

WATCH WHAT NEWSLETTERS DO, NOT WHAT THEY SAY THEY'LL DO

By Mark Hulbert

Although many investment newsletters say they are value-oriented, the data indicates they are more growth-oriented, probably because newsletter editors, like many of us, find it easier to buy stocks that are currently in fashion.

Investors face two related problems when searching for an adviser who will embody a certain investment style. The first is definitional: Even among advisers who say they are doing the same thing, there is an incredibly wide variation in what they actually do. Some advisers who say they are value-stock pickers, for example, actually are recommending growth stocks.

The second is evolutionary: Advisers don't always stick to their game plans. For example, they might start out as a value investor and gradually, over time, become increasingly growth-oriented. Style shift can have serious consequences. A pension consultant once complained to me about one of his client corporations that had hired seven value and several growth managers to run various portions of their pension fund. Several years later, upon analyzing what these managers actually were doing, the consultant discovered that this corporation in fact had 13 growth managers and only one value manager.

The same problems crop up when choosing an investment newsletter. Fortunately we now have some data with which we can determine which newsletters are which. The data comes from an extensive study of the Hulbert Financial Digest newsletter database conducted by Harvard Economics Professor Andrew Metrick (the October issue of the *Journal of Finance*). Among other things, Metrick graded newsletters along three dimensions: large cap vs. small cap, value vs. growth, and contrarian vs. momentum.

GROWTH VS. VALUE

The definition of value that Metrick used is the ratio of price to book value. A company that has a low ratio is considered to be more value-oriented than one with a higher ratio. To be sure, this isn't the only definition of value, but it is objective, and thus immune to the subjective considerations that lead to style shift.

Here's how Metrick graded newsletters along this dimension: He periodically segregated all stocks listed on the New York Stock Exchange into five quintiles according to their price-to-book-value ratios; stocks in the quintile with the lowest price-to-book-value ratios were given a grade of five, while those with the highest ratios earned a grade of one. For grading stocks on the American Stock Exchange and Nasdaq National Market, Metrick used the breakpoints between the NYSE quintiles.

For each newsletter, Metrick then averaged the grades received by each of its stocks. A newsletter with a grade of five, therefore, would be one whose stocks always fell within the quintile having the lowest ratios of price-to-book value. Table 1 lists the five newsletters with the highest ratios of price to book value among all those tracked by the Hulbert Financial Digest, while Table 2 lists the five with the lowest ratios—the most growth-oriented newsletters.

A number of interesting patterns emerge from the data. For starters, notice that none of the newsletters' grades in Table 1 is very close to 5.0, the highest value-oriented score. In fact, only one letter has a grade above 4.0. Consider

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GRADING NEWSLETTERS BY INVESTING STYLE

Table 1. The Most Value-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(800) 832-2330	Utility Forecaster	4.02	1/1/93	9.2	20.4	92.6	35.7
(800) 392-0992	FXC Newsletter	3.70	1/1/88	13.8	18.4	71.6	90.2
(914) 632-0422	Investors Intelligence	3.63	1/1/87	10.7	17.0	62.2	74.0
(508) 757-2881	Contrarian's View	3.50	1/1/91	2.2	20.5	86.4	-13.2
(800) 468-3810	Turnaround Letter	3.49	1/1/88	13.6	18.4	193.1	43.9

Table 2. The Most Growth-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(800) 634-3583	Value Line Spec'l Situations Serv	1.32	7/1/80	11.8	17.0	183.0	44.5
(847) 945-4700	The Pure Fundamentalist	1.37	1/1/94	33.2	22.2	176.4	94.0
(510) 843-1857	Medical Tech'gy Stock Letter	1.43	1/1/85	7.9	18.4	380.8	31.6
(800) 832-2330	Growth Stock Winners	1.48	1/1/95	7.7	28.0	231.2	16.5
(714) 641-3579	Blue Chip Investor	1.56	1/1/91	12.1	20.5	119.4	45.1

