HOW TO KNOW WHEN TO LET GO WHEN YOUR ADVISOR STARTS TO LAG

By Mark Hulbert

Most investors have no contingency plan for how to react if their chosen advisor doesn't perform as hoped—a major failing, since few investors are able to analyze their portfolio dispassionately and objectively once they have lost a lot of money. It's far better to have a contingency plan.

How long a leash should you give your chosen investment advisor: Should he be kept on a short one and given the boot at the first hint of lagging performance, or should you loosen the leash and give him more time to show his stuff?

I have been asked this question by a record number of individuals over the last year, reflecting the fact that most investors have no contingency plan for how to react if their chosen advisor doesn't perform as hoped.

That's a major failing, since few investors are able to analyze their portfolio dispassionately and objectively once they have lost a lot of money. It's far better to decide in advance how you will react if things don't work out as planned.

This article studies the performance of several possible contingency plans. Each plan was then tested against the investment newsletter performance database maintained by the Hulbert Financial Digest.

CONTINGENCY PLANS

I examined 64 separate decision rules, representing all possible permutations of the following four dimensions:

- *Years of Past Performance:* This measures the performance time period by which you measure your advisor—the longer the performance period, the longer the leash you put on your advisor. For this study, I looked at four different leash lengths: one, three, five, and 10 years. This allows me to test Hypothesis #1: Decision rules will perform better to the extent that they focus on longer-term performance.
- *Maximum Slippage:* This is another measure of leash length—do you give your advisor the boot if he drops from being ranked in first place, or do you let him slip further in the rankings before doing so? I looked at four different thresholds for switching advisors: a slippage in rank below the 95th percentile, below the 90th, below the 80th, and underperforming the Wilshire 5000. This tests my Hypothesis #2: Decision rules will do better to the extent that they allow a newsletter to slip further in the rankings before being given the boot.
- *Risk Adjustment*: One can either measure performance in terms of raw return, or in terms of risk-adjusted return. I studied both. This tests Hypothesis #3: Decision rules based on risk-adjusted performance will outperform those that focus on unadjusted performance only.
- *Portfolio Averages*: Some newsletters recommend more than one portfolio, so you can either measure the performance of multi-portfolio letters by averaging all the individual portfolios, or focus on each as a separate entity. I studied both. This tests Hypothesis #4: Decision rules will perform better if they focus on portfolio averages, since, in my opinion at least, the average performance is a better reflection of ability.

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TABLE 1. ADVISOR SWITCH RULES: YEARS OF PAST PERFORMANCE

	10 yrs	5 yrs	3 yrs	1 yr
Annualized Gain (%)	13.5	9.7	10.0	19.6
Volatility of Monthly Returns (%)	6.5	8.1	6.4	13.2
Risk-Adjusted Ratio*	0.15	0.09	0.09	0.16

**A measure of return per unit of risk. The higher the ratio, the greater the return based on the amount of risk undertaken.*

The 64 distinct contingency plans generated by these dimensions were tested from the time period beginning on June 30, 1990, through April 30, 2001. Each rule was reapplied on a monthly basis. If a newsletter no longer satisfied the decision rule, it was dropped in favor of the one that was in first place. To make an adjustment for likely transaction costs, 1% was debited for each newsletter switch.

ANALYSIS

The results were a mixed bag for my four hypotheses.

For starters, take a look at Table 1, which reports the results of the rules based on length of performance period. The decision rules that focus on performance over the trailing 10 years had both greater returns and higher risk-adjusted returns than those that focused on the trailing five or three years—consistent with my hypothesis. An exception is the strong performance of the decision rules that focus on one-year returns.

What explains this surprisingly strong showing? My hunch is that the decision rules focusing on trailing one-year returns are capturing the "momentum effect": Stocks that have performed the best over the trailing year tend to continue outperforming for another six months to a year. A decision rule that focuses on longer-term performance doesn't capture this effect, since in that case a newsletter's ranking will only sluggishly respond to a recent loss of momentum.

Note, however, that the decision rules based on one-year returns were significantly more volatile than any of the other decision rules, which explains why the one-year decision rules had an average risk-adjusted ratio only slightly higher than the 10-year rules. In other words, while the one-year decision rules may produce higher returns, they will produce volatility and risk that are correspondingly higher.

Also note that my calculations did not take taxes into account. If they had done so, the one-year decision rules would have performed less well.

The momentum effect also is evident in Table 2, examining the rules relating to slippage. Contrary to my hypothesis, the decision rules that performed the best were those that got rid of a newsletter as soon as its rank slipped below the 95th percentile. While these rules were more volatile, they were only modestly so, producing a significantly higher risk-adjusted ratio.

Another result I find interesting is that slipping below the Wilshire 5000 does not seem to be a particularly helpful basis for deciding when to get rid of a newsletter. The reason for this, I suspect, is that the Wilshire 5000 is a market cap-weighted index and thus heavily reflects the large-cap sector. Furthermore, most of the largest-cap stocks over the last decade have been growth stocks, as opposed to value stocks. A newsletter that focused on small-cap value might have been beating the average small-cap value stock but still seriously lagging the Wilshire 5000.

