TRADING VERSUS HOLDING IN A ROLLER-COASTER STOCK MARKET

By Mark Hulbert

An examination of trading performance last year indicates that you can better capture the value of an investment newsletter's advice by ignoring its shorter-term trades and treating its current recommendations as longer-term advice.

I doubt you'll ever hear money managers saying so, but they should have welcomed last year's volatile stock market. This isn't because they sadistically get pleasure from investors' pain, but because the year 2000 presented the best opportunity in years for them to actually beat the market—in other words, to show that they are worth their fees. Markets that go more or less straight up, in contrast, don't present as good a showcase of investment talent.

Consider a money manager who focuses on the kind of growth stocks that dominate the Nasdaq composite. That index itself gained 26% through mid-March, fell by 41% through mid-May, gained 41% through late summer, and then declined by more than 42% through the end of the year—travelling a total of 150 percentage points on the way to losing 39.3% for the year as a whole.

To beat the market, all an adviser would have had to do is sidestep even a small portion of those two 40%-plus declines. Any short-term trader worth his or her salt ought to have been able to do that.

Believe it or not, however, only a minority of advisers who focused on such stocks during 2000 was able to better the Nasdaq composite. And that's one reason why, I suspect, that so few money managers yearn for markets like last year's. Most of them are like the prizefighter who publicly begs for the title bout but secretly hopes to never have to fight.

The inability of these growth managers to beat the Nasdaq market may come as a surprise to you, particularly if you have read the mutual fund rankings columns recently and found that nearly two-thirds of domestic equity mutual funds in 2000 did better than the S&P 500. The problem with this statistic is that the S&P 500 is not necessarily the best benchmark against which to judge a manager's performance. The index is dominated by a few large-cap growth stocks, and the large-cap growth stock sector was one of the poorest performers for the year. So it's hardly surprising that a lot of managers look different by comparison, particularly those that did not focus as much on growth stocks. In contrast, the 50% of stocks that fall closer to the value end of the spectrum actually had a decent year.

In this article, I judge advisers' performance by a different standard that avoids comparisons to general benchmarks such as the S&P 500 and focuses instead on the managers' own style. I then apply this standard to the several hundred model portfolios recommended by investment newsletters that are tracked by the Hulbert Financial Digest (HFD).

TAILORED MEASURES

One way of determining whether advisers' trading abilities added value in 2000 is by comparing each of them to a benchmark that is tailored to his or her kind of stocks. To calculate these benchmarks, I constructed a hypotheti-

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cal portfolio for each newsletter that bought and held for the entire year what it was recommending at the beginning of the year.

The rationale for comparing advisers to these benchmarks is simple: Any change that an adviser recommended during the year to his or her model portfolio was in expectation that he or she would be improving their performance. Only if that turned out to be the case can we fairly say that value was added through the advisor's trading activity.

Figure 1 reports the results that emerged when I applied this standard to all the portfolios monitored by the HFD. To do so, I simply froze into place whatever the newsletter was recommending at the beginning of the year. If a security stopped trading during the year, I credited to the portfolio whatever the value of that security was at the point it stopped trading.

The results? Fully 53% of the newsletters' actual model portfolios were worse off on December 31, 2000, than they would have been if they had simply stuck with whatever they were holding at the beginning of the year.

There's another way of reporting this result. Let's assume that you had $1 million at the beginning of 2000, and you divided it equally among all the newsletter portfolios the HFD was tracking. If you dutifully followed each newsletter's recommendations in each of these portfolios, at the end of the year 2000 your $1 million would have shrunk to $964,054. In contrast, if you made no changes through the year to the portfolios you created at the beginning, your $1 million would have shrunk by a slightly smaller amount—to just $966,343.

Also, you should note that my calculations do not take taxes into account. If they had, then the hypothetical frozen portfolios would show an even greater advantage than they do already. In short, you could have come out slightly ahead despite doing absolutely nothing during the year—not having to call advisers' telephone hotline updates, log on to their Web sites, track their contingent advice, and so on.

You might be tempted to take exception to my generally pessimistic conclusion because, even though the majority of newsletter editors were unable to add value during the year, a relatively large minority—47%—were in fact able to do so. I suggest resisting this temptation. The only

FIGURE 1. NEWSLETTER PERFORMANCE RELATIVE TO BENCHMARKS IN YEAR 2000

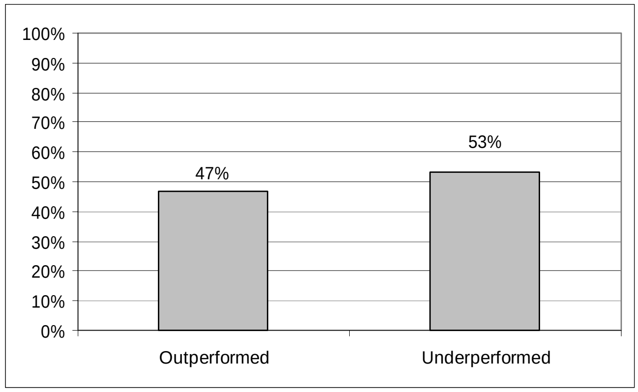


TABLE 1. TRADING VS. HOLDING: HOW THE TOP 10 NEWSLETTERS FARED IN 2000

Reports the actual performance of the newsletter's portfolio and the performance that would have been achieved if the portfolio recommended on January 1 had been held throughout the year and no trades had been made.