Table 3. The Most Momentum-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(800) 832-2330	Growth Stock Winners	4.99	1/1/95	7.7	28.0	231.2	16.6
(800) 955-9566	OTC Insight	4.95	8/1/87	24.3	15.3	242.8	95.1
(800) 454-1395	MPT Review	4.92	1/1/85	26.8	18.0	183.4	99.1
(800) 487-7626	Hussman Econometrics	4.74	1/1/91	11.1	20.5	164.5	32.7
(800) 634-3583	Value Line Investment Survey	4.67	7/1/80	17.9	17.0	117.6	95.8

Table 4. The Least Momentum-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(800) 468-3810	Turnaround Letter	2.56	1/1/88	13.6	18.4	193.1	43.9
(650) 726-8495	California Tech'gy Stock Letter	2.67	1/1/83	2.0	17.3	219.8	5.8
(800) 477-3400	The Ground Floor	2.68	1/1/94	2.4	22.2	259.0	8.9
(800) 327-6720	New Issues	2.78	1/1/83	12.6	17.3	159.6	49.0
(888) 417-5400	Equities Special Situations	2.82	1/1/87	6.6	17.0	143.7	21.1

* Annual returns for newsletter and Wilshire are for periods beginning when HFD data began coverage and through April 30, 1999.

Source for all data except the "Metrick Grade": The Hulbert Financial Digest. For a copy of Metrick's data, go to www.cob.ohio-state.edu/~fin-journal/archive_papers/issoc99/ms6346.pdf.

what this means: In a ranking of all NYSE stocks from most to least value, the average stock recommended by a letter with a 4.0 grade would fall between the 60th and 80th percentiles. Yet only one letter has a grade above 4.0.

Another way of appreciating the significance of this is realizing that a

grade of 3.0 would mean that a newsletter's average stock pick falls in the middle of the range between value and growth. But even the most value-oriented newsletters have a Metrick grade that's not all that far from 3.0. This suggests that newsletters as a group shun stocks that are closest to the value-end of the

spectrum, favoring growth stocks instead. The average Metrick grade of all newsletters the HFD tracks is 2.41 (with 1.0 representing pure growth and 3.0 being the midpoint).

What's the explanation? My own interpretation is that investment newsletter editors are human, and they, like the rest of us, find it easier

GRADING NEWSLETTERS BY INVESTING STYLE (CONTINUED)

Table 5. The Most Small-Cap-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(757) 877-5979	The Bowser Report	1.00	1/1/93	2.8	20.4	207.2	5.8
(800) 477-3400	The Ground Floor	1.05	1/1/94	2.4	22.2	259.0	8.9
(888) 417-5400	Equities Special Situations	1.24	1/1/87	6.6	17.0	143.7	21.1
(617) 332-3323	Richard Geist's Strategic Inv'g	1.54	1/1/96	-26.7	25.6	197.6	-79.5
(212) 843-2777	Indiv. Investor's Spec'l Sit'ns Rep	1.61	1/1/91	13.6	20.5	250.3	34.9

Table 6. Most Large-Cap-Oriented Newsletters

Telephone Number	Newsletter	Metrick Grade	HFD Data Begin	Annual Return* (%)	Wilshire Return* (%)	Risk (Wilshire = 100)	Return (Wilshire = 100)
(800) 477-3400	Beating The Dow	4.92	1/1/93	19.6	20.4	122.7	79.9
(714) 641-3579	Blue Chip Investor	4.77	1/1/91	12.1	20.5	119.4	45.1
(32) 16-5336-84	Inter'l Harry Schultz Letter	4.74	7/1/80	5.9	17.0	92.8	0.9
(215) 862-1313	US Investment Report	4.59	1/1/92	9.8	18.9	158.7	31.2
(617) 235-0900	Babson & United Invest Report†	4.51	7/1/80	6.4	17.0	89.4	4.3

* Annual returns for newsletter and Wilshire are for periods beginning when HFD data began coverage and through April 30, 1999.

† Babson-United Advisors has disputed the HFD's calculations; see www.hulbertdigest.com/ub.

Source for all data except the "Metrick Grade": The Hulbert Financial Digest. For a copy of Metrick's data, go to www.cob.ohio-state.edu/~fin-journal/archive_papers/issoc99/ms6346.pdf.

to buy stocks that are currently in fashion. This usually means they recommend growth stocks. After all, the news about growth stocks is generally good, particularly these days. Just the opposite is true for stocks at the value end of the spectrum. Recent news about them generally is poor, and the market has bid their prices down. Holding them in spite of this requires courage that many investors, and evidently many newsletter editors, do not possess.

