworthy finding of Professor Kumar's study, however, is that neither type of timer on average performs better than the other. This is surprising because, on first principles alone, one would expect momentum-based timers to do better in a bull market. But this hasn't been the case. Both Fabian's newsletter and Investors Intelligence, for example, have beaten the market in this and the last decade's bull market, their contrasting approaches notwithstanding. Since mid-1980, which is when the HFD began tracking Fabian's newsletter, its risk-adjusted performance has been 19% ahead of a buy-and-hold. And since the end of 1984, which is when the HFD began tracking Investors Intelligence, its risk-adjusted return is 34% ahead of a buy-and-hold.

MARKET TIMERS AND RISK

Another finding that emerges strongly from Kumar's study is that market timers significantly reduce the risks otherwise associated with investing in equities. He calculated the average beta of each of the market timers the HFD follows to be 0.60. [Beta is a measure of stock market risk, and a beta greater than 1.0 indicates that when the market rises or falls, the portfolio will rise or fall to a greater extent; a beta lower than 1.0 indicates that when the market rises or falls, the portfolio will rise or fall to a lesser extent.] The reason these newsletters have less stock market risk is that they are not always in the stock market, and when they are not in the stock market they are invested in T-bills, which have virtually no stock market risk.

The fact that market timers reduce risk doesn't necessarily mean they've added value, however. After all, you could reduce the risk in your own portfolio without paying for a market timer simply by allocating to cash some of what you would otherwise invest in stocks. To determine whether a market timer has added value, therefore, you need to judge the newsletter on a risk-adjusted basis. It has beaten the market on a risk-adjusted basis if risk was reduced by more than the performance forfeited in the process.

Consider, for example, the performance since the end of 1984 of a portfolio that used Investors Intelligence's timing advice to switch between hypothetical shares of the Wilshire 5000 and T-bills. This portfolio lagged a buy-and-hold strategy over these 14 years, gaining 14.4% annualized in contrast to 17.7% for buying and holding. At the same time, however, this portfolio was 49% less volatile, or risky, than buying and holding. That turns out to be good enough to beat the market on a risk-adjusted basis.

One way to think about this is to ask yourself: Would you be willing to give up 3.3 percentage points per year of return in exchange for having only half the stock market risk of a buy-and-hold portfolio?

Furthermore, you could be tempted by such a portfolio even if you don't want to reduce your risk by this much. Assuming you wanted to incur the same amount of risk as the market as a whole, you could have allocated twice as much of your wealth to following Investors Intelligence as you otherwise did to equities in general. Though your resultant risk over the last 14 years would have been no higher than the market as a whole, your performance would have been. Of course, there is no guarantee that this performance could be duplicated over the next 14 years.

RISK-ADJUSTED RATINGS

Table 1 reports the risk-adjusted performances of all market timing newsletters the HFD has followed over the last 15 years. The return calculations were conducted in the same way as reported above for Investors Intelligence—that is, each newsletter owned hypothetical shares of the Wilshire 5000 index when invested in the market, and otherwise invested in 90-day Treasury bills when out of the market. The risk reported in the table is based on standard deviation, a measure of volatility. The risk-adjusted return measures the return per unit of risk undertaken, and then relates it to the risk-adjusted return of the Wilshire 5000, which is equal to 100, with returns higher than 100 indicating a market-beating risk-adjusted return.

There is nothing magical about 15 years, of course. But we wanted to compare performance over a long enough period to encompass several different market environments. Yet if we extend the comparison period too many years, we eliminate too many newsletters from the comparison. (You'll notice, by the way, that Investors Intelligence isn't included

TABLE 1. TIMING-ONLY PERFORMANCE OF INVESTMENT NEWSLETTERS OVER 15 YEARS (JANUARY 1, 1984, TO DECEMBER 31, 1998)

(*Note: The performances in this table reflect timing advice only, and do* not *take into account the newsletters' recommendations of individual stocks or mutual funds.*)