Newsletter (Portfolio)	Actual Gain in 2000 Gain (%)	No Trades: Gain based on 1/1/00 Portfolio (%)
OTC Insight* (800/955-9566)	–31.9	–7.2
The Prudent Speculator* (949/497-7657)	2.5	–13.0
Timer Digest (203/629-3503)		
Dow Jones 30 Portfolio	–22.9	–17.1
Diversified Select Fund Portfolio	8.8	–12.7
Model Stock Portfolio	12.8	11.8
Fidelity Select Portfolio	–0.4	–28.2
MPT Review* (800/861-5968)	–15.1	–15.2
Insiders (800/442-9000)	17.6	21.2
Equity Fund Outlook (800/982-0055)		
Tax Advantaged Portfolio	–2.2	–22.7
Taxable Portfolio	–11.0	–28.3
Turnaround Letter (800/468-3810)		
Conservative Portfolio	36.8	21.8
Moderately Aggressive Portfolio	–32.3	–27.0
Aggressive Portfolio	–22.5	79.2
Oberweis Report* (800/323-6166)	–17.3	–20.0
No-Load Fund X* (800/763-8639)	2.3	–20.0
Chartist (562/596-2385)		
Actual Cash Account	–23.5	–22.3
Traders Portfolio	–14.8	–0.2

**Newsletter recommends more than one portfolio; a representative portfolio was chosen to appear in this table.*

good that this statistic could do you is if there had been any way in advance for you to pinpoint which newsletters were going to add value during 2000. I know of no such way.

In fact, the newsletters with the better track records as of the beginning of the year did no better, as a group, than those with inferior records. For example, I divided all the 496 portfolios the HFD tracked for the year into two groups, with the 50% having the best lifetime records going into Group A and the remaining 50% into Group B. There was no statistically significant difference between Groups A and B in the advisers' abilities to do better than simply sticking with whatever they were recommending at the beginning of the year.

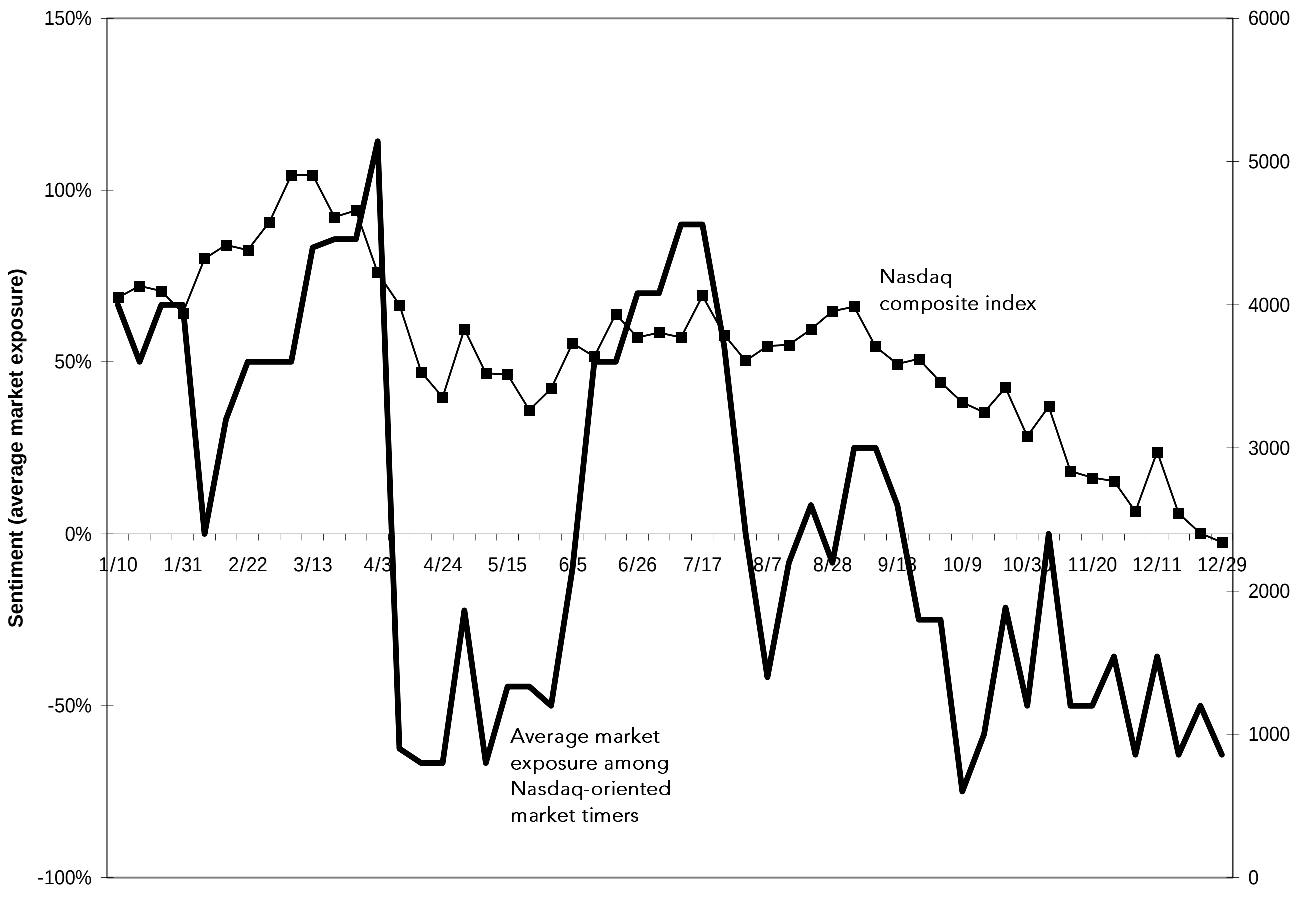
With no way to know in advance which advisers would be adding value during the year through their trading, the best anyone could hope for is mere randomness. Therefore, even though 47% of advisers were able to add value, the fact remains that the odds would have been against you at the beginning of the year when picking an adviser who would beat the market. Table 1 illustrates the results for representative portfolios from the top 10 performing newsletters. For half of these portfolios, you would have been better sticking with their beginning-year recommendations.

