

Believing Performance Claims: A Triumph of Hope Over Experience

By Mark Hulbert

Article Highlights

- The maximum sustainable performance over long periods is about 15% annualized.
- Investors should be skeptical of performance claims above this level.
- Some advisors may claim better performance by reporting on select periods or portfolios.

I am constantly bombarded with questions about investment advisers that my Hulbert Financial Digest (HFD) has not been monitoring.

Inevitably, the inquiries focus on alleged performance that is tantalizingly good—so good, in fact, that even if actual performance were only half as good, it still would justify our immediately allocating all our investment portfolios to following the adviser or strategy in question.

My reply is always the same: Don't believe it.

To be sure, it is theoretically possible that the adviser or strategy over which I am throwing cold water has discovered the key to understanding the financial markets once and for all. More likely, however, is that the adviser is analogous to Joe Granville, editor of the Granville Market Letter, who called several market turns correctly in the early 1980s, bragged that he should receive the Nobel Prize in economics for unlocking the mystery of the markets, and subsequently became the worst performer of any the HFD has been tracking over the last three decades.

Of course, I wish that the HFD were a large enough organization to track