Phone	Newsletter—Market Timing Strategy	Average Annual Return Last 15-Yrs (%)	Risk Relative to Wilshire 5000* (Wilshire = 100)	Risk-Adjusted Return Relative to Wilshire 5000* (Wilshire = 100)	Average No. of Switches Per Year**
(800) 442-9000	Market Logic—Seasonality Timing System	14.7	51.8	146.3	31.5
(516) 829-6444	Systems and Forecasts—"Time Trend" Timing Model —100% Cash on Sells	18.0	75.7	139.2	16.9
(562) 596-2385	The Chartist—Actual Cash Account	14.5	70.9	108.8	1.3
(800) 886-5075	Peter Dag Portfolio Strategy and Management—Vanguard No-Load Mutual Fund Portfolio	12.8	58.6	104.6	1.1
(800) 950-8765	Fabian Premium Investment Resource—Domestic Fund Composite	14.6	77.1	102.0	1.9
(978) 745-5532	The Cabot Market Letter—Model Portfolio	14.5	77.9	100.6	1.4
	Wilshire 5000 Total Return	**16.7**	**100.0**	**100.0**	**0.0**
(562) 596-2385	The Chartist—Traders Portfolio	16.3	95.9	99.7	0.3
(949) 497-7657	The Prudent Speculator	23.4	192.4	94.4	0.5
(800) 832-2330	Personal Finance—Growth Portfolio	15.3	94.9	92.7	0.3
(619) 454-0481	Dow Theory Letters—Primary Trend—100% Cash on Sells	12.4	63.0	92.5	1.3
(800) 423-4893	FundAdvice.com	11.9	58.6	91.5	3.0
(219) 931-6480	Dow Theory Forecasts	14.9	92.5	91.2	0.3
(203) 270-9244	BI Research	13.8	79.6	91.1	0.6
(770) 536-0309	The Elliott Wave Theorist—Investors—100% Cash on Sells	10.7	47.0	90.6	1.2
(800) 634-3583	The Value Line Investment Survey	13.8	84.5	87.1	0.2
(800) 442-9000	Market Logic	13.0	80.0	83.1	0.1
(508) 528-8678	The Addison Report—Aggressive Portfolio	12.7	75.7	83.0	4.0
(800) 845-8259	The Dines Letter—100% Cash on Short-Term Sells	12.1	71.9	80.6	4.7
(800) 852-1641	The Outlook	12.7	79.3	80.5	0.1
	LaLoggia's Special Situation Report—Master List of Recommended Stocks	13.0	84.5	79.9	0.4
(800) 955-8500	InvesTech Market Analyst	8.9	35.2	74.8	1.3
(301) 654-5205	Growth Stock Outlook	8.4	30.3	74.2	0.3
(816) 474-5353	The Granville Market Letter	12.1	89.1	68.6	1.3
(605) 341-1971	Growth Fund Guide—Timing Only: Mutual Fund Allocation	10.7	70.3	65.1	0.4
(800) 845-8259	The Dines Letter—Nearer-Term Trading Portfolio	10.3	67.2	63.2	4.9
(800) 868-7857	The Professional Tape Reader—Model Stock Portfolio	7.1	33.1	33.5	7.0
(816) 474-5353	The Granville Market Letter—Traders' Stock Portfolio	2.9	100.7	–15.7	2.5

** Risk defined as standard deviation, a measure of volatililty*
*** A round trip (once out and once back in the market) counts as two switches*

in the table; this is because the HFD has just 14 years of performance data for its market timing advice.)

Careful readers of the table will notice that 21 of the 27 market timing strategies—78%—did not beat the market over the last 15 years on a risk-adjusted basis. On the other hand, a not-insignificant number of them did—six of the 27 strategies reported in the table (22%) did outperform the market on a risk-adjusted basis.

The proportion beating the market seems to hold for other time periods as well. For all 305 timing strategies the HFD follows, regardless of how long they've been followed, Kumar also found that 22% beat the market on a risk-adjusted basis.

A MATTER OF INTERPRETATION

How should you interpret these results? Being an agnostic, I'll leave that to the reader. I would point out, however, that because only 22% of the market timing newsletters beat the market, the *average* market timer didn't add value. The implication of this is that if you pick your

market timing newsletter at random, you most likely will do less well than you could have if you bought and held an index fund instead.

Can you do better than random? Is there any way of increasing your odds of picking one of the letters that will be part of this 22% in the future? At least to some extent, yes. Research conducted by the Hulbert Financial Digest shows that your odds of success can be improved by picking those services that have beaten the market on a risk-adjusted basis over the long term. However, there are no guarantees that the past will repeat: Though your odds of success go up, there is no statistical assurance that you will beat the market on a risk-adjusted basis.

You should also note, however, that these performances do not take taxes into account. If you're using a market timer in a taxable account, your aftertax results would be lower than those reported here—and the presumption in favor of buying and holding would be stronger.

This warning especially applies for those timers who switch into and out of the market very frequently. You'll notice from the accompanying table that two of the newsletters that beat the market on a risk-adjusted basis were particularly active switchers.

To those who are afraid of investing in equities without using the services of a market timer, these results thus pose the following question: Why not instead reduce your equity exposure to your comfort level, and then invest that smaller amount for the longer term? Though you give up the possibility of beating the market, you also assure yourself of outperforming the majority of market timers.✦