Some newsletters have large model portfolios, trade frequently, and are appropriate only for large investor portfolios. Others work quite well for small portfolios.

What Portfolio Size Is the Best Fit for Following an Investment Newsletter?

By Mark Hulbert

How big should your portfolio be before following the advice of an investment newsletter starts to make sense? It depends on the newsletter. Some are appropriate for only the largest of portfolios: They maintain sizable model portfolios and trade frequently in them. In contrast, others will work just fine for portfolios that are no larger than just a few thousand dollars.

One way to get an answer is to examine the optimal portfolio size for an individual who follows the advice of the past decade's top-performing investment newsletters (as calculated by the Hulbert Financial Digest). In this article, I've come up with an estimate of how large your portfolio should be before following these newsletters.

Commissions

One of the primary issues facing any investor who is following a newsletter's advice concerns transaction costs, which can take a significant bite out of your performance if you are not careful.

Typically, smaller portfolios pay a higher percentage in transaction costs than do larger ones, all other things being equal, because the size of their individual trades tends to be smaller, commissions typically take a bigger bite out of small trades then large ones. How big must a portfolio be before typical discount brokerage commissions are as low as those assumed in the HFD newsletter rankings?

In devising my answer, I used the HFD's standard commission assumptions as a guide. For stocks, the HFD assumed that one-way commissions were 1% through the end of 1996, and 0.75% for trades since then. At the nation's three largest discount brokers (Schwab, Fidelity and Quick & Reilly), an average of around $10,000 is needed to be allocated to each transaction for one-way stock commissions to amount to no more than what the HFD assumes. (The precise level depends on whether the stock is low- or high-priced.) What this means is that a portfolio with, say, 100 stocks in it would need to be worth around $1 million to keep one-way commissions as low as those assumed by the HFD.

However, this $1 million total overstates what a subscriber to such a newsletter would actually need to have in order to keep commissions as low as 0.75% each way, because an investor need not purchase each of a newsletter's 100 stocks in order to mimic the newsletter's performance. As long as an investor constructs a diversified portfolio from these 100 stocks, his performance will closely match what is reported by the HFD for all 100.

How big must this subset be? The academic studies I have seen suggest that, at a minimum, a portfolio must contain 15 stocks picked randomly from the overall list in order to be adequately diversified. In practical terms, therefore, this means an investor could follow a newsletter with a 100-stock model portfolio with as little as about $150,000.

Is this $150,000 level set in granite? Of course not. For starters, there are discount brokers with lower rates than those of the Big Three. Let's say that you invest with a deep discounter from which you can obtain average one-way commissions of 0.75% with just $5,000 allocated to each position. In that event, your minimum portfolio size could be as low as $75,000. However, since the majority of investors who use discount brokers use Schwab, Fidelity or Quick & Reilly, I will stick with $150,000 as the minimum portfolio size in the accompanying table.

Another factor that influences the minimum necessary portfolio size is the frequency of trading. A portfolio that doesn't trade very often can afford to pay higher commissions on those few occasions when it does trade. Consider New Issues, for example, published by the Institute for Econometric Research. It is in third place for overall performance over the last decade (see Table 1). As you can see, the average holding period of its holdings as of August 31, 1997, was 2,451 days—nearly 7 years. You could have followed this newsletter with individual positions of

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less than $10,000 each and thus with a portfolio worth significantly less than $150,000 and still have come quite close to what the HFD has reported for it.

At the other end of the spectrum are newsletters whose average holding periods are very short. Take OTC Insight (edited by Jim Collins) and MPT Review (edited by Louis Navellier), for example, which are in first and second place, respectively, for performance over the last decade. Each has average holding periods of around six months, which implies two round trips per year. Keeping per-trade commissions low is thus much more crucial for services such as these than it is for services such as New Issues.

Mutual Fund Letters

This discussion helps us understand why we get so many requests to add mutual fund newsletters to the list of those we monitor. Such newsletters reduce the minimum necessary portfolio size to a much lower level. In fact, mutual fund letters bring this minimum down to the minimum initial investment that is set by the mutual fund—typically just a few thousand dollars.

Consider the top-performing mutual fund letter over the last decade:

Table 1.
Top 25 Performing Newsletters Over Last Decade (8/31/87 to 8/31/97)

