NEWSLETTERS VS. FUNDS: WHICH ARE THE BETTER PERFORMERS?

By Mark Hulbert

Newsletters do about as well as mutual funds when the focus is on the top rankings, but poorly when the focus is on the bottom rankings. If you are picking a newsletter, it's even more important to avoid the losers than to pick winners.

The Hulbert Financial Digest now has a full 18 years of performance data for investment newsletters, and to conclude that it's been an incredibly difficult period in which to beat the market would be an understatement. As you can see from Table 1, out of the 18 newsletters the HFD has followed over this period, only two have beaten the Wilshire 5000's total return. And on a risk-adjusted basis, none has done so.

How bad are these results?

By way of answering, I propose comparing newsletters' long-term returns with those of the mutual fund industry. By doing so, we'll be in a better position to understand whether beating the market has been incredibly difficult for everyone, or whether newsletter editors have reason to hang their collective head in shame over their long-term results. And in the process, we'll draw some cautionary lessons about how performance rankings can result in misleading conclusions.

Because 18-year mutual fund returns are not readily available, I chose here to focus on performance over the last 15 years, based on data from Lipper Analytical Service's performance review for equity mutual funds. I chose not to include Lipper's data for fixed-income funds in my comparison because none of the newsletters the HFD has followed for 18 years focuses exclusively on this sector. On a related note, I should mention that while newsletters over the years have had a heavy allocation to gold and international investments, mutual funds in both of these sectors are reflected in Lipper's equity mutual funds volume.

OVERALL STATISTICS

Did mutual funds do better than newsletters? The answer depends on whether we focus at the top or the bottom of the rankings. Let's start at the top. Of the 360 equity mutual funds for which Lipper has 15 years of data, 22 have bettered the 16.9% annualized return over this period of the Vanguard Index 500 fund. That means that 6.1% of this universe of mutual funds "beat the market."

In contrast, over this same period the HFD has data for 31 investment newsletter portfolios, of which only two—or 6.5%—produced a return in excess of 16.9% annualized.

To be sure, a sample size of just 31 newsletter portfolios is not large enough to draw very robust conclusions. But we nevertheless can say that, at least with data currently available, there's no reason to conclude that newsletters do better or worse than mutual funds in terms of beating the market.

It is true that the top-performing mutual funds over these 15 years outperformed the top-performing newsletters. The two newsletter portfolios that beat the S&P 500 over this period (the traders portfolio from The Chartist, and the portfolio of higher quality growth funds from the No-Load

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Fund X) produced annualized gains of 17.1% and 16.9%, respectively. In contrast, 19 mutual funds over the last 15 years did better than these two top-performing newsletter portfolios.

However, there may be less here than meets the eye. Several of these top-performing mutual funds are sector funds, for example, and it would be unfair to compare their returns with newsletters that maintain more diversified portfolios. In addition, the top-performing fund over these 15 years is the Sequoia fund, which has invested heavily in Berkshire Hathaway. Its success thus reflects more on Warren Buffett's prowess than it does on the relative market-beating abilities of funds and newsletters.

THE BOTTOM RANKINGS

The picture differs dramatically at the bottom of the rankings. First, consider the proportion of funds that produced less than a 10% annualized return over the last 15 years—just 12% of the 360 funds for which Lipper has data. In contrast, over 70% of the newsletters the HFD has tracked over 15 years have produced returns below 10% annualized.

This undeniably is a dramatic difference, but once again there is less here than meets the eye. Fund families will discard their losing funds, keeping only their winners. This significantly biases the results by making the fund industry look a lot better than it really is. In contrast, the HFD ranks newsletters on the basis of all of their portfolios, including those that may have been discontinued over the years.

How significant is this survivorship bias among mutual funds? Very. Professor Mark Carhart of the University of Southern California has studied fund attrition rates back to the early 1960s. He discovered that, on average, 3.6% of all mutual funds stop trading each year. That means that nearly half the funds that traded 15 years ago no longer exist. In fact, assuming this historical average held up for each of the last 15 years, that suggests there were more than 600 equity mutual funds that existed in 1983, in contrast to the 360 funds 15 years or older that still exist today. And because the discontinued funds undoubtedly were poor performers on average, it's little wonder that the surviving funds appear to do much better than the newsletters.

None of this is a criticism of the excellent Lipper rankings, by the way. When they report fund performance over the last 15 years, they have no choice but to focus only on those funds that have survived for the entire 15 years. Nevertheless, the

