

Think Twice, Even Thrice, Before Trading

By Mark Hulbert

Article Highlights

- Since the average transaction lowers portfolio returns, investors ought to undertake as few as them as possible.
- Newsletter advisers were compared against their own portfolios to see if transactions added value.
- Since the early 1980s, about two-thirds of the portfolios studied would have done better by not trading.

If the average thing you do as an investor is a mistake, then you ought to do it as little as possible.

Though the logic of this argument is unsailable, investors repeatedly resist it—either by denying it outright or, more commonly, by believing that it applies to everyone but themselves.

For this article I review the evidence I have compiled about portfolio transactions from my more than three decades of tracking the performance of investment advisory newsletters in the Hulbert Financial Digest (HFD). Though the weight of my evidence doesn't mean that you should never trade, it does show just how large a burden of proof each of us must satisfy before it becomes rational to do so.

HFD Data

To measure the cost of trading, I employed a unique methodology for analyzing each of the hundreds of model portfolios recommended by advisers on the Hulbert Financial Digest's monitored list. For each portfolio, I created an additional—hypothetical—one that I refer to as the adviser's "frozen" portfolio. This frozen portfolio contained exactly what its author had placed in his actual portfolio as of the beginning of a given year, but—unlike the actual portfolio—undertook no transactions during the year.

The beauty of this approach is that it does not compare an adviser to an abstract market index or benchmark. Such a comparison is subject to criticism, of course, since the adviser can argue—perhaps even legitimately—that the benchmark does not fairly represent the kind of stock or market sector



on which he himself focuses.

Instead, by judging an adviser in relation to his "frozen" portfolio, I am comparing him to himself—absent the trading. It's much harder for him to wriggle out from underneath the conclusions of such a comparison. If his actual portfolio did worse than his frozen portfolio—something that happens quite often, as you will soon see—then we know

conclusively that his trading didn't add value.

How often? On average, across the many calendar years since the early 1980s that I have studied using this methodology, around two-thirds of the portfolios would have done better by not trading. Furthermore, in no calendar year studied did the majority of portfolios come out ahead of their hypothetical frozen counterparts.

Consider what I found for last year. In calendar-year 2010, the 500 model portfolios the Hulbert Financial Digest tracks would on average have made 18.0% if they had simply stuck with their holdings at the beginning of the year. Their actual portfolios, in contrast, gained 14.6%, or 3.4% less.

What's fascinating, furthermore, is that I found that this same result held even during years in which there was a change in the stock market's primary trend during the year. That's noteworthy, because in such years one might think that portfolios that don't trade would be at a particular disadvantage. But the advisers still, on average, failed to add value through their trading.

Consider what happened in calendar-year 2009, for example. Through March 9 of that year the stock market plunged, but then it embarked on an explosive rally. It's difficult to imagine a buy-and-hold posture that made sense at

the beginning of that year that didn't get crushed later in the year. And yet the average frozen portfolio in 2009 gained 29.4%, versus a gain of 28.7% for the average model portfolio.

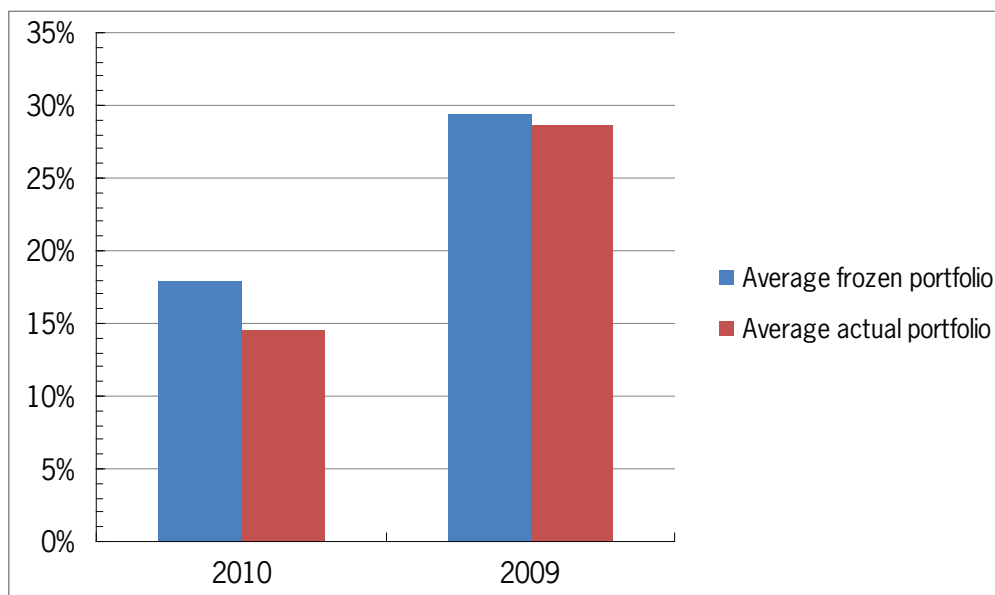
Academic Evidence

Lest you think that newsletter editors are unique in this regard, consider a major study of individual investors' behavior. The authors, finance professors Terrance Odean of the University of California—Berkeley and Brad Barber of the University of California—Davis, studied the trades made at 10,000 randomly selected accounts at a major discount brokerage firm between January 1987 and December 1993. (The study can be read at ssrn.com/abstract=219175.)

They focused in particular on all cases in which an investor bought a stock less than 30 days after selling another. It seems reasonable to expect in these cases that the investor believed that the stock that was being bought would outperform the stock that was sold. Yet the professors found that just the opposite was the case.

The results weren't even close, in fact. The researchers found that over the 12 months following the transactions, the stocks that were sold did 3.2% better than the stocks that were bought. Investors would have been far better off had they done nothing.

Figure 1. The Virtues of Doing Nothing



The average newsletter editor would have made more money in each of the last two years if he had simply held for the entire year whatever he was recommending on New Year's Day.

Source: Hulbert Financial Digest.

One Top Newsletter's Experience

Still not convinced? Consider the amazing experience of an advisory service entitled the Closed-End Country Fund Report. This newsletter is ranked in third place for 10-year performance among all newsletters the Hulbert Financial Digest tracks (through March 31 of this year) and in first place over this period for performance among mutual fund advisory services.

Believe it or not, however, the Closed-End Country Fund Report's model portfolio has not undertaken even one transaction in nearly seven years. In fact, the last issue of it that we received was in October 2004. Because the newsletter did not formally cease publication at that time, and held out

the possibility that it might some day resume, the Hulbert Financial Digest has been faithfully keeping watch over the last-known sighting of its model portfolio.

Conclusion

The implication, hard as it is to believe, is that the average transaction lowers portfolio returns. You don't have to be a rocket scientist to draw the corollary: If the average transaction lowers returns, you ought to undertake as few of them as possible.

This doesn't mean you should never, ever make any transactions. But it does mean that the burden of proof you should satisfy before you do trade is probably several orders of magnitude higher than you think. ▲

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