MOMENTUM

This suspicion about newsletter editors' psyches is confirmed by another of Metrick's measures: momentum. Metrick defines momentum in terms of the trailing one-year performance of all U.S. stocks. If a newsletter's stocks always fell within the 20% that gained the most, then it would be given a grade of 5.0. Such a newsletter would be favoring stocks with the greatest momentum.

Conversely, a newsletter that always picked stocks among the 20% with the worst trailing one-year performance would be given a grade of 1.0. Such a newsletter would pick stocks with the lowest momentum; some would refer to this service as a contrarian letter.

The pattern in Table 3, which reports the five newsletters with the highest momentum grades, and Table 4, which reports the five letters with the lowest momentum grades, is similar to the pattern in Tables 1 and 2 (the value and growth newsletters). Notice how far the grades of even the most contrarian-oriented letters (Table 4) are from a grade of 1.0. In fact, their grades are not far from 3.0—the midpoint in the spectrum between contrarian and momentum.

The way to read this result: Newsletters shun stocks that have performed the worst over the last year. Indeed, almost all newsletters' picks fall within the 60% that have performed the best on a trailing 12-

month basis. The 40% that have performed the worst are rarely recommended. As is the case for value stocks, it takes guts to continue recommending a stock that has performed the worst.

This wouldn't be a cause for concern if last year's dogs continued to perform poorly. But, depending on how long stocks are held, just the opposite can be the case. A number of studies suggest that, though yesterday's worst performers may continue to be poor performers for a few months longer, they often are among the best performers over the subsequent three to five years. Unfortunately, newsletters are not a good source of advice about such stocks.

LARGE CAP VS. SMALL CAP

The third dimension on which Metrick graded newsletters is between large- and small-cap stocks. As is the case for growth and value, this is an area in which advisers put

widely varying meanings to the same words.

Consider the very specific definition that arose from the first academic studies to discover that small-cap stocks outperform large caps over the very long term. Those studies defined small cap to be companies whose market capitalizations would place them among the smallest 20% of NYSE companies. This turns out to be very small indeed. To currently qualify using this definition of small cap, for example, companies' market caps would have to be no larger than around \$200 million. And yet many so-called small-cap mutual funds have portfolios whose average market cap is over \$1 billion, with some exceeding \$2 billion.

Metrick graded newsletters using the original academic definition of small cap. Thus, if a stock's market cap would place it within the bottom quintile of all NYSE stocks, it would be given a grade of 1.0. At the other end of the spectrum, stocks in the quintile with the largest market caps were given a grade of 5.0.

Table 5 lists the five newsletters whose average stock recommendations have the lowest market caps, while Table 6 lists the five whose stock picks on average have the largest market caps. In contrast to the dimensions of momentum and value, where newsletters are significantly skewed toward one end of the spectrum, newsletters span the entire spectrum of small to large capitalization. Thus, for example, there are newsletters at the small-cap extreme of the spectrum, with a Metrick grade of 1.0, which means that each and every one of their stock picks would qualify for the smallest quintile of NYSE stocks. And at the other end of the spectrum, there are newsletters with grades close to 5.0.

CONCLUSION

All of the tables list each newsletter's annual performance since the HFD began coverage of it. For comparison, the annual return for the Wilshire 5000 for the same time period (since HFD began coverage of the newsletter) is also provided. The tables also list each

newsletter's risk level and risk-adjusted performance (this is not an actual return an investor would receive, but rather a measure of the return per unit of risk in the portfolio). Among the newsletters listed in any given table, you should favor those with the highest risk-adjusted return.

Be careful not to place too much weight on performance comparisons between newsletters in the different tables. In a market dominated by large-cap and growth stocks, for example, as it has been this decade, it's much more difficult for a small-cap value newsletter to beat the broad market averages. By comparing such a newsletter's performance to large-cap growth newsletters, you'd likely dismiss it as not worth following. And yet during those phases of the market cycle in which small-cap value stocks perform well, such a newsletter is likely to be a stellar performer.

It's a far better idea to diversify your portfolio among a few investment styles. And then, within each style, follow the newsletter that has the best risk-adjusted performance. ♦

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