Phone Number	Newsletter	No. of Securities Held*	Average Holding Period (days)*	10-Year Gain (%) (annual)	Risk-Adjusted Return (Wilshire = 100)
Top-Performing Stock Newsletters (Optimal Portfolio Size: At Least $150,000)					
(800) 955-9566	OTC Insight (portfolio average)	24	176	24.3	111.8
(800) 454-1395	MPT Review (portfolio average)	27	190	19.8	102.4
(800) 442-9000	New Issues	153	2,451	17.3	104.7
(203) 270-9244	BI Research	12	152	16.5	91.7
(714) 497-7657	The Prudent Speculator	110	2,178	15.0	78.1
(800) 442-9000	The Insiders	36	1,339	14.1	86.4
(800) 786-8916	The Chartist (portfolio average)	33	300	13.1	79.9
(416) 869-1177	Investment Reporter (Canad'n Business Serv) (portfolio avg)	9	1,511	13.1	91.7
(516) 223-3800	Zweig Performance Ratings Report	49	205	12.8	132.5
(619) 459-3818	Investment Quality Trends	110	2,628	12.3	108.9
(800) 804-0942	Investor's World	59	546	11.7	79.9
(800) 833-0046	Value Line Investment Survey (portfolio average)	40	308	11.7	75.1
(415) 726-8495	California Technology Stock Letter	16	497	11.1	58.6
(800) 852-1641	Emerging & Special Situations	56	684	10.9	61.5
(617) 861-0302	Margo's Small Stocks (portfolio average)	24	226	10.3	61.5
(800) 833-2782	The Peter Dag Portfolio Strategy and Mgmt (portfolio avg)	8	228	10.3	100.6
(800) 833-0046	The Value Line OTC Special Situations Service	19	166	9.0	44.4
Top-Performing Mutual Fund Newsletters (Optimal Portfolio Size $20,000; $10,000 for IRAs)					
(818) 346-5637	Fundline (portfolio average)	7	140	14.0	100.0
(800) 397-3094	Fidelity Monitor (portfolio average)	4	390	13.4	100.0
(516) 829-6444	Systems & Forecasts (portfolio average)	3	98	11.7	126.6
(415) 986-7979	No-Load Fund*X (portfolio average)	5	96	10.9	71.6
(800) 442-9000	Mutual Fund Forecaster (portfolio average)	5	530	10.8	68.0
(800) 252-2042	No-Load Fund Investor (portfolio average)	8	489	10.4	83.4
(800) 833-2782	The Peter Dag Portfolio Strategy and Mgmt (portfolio avg)	8	228	10.3	100.6
(800) 423-4893	Fund Exchange (portfolio average)	5	234	9.7	112.4
Top-Performing Newsletters: Special Cases					
(800) 833-0046	The Value Line Convertibles Survey	23	127	12.6	94.7
(516) 829-6444	Systems & Forecasts (portfolio average)	3	98	11.7	126.6

Source: Hulbert Financial Digest. Newsletters are ranked on the basis of an average of their portfolios' performances in the event that HFD tracks more than one.
** As of 8/31/97*

Fundline (edited by David Menashe), whose model portfolios invest solely in Fidelity mutual funds. The first of his two model portfolios currently owns eight different funds, and the second currently owns six. The minimum initial investment in each of these funds is just $500 for IRAs and $2,500 for non-IRA accounts. That means that a subscriber could begin following these portfolios with as little as $20,000 in a non-IRA account, and less than $10,000 in an IRA.

By the way, even if your portfolio is worth at least $150,000 and you are able to follow a stock letter, don't automatically assume you ought to. You can if you want to, of course. But as you can see from Table 1, the top-performing mutual fund newsletters are able to hold their own against the top-performing stock letters.

Special Cases

There are two newsletters in Table 1 for which the above discussion doesn't apply. The first is the Value Line Convertibles Survey. The reason: This letter's buy list is comprised almost exclusively of convertible bonds—the bid-asked spreads for which can be huge on transactions no larger than a few thousand dollars.

I'm not going to try to estimate the minimum portfolio size to follow the Value Line Convertibles Survey, except to note that it will be significantly larger than the $150,000 minimum for individual stock portfolios. Convertible bonds' bid-asked spreads that are quoted in newspapers' financial sections or on electronic databases, for example, are those that would prevail on million-dollar positions.

Assuming you are intent on following the Value Line Convertibles Survey with a small portfolio, however, here are a few suggestions. First, purchase just the exchange-listed bonds, for which spreads are lower in general but especially so for smaller purchases. Fortunately, this is not a particularly onerous restriction: Of the 23 securities on this letter's buy list at the end of August 1997, 15 traded on either the New York or the American exchanges.

Another way to follow the Value Line Convertibles Survey with a small portfolio is to invest instead in the Value Line Convertible mutual fund. Though this fund's portfolio is not identical to the buy list that appears in the newsletter, the fund's performance has been within shouting distance of what the HFD reports for the newsletter. Over the last decade, for example, the fund has produced a 10.4% annualized return, in contrast to 12.6% for the newsletter. Furthermore, over the last five years, the fund has significantly outperformed the newsletter: 14.6% annualized vs. 11.6%.

The other special case in Table 1 is Systems & Forecasts (edited by Gerald Appel). The first three of Appel's portfolios invest in mutual funds and options, thus requiring a relatively small minimum portfolio size. But the fourth invests in futures, and this portfolio cannot be smaller than $200,000.

The reason this portfolio's minimum acceptable level is so high is that Appel's recommendations come in the form of a certain number of stock index futures for every $200,000 in portfolio value. Needless to say, it would be impossible to follow this advice in a portfolio that is worth less than $200,000.

Conclusion

My recommendation: If you want to follow a particular newsletter and your portfolio is significantly smaller than what is indicated in this article as the necessary minimum, shift your focus elsewhere. If you don't, odds are high that your returns will be substantially lower than what the HFD reports for that newsletter.