WHY LAST YEAR'S WINNERS FALTER: A BEHAVIORAL EXPLANATION

By Mark Hulbert

When investors start outperforming most competitors, it's all too easy to become overly confident in our abilities, with a subsequent tendency to trade more frequently and incur greater risk.

Why are last year's top-performing newsletters so often among this year's worst?

This result is contrary to what many people, including me, would have expected. In fact, I would have thought that last year's winners would either:

- Perform no differently this year than the average newsletter—after all, numerous studies have shown that short-term performance is statistical noise, having therefore only a random relationship to the future—or
- Perform better this year than the average newsletter. The basis for this expectation is other studies that have discovered a phenomenon known as the "momentum effect," whereby the stocks that recently have outperformed the market tend to continue doing so for a while longer.

Neither of these two expected outcomes, however, occurs on average among any one year's top-performing newsletters.

In fact, in my article in the September 1999 *AAII Journal*, I reviewed data that demonstrated how poorly last year's top-performing newsletter does the following year [past *AAII Journal* articles are available to members at the AAII Web site: www.aaii.com]. In the article, I showed that an investor would have lost nearly everything by investing each January 1 in the top-performing investment newsletter portfolio of the calendar year just ended. From the beginning of 1991 through mid-1999, in fact, such an approach would have produced an annualized loss of 36.6%. In contrast, over this same period the Wilshire 5000 index gained 18.4% annually.

A BEHAVIORAL EXPLANATION

So, why do last year's top-performers on average fall so abysmally in the following year?

The explanation of this newsletter phenomenon that makes most sense to me focuses on what happens to us psychologically not only when we are beating the market, but also when we are outperforming most of our competitors. Human nature being what it is, it's all too easy to let this performance go to our heads. We grow more confident in our abilities, and as a result tend to trade more frequently and incur greater risk. This process rarely leads to a happy outcome.

Consider the newsletter Seasonal Trade Portfolio, a commodity futures service edited by Frank Taucher that the Hulbert Financial Digest (HFD) tracked for three years from 1994 through 1996. The Hulbert Financial Digest chose to begin tracking this service because of numerous requests we received in the summer of 1993. Those requests were generated by news that the publishers of The Big Picture (another investment newsletter) had awarded Taucher the $10,000 reward they were offering any system that between 1980 and 1991 turned $10,000 into more than $39 million (equivalent to a 99% annualized rate of return).

In 1994, the first year the HFD tracked the Seasonal Trade Portfolio, it lived

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up to its billing, gaining 118.5% according to the HFD's calculations, and coming in first among all the services tracked by the HFD. But then Taucher started increasing the frequency of his trades—dramatically so.

When the HFD first started following Taucher's advice, subscribers received recommendations just once a quarter. These quarterly updates provided subscribers with one to two dozen recommended trades, complete with entry and exit dates and stop-loss levels. Taucher could pre-announce these trades so far in advance because he was basing them on historical seasonal patterns.

But at some point in 1995, Taucher decided to communicate more frequently with subscribers, and he started supplementing these quarterly mailings with faxed recommendations. In some of these faxes, he modified the trades recommended in his quarterly mailings, and in others he made brand new recommendations that had nothing to do with seasonal patterns. He sent over 100 faxes in 1995, and nearly 200 of them in 1996. In the process, this service underwent quite a metamorphosis, from a quarterly newsletter based on seasonal patterns to essentially becoming a day-trading commodity advisory.

This metamorphosis coincided with significant losses. According to the Hulbert Financial Digest, a portfolio that followed each of Taucher's trades lost 90.4% in 1995, and another 68.9% in 1996. Cumulatively for the three years in which Taucher's service was tracked, the HFD is reporting an almost complete loss.

THE CASE OF JOE GRANVILLE

Consider also the case of Joe Granville, editor of the Granville Market Letter. Back in the early 1980s, he was riding high, having precipitated mini-crashes on the New York Stock Exchange and European exchanges with his travelling road show that included predictions of bear markets in each country. His picture was on the front page of the New York Times, which, as he pointed out, was the first time any newsletter editor had been so honored.

Granville continued to ride high for a while, as 1981 indeed was a bear market year. But not leaving well enough alone, Granville decided to try his hand at predicting non-financial phenomena as well. One of his most-celebrated non-financial predictions was that an earthquake would strike Los Angeles.

Granville's investment advice hasn't fared much better. His newsletter's good performance in 1981 notwithstanding, his overall performance has been a substantial loss. In fact, over the entire period since mid-1980, when the HFD started tracking newsletters, Granville's recommended stock portfolio has lost 7.1% on an annualized basis, in contrast to a 16.6% annualized gain for the Wilshire 5000.

INVESTOR IMPLICATIONS

All of this would be of only mild curiosity if this behavioral phenomenon applied to just investment newsletter editors. You'd simply avoid following last year's top-performers, and that would be that. But in fact there's evidence that individual investors suffer from these same psychological traits.

Two professors at the University of California (Davis) just completed a study of 1,600 individual investors at a major discount brokerage house who in recent years switched from phone-based trading to on-line trading. The study documents that as these investors grew more confident, they increased the frequency and speculativeness of their trading, to their ultimate detriment. (The study is "On-Line Investors: Do the Slow Die First?," by Brad M. Barber and Terrance Odean, available on-line at www.gsm.ucdavis.edu/~bmbarber.)

For example, the professors found that, prior to the switch to on-line trading, these investors on average turned in unusually strong performances, beating the market by more than two percentage points annually. After switching to on-line trading, these investors' annual turnover rates jumped from 74% to 96%. Furthermore, the percentage of these investors' trades defined by the professors as "speculative" nearly doubled. And, most importantly, their performance dropped significantly after the switch: They subsequently underperformed the market by more than three percentage points annually.

My interpretation is that these investors committed the cardinal sin of confusing their brains with a bull market. Upon outperforming the market, they began to believe it wasn't luck but genuine ability. This increased confidence led them to become on-line traders, where they began to trade more frequently and speculatively. Only later did they discover that not only did they not have as much ability as they initially thought, but also their increased and risky trading was counterproductive.

CONCLUSION

Let this be a lesson to us all. While caution should be our watchword at all times, we need to exercise extra care when our confidence levels begin to grow.

At such times, we need to remember that genuine ability only becomes evident over many years. Over shorter periods of even up to a few years in length, it is virtually impossible to tell the difference between ability and sheer luck.✦