The momentum effect's fingerprints also are evident in Table 3, which reports results for rules relating to risk-adjusted performance. The decision rules focusing on risk-adjusted returns are not particularly impacted by momentum strategies—since momentum's higher returns are accompanied by higher risk, their risk-adjusted returns are no better. Thus, decision rules that focused on unadjusted performance were dominated by momentum strategies, and they therefore were significantly riskier than those that employed risk-adjusted performance. In consequence, the average risk-adjusted ratio of the former decision rules was only marginally greater than that of the latter.

Lastly, in Table 4 there does not appear to be any significant improvement in performance for decision rules that rank multi-portfolio newsletters on the basis of an average of their several portfolios. More research is needed to determine what this result means.

CONCLUSION

With regard to the length of time over which performance should be

TABLE 2. ADVISOR SWITCH RULES: PERFORMANCE SLIPPAGE

	Switch When Ranking Slips Below:			
	95 Perct'l	90 Perct'l	80 Perct'l	Wilshire 5000
Annualized Gain (%)	19.7	14.4	11.3	7.6
Volatility of Monthly Returns (%)	10.6	8.1	8.3	7.2
Risk-Adjusted Ratio*	0.16	0.13	0.10	0.09

**A measure of return per unit of risk. The higher the ratio, the greater the return based on the amount of risk undertaken.*

TABLE 3. ADVISOR SWITCH RULES: RISK-ADJUSTED VS. NON-ADJUSTED PERFORMANCE

	No Risk Adjustment	Risk Adjustment
Annualized Gain (%)	15.6	10.9
Volatility of Monthly Returns (%)	12.2	4.8
Risk-Adjusted Ratio*	0.13	0.12

**A measure of return per unit of risk. The higher the ratio, the greater the return based on the amount of risk undertaken.*

judged, my bias continues to be that longer is better. But if you are in a tax-deferred account and willing to play the high-risk momentum game of focusing on one-year returns, you have support within the data for your position, although not overwhelming support. From a risk-adjusted return perspective, you should be indifferent between decision rules based on 10 years or one year.

A similar conclusion applies to whether or not you focus on performance that is or is not adjusted for risk. Though my bias continues to be in favor of focusing on risk-adjusted performance, your decision should depend on your risk tolerance.

There does seem to be support for quickly getting rid of a newsletter when its rank begins to slip, however.

In fact, coupling this result with the others suggests that one of the better decision rules would be to focus on performance over the last 10 years and giving your newsletter the boot whenever its rank drops below the 95th percentile. These particular decision rules, in fact, were some of the best performing of any of the 64 I studied. ❖

TABLE 4. ADVISOR SWITCH RULES: RANKINGS BASED ON SINGLE VS. PORTFOLIO AVERAGES

	Rankings Based On: Portfolio Averages	Single Portfolios
Annualized Gain (%)	12.6	13.9
Volatility of Monthly Returns (%)	7.7	9.4
Risk-Adjusted Ratio*	0.12	0.13

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CHAPTER MEETINGS

Boston

Mon., June 18, Doubletree Guest Suites, 550 Winter St, Waltham. Speaker: Jonathan D. Pond, president, Financial Planning Information, Inc. Topic: “Making the Most of Your Money in the New Century.” Registration/cash bar, 6:00 p.m.; dinner, 6:30; program, 7:30.

Charlotte

Sat., June 9, Piedmont Natural Gas Co., Corporate Office, 1915 Rexford Rd., Charlotte. Speaker: George Dagnino, editor, Peter Dag Portfolio Strategy and Management. Topic: “Profiting in Bull or Bear Markets.” Registration, 9:30 a.m.; program, 10:00; Q&A, 11:30-12:00.

Eastern Michigan

Thurs., June 14, Bloomfield Township Library, Green Room LL, 1099 Lone Pine Rd., Bloomfield Hills. Speaker: Harry Veryser, chair, Economics and Finance Department, Walsh College. Topic: “The State of the Economy.” Registration/refreshments, 6:30 p.m.; program, 7:00.

Metropolitan Washington

Mon., June 11, Key Bridge Marriott Hotel, 1401 Lee Hwy., Rosslyn, Va. Speaker: Charles Babin, principal, Boston Research and Management. Topic: “Back to the Future: Putting a New Face on Timeless Investing Strategies.” Registration, 6:15 p.m.; dinner, 6:30; program, 7:00.

Piedmont Triad

Sat., June 16, Marriott Greensboro/High Point Hotel, Piedmont Triad Int’l. Airport, One Marriott Dr., Greensboro. Speaker: Donald L. Cassidy, senior research analyst, Lipper, Inc. Topic: “Stock Selling Discipline: Key to Investment Success.” Program, 10:00 a.m.; Q&A, 11:00.

Research Triangle

Sat., June 9, Dreyfus Auditorium, Research Triangle Institute, 3040 Cornwallis Rd., Research Triangle Park. Speaker: Andrew G. Marino, vice president, Oak Value Capital Management. Topic: “Value Investing.” Program, 9:00 a.m.

San Francisco

Wed., June 20, Hs Lordships Restaurant, 199 Seawall Dr., Berkeley. Speaker: Kevin Gahagan, senior advisor, Boone Financial Advisors, Inc. Topic: “Is It Time to Be Thinking International? Making the Case for International Investing.” Registration, 6:30 p.m.; program, 7:00; Q&A following program.