WHAT THE RESULTS MEAN

You do need to be careful when drawing lessons from these results. They do not show, for instance, that newsletters are not worth following. Instead, my results simply show that, on balance, their short-term trading is not profitable. To put it another way, you can capture the value added by the average newsletter by ignoring its shorter-term trades and treating its current recommendations as longer-term advice.

To illustrate, consider the performance of the so-called "Expanded Edition" of the Value Line Investment Survey, which focuses on several thousand secondary issues that are not covered by Value Line's regular, original edition [this newsletter did not make it onto the Table 1 list]. The HFD calculates that an investor would have lost 3.2% if during 2000 the investor each week had sold those stocks that this

FIGURE 2. NEWSLETTER SENTIMENT RELATIVE TO THE NASDAQ COMPOSITE OVER THE LAST YEAR



expanded edition downgraded and bought the newly upgraded ones. You might consider a 3.2% loss not to be all that awful, given the carnage experienced by some other secondary issues. But you could have made 12.0% for the year, 15.2 percentage points more, simply by buying and holding what this service was recommending at the beginning of the year.

But this doesn't mean that Value Line's advice was not worthwhile. It simply means that it was poorly served by making weekly adjustments to its portfolio. The best way to capitalize on Value Line's advice in its expanded edition would be to treat its recommendations as longer-term advice.

There no doubt are many reasons why advisers had such a difficult time adding value through their shorter-term trading, even in a year such as 2000 that provided so many opportunities to shine. But one of the most important reasons surely was the failure to be disciplined. Beating the market requires the discipline to stick with one's strategy through thick and thin, which turns out to be quite difficult. The market's gyrations exert a powerful gravitational pull on advisers' emotions, tempting them to become more and more bullish as the market rises and more bearish as it declines. Unfortunately, more often than not that turns out to be a losing strategy.

Take a look at Figure 2, which plots advisory sentiment during the year 2000 among those newsletters that focus on the Nasdaq composite index. This data series was calculated by averaging the percentage market exposure that these newsletter editors were recommending. In general, you can see from the chart how rallies in the Nasdaq composite seduced advisers into greater and greater exposures, while declines led them to reduce exposure. For example, the peak of advisory bullishness during 2000 came in late March/early April, at what in retrospect we now know to be the Nasdaq composite's high for the year. This subset of advisers became quite bearish in May and June as the Nasdaq composite fell, and thus were out of the market as it began its summer rally.

The frozen portfolios that the HFD constructed as benchmarks were immune from these emotional pulls. They stayed the course regardless, sticking with whatever the newsletters were recommending at the beginning of the year.

It's a crude discipline, but a discipline nonetheless.❖

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