TABLE 1. INVESTMENT NEWSLETTER PERFORMANCE: 1980 TO 1998

Ranked in order of risk-adjusted performance

Telephone Number	Newsletter	Total Return (%)	Risk** (Wilshire = 100)	Risk-Adjusted Performance*** (Wilshire = 100)
301/654-5205	Growth Stock Outlook	12.2	55.3	92.6
562/596-2385	The Chartist	18.1	130.4	91.6
800/634-3583	The Value Line Investment Survey	17.4	123.0	90.2
800/763-8639	No-Load Fund X	14.9	99.8	84.3
714/497-7657	The Prudent Speculator	20.3	252.0	77.0
219/931-6480	Dow Theory Forecasts	13.0	94.8	68.2
800/950-8765	Fabian Premium Investment Resource	12.2	82.9	66.2
800/852-1641	The Outlook	11.8	86.7	60.5
800/442-9000	Market Logic	11.8	88.8	59.0
800/634-3583	The Value Line OTC Special Situations Service	11.8	186.0	43.9
707/935-6504	Kinsman's Stock Pattern Recognition Service	7.9	44.4	22.0
32/16-5336-84	International Harry Schultz Letter	7.3	91.9	13.2
605/341-1971	Growth Fund Guide	7.2	86.5	9.9
617/235-0900	United & Babson Investment Report*	6.1	91.0	0.0
816/474-5353	The Granville Market Letter	–22.5	618.8	–8.3
801/489-8681	The Ruff Times	4.5	108.3	–10.1
na	The Dines Letter	1.8	158.7	–16.1
800/868-7857	The Professional Tape Reader	1.8	63.4	–73.0
	Wilshire 5000 Index (dividends reinvested)	**16.8**	**100.0**	**100.0**

Newsletter performance is measured from June 30, 1980, through June 30, 1998.
na = not available
* *United & Babson Investment Report has disputed their HFD performance rating. For more information, log on to www.hulbertdigest.com/ub*
** *Risk as measured by standard deviation, a measure of volatility, normalized so that the Wilshire 5000 equals 100.*
*** *Risk-adjusted performance as measured by the Sharpe ratio, an indication of return per unit of risk undertaken, normalized so that the Wilshire 5000 equals 100.*

presence of survivorship bias means that you must be careful when drawing conclusions about an entire industry on the basis of the survivors alone.

Incidentally, I'm afraid that survivorship bias is only going to get worse. The SEC recently decided that, when a fund splits into two new funds, each of the successor funds will be able to claim the historical record of the predecessor fund. My suspicion is that we soon will begin to see a proliferation of "new" funds with great long-term historical returns.

For reasons I'm not sure of, survivorship bias doesn't seem to work in the same way for newsletters. Quite a few of the non-surviving newsletters were *ahead* of the market at the time they were discontinued. Prominent examples are two letters edited by Martin Zweig: the Zweig Forecast (which was discontinued a couple of years ago) and the Zweig Performance Ratings Report (which was discontinued this past February).

LOSING LETTERS

Nevertheless, the fact remains that a large percentage of newsletters produced very low returns over the last 18 years. Why might this be? The hypothesis that makes most sense to me comes from Peter Bernstein, editor of the Journal of Portfolio Management. His hypothesis focuses on the growing fear among money managers of tracking error risk (the fear not just that they will lag the market, but that they will lag it by a large amount). As a result of this fear, managers "are less willing than they used to be to make the kind of concentrated bets that are essential if the aim is to provide high excess returns."

Here's how Bernstein relates this tracking error risk to funds and newsletters: He hypothesizes that, compared to fund managers, newsletter editors are less concerned about tracking error. They don't have direct contact with clients, nor (in most cases) are they personally managing client accounts. Unconstrained by a preoccupation with tracking error, they therefore are free to take more out-of-the-mainstream bets on beating the market. To put it another way, fund managers are far more preoccupied than newsletter editors about failing unconventionally; if they are to fail, it's far better for them to fail conventionally. That's why we see fewer of them at the bottom of the rankings.

If I may be permitted a philosophical reflection at this point, I believe we all should be glad that newsletter editors are willing to take unconventional risks. In a world increasingly preoccupied with tracking error risk, it becomes even more important that advisers are willing to take risks to search for and explore possible market inefficiencies. Though we know that most of them will end up failing, we're all better off that they tried—a select few of them will come upon strategies that actually work.

Peter Brimelow, senior editor at Forbes and author of the classic "Wall Street Gurus" (Minerva Books, 1986), likens newsletter editors to a guerilla army: They are the first who are willing to risk walking across the investment minefields. Sure, most of them will get blown up before they reach the other side, but we're nevertheless better off because we can follow in the footsteps of those who succeed.

AVOIDING THE LOSERS

What does this mean for individual investors?

For starters, it suggests that you shouldn't dismiss the newsletter industry because of the relatively large number of market laggards. To be sure, if you were to pick a newsletter at random, you have a greater chance of lagging the market by a large margin than if you were to pick a mutual fund at random. But you can do better than picking at random.

The second implication is that when you are picking a newsletter, it's even more important to avoid the losing newsletters than it is to follow the winners. Here's why: The strongest correlations that exist between past and future performance exist at the bottom of the rankings. That is, a newsletter that has done exceedingly poorly over many years is a strong bet to do poorly over many years into the future. Therefore, if you simply avoid the losers, you already have a leg up.

To be sure, correlations also exist at the top of the rankings: A newsletter that has outperformed all others over the long term is a good bet to be top-ranked in the future. Good as that bet is, however, it's an even better bet that the worst performers will remain losers.

This means that when you focus on performance rankings, whether they are for newsletters or mutual funds, you shouldn't always go immediately to the top of the list, but you also should look at the bottom of the list and weed out those that you may be following. ✦