THE FOLLY OF PICKING ADVISORS BASED ON SHORT-TERM RETURNS

By Mark Hulbert

Investors who are obsessed by the short term can't leave their portfolios alone. They invariably become more active traders, to the detriment of the performance of their portfolios.

I'd be guilty of revisionist history if I claimed that at some point in the past, most investors analyzed performance in a statistically rigorous way. On the contrary, too many investors have always been far too overly impressed with the short term, mistakenly believing that such fluctuations have meaning.

But in comparison to some of today's investors, investors of old were paragons of statistical virtue. The Internet is a major co-conspirator in this regard. According to a 1996 study conducted by Galt Technologies, 77% of those who follow their investments on-line check their portfolios' worth at least as often as once per week. Incredibly, 21% of such investors check their net worth more than once a day.

Such short-term focus most definitely affects investors' behavior. Just as the Heisenberg uncertainty principle applies in the physical realm (it states that it is impossible to measure a subatomic particle without affecting it), investors obsessed by the short term can't leave their portfolios alone. They invariably become more active traders.

Very revealing in this regard is an experiment conducted by University of Chicago economics professor Richard Thaler and the late Stanford University psychologist Amos Tversky. Two groups of investors were asked to make asset allocation decisions over a hypothetical multi-year time horizon, with one group receiving updates on the performances of each asset class every month and the other only once every five years. The group receiving performance updates every month became preoccupied with quarterly fluctuations and had a significantly lower allocation to stocks than did the other group. They consequently earned lower returns.

I propose in this article to add yet more evidence to the case against an obsession with short-term performance. The perspective I take is of an investor who intends to switch advisers every January 1. I do so not because I think investors should switch horses this often; I don't. I believe investors should keep their chosen advisers on a longer leash than this. I nevertheless adopt this switch-advisers-once-a-year perspective in order to show that, even if you were to do so, you still ought to pick your advisers on the basis of performance over the long term.

THE DATA

I use the Hulbert Financial Digest's (HFD) 20-year database of investment newsletter performance to make my case. Imagine first how you would have performed if you had invested each January 1 in the best-performing newsletter portfolio over the calendar year just ended. That is, on January 1, 1999, you would have started following the newsletter portfolio that did the best for calendar year 1998 (which, by the way, was the so-called "Rulebreaker Portfolio" maintained by the Motley Fool, an on-line newsletter, with a 1998 gain of 192.4%). You'd follow this portfolio for 12 months, switching advisers on January 1, 2000, to the newsletter that turns out to have per-

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formed the best during the calendar year 1999.

How has this strategy performed in back testing? Extremely poorly. From the beginning of 1991 through mid-1999, such a strategy has produced an annualized *loss* of 36.6%! Over this same period, by the way, the Wilshire 5000 index gained 18.4% annually.

Clearly, great performance over the short term more often than not turns out to be unsustainable. In some cases, in fact, extraordinary one-year gains are followed by equally extraordinary losses in the following year. Choosing your adviser based on short-term performance most likely will be hazardous to your wealth.

By the way, don't conclude from this that you'd do any better by switching each January 1 into the previous year's worst performer. In fact, you wouldn't—you would have done even worse. Over these same 8½ years, according to the HFD, such a strategy would have produced an 83.6% annualized loss (essentially losing everything).

LONGER-TERM RETURNS

Next, consider your profit assuming that each January 1 you switch to the adviser with the best trailing five-year return. For example, last New Year's you would have switched to the "Conservative U.S. Stocks" portfolio maintained by the Investment Reporter (with a trailing five-year gain through December 31, 1998, of 30.2% annualized). You would follow this portfolio for all of 1999, and then on January 1, 2000, switch to the newsletter with the best return over the five years 1995 through 1999.

This strategy of following the five-year leaders has done much better than the strategy of following the one-year leaders. In contrast to a 36.6% annualized loss, the strategy of following the five-year winners gained 18.2% annually from January 1, 1991, through June 30, 1999. To be sure, this still is below the Wilshire's 20.4% return over the same period. But it's worlds apart from the huge losses that accompany the strategy of following the one-year leaders.

Your performance would have been even better if you switched each January 1 into the 10-year best performer. In that instance, you would have earned 21.6% annually from January 1, 1991, through June 30, 1999, or 3.4 percentage points per year better than the strategy of following the five-year winners. At the beginning of this year, for example, this strategy would have started following the portfolio with the best return over the 10 years from January 1, 1989 through December 31, 1998—OTC Insight's so-called "$200,000 Aggressive Portfolio," with a 10-year gain of 35.0% annually. You'd follow this portfolio until the end of 1999, at which point you'd start following whatever newsletter at that time had the best return over the 10 years from January 1, 1990, through December 31, 1999.

This strategy of following the 10-year winners also did better than the Wilshire 5000 over this period. However, this does not take into consideration taxes. And such a strategy was more volatile than the Wilshire and therefore lagged it on a risk-adjusted basis.

CONCLUSION

The inescapable conclusion: Even if you switch advisers as often as every year, you still should choose which ones to follow on the basis of long-term performance. There is no magical length of time on which you should focus, but it should encompass at least five years and preferably a longer period than that.

Table 1 lists the top five newsletters from the HFD's database for performance through June 30, 1999, over the trailing 10 years and 15 years. I'm willing to bet a year's subscription to the Hulbert Financial Digest that a strategy of following newsletters that each year are on this list will do much better than a strategy that continually shifts into last year's best performer.◆

TABLE 1. LONG-TERM TOP NEWSLETTER PERFORMERS

The Top Five Performers Over 15 Years (through 6/30/99)

Telephone	Newsletter	15-Yr Annualized Gain (%)
(949) 497-7657	The Prudent Speculator	19.5
(562) 596-2385	The Chartist	19.3
(800) 634-3583	The Value Line Investment Survey	15.9
(800) 763-8639	No-Load Fund-X	15.8
(800) 804-0942	Investor's World	15.6

The Top Five Performers Over 10 Years (through 6/30/99)

Telephone	Newsletter	10-Yr Annualized Gain (%)
(800) 955-9566	OTC Insight	30.4
(800) 454-1395	MPT Review	22.8
(800) 327-6720	New Issues (no longer published)	21.3
(562) 596-2385	The Chartist	19.4
(818) 346-5637	Fundline	19.0

Source: The Hulbert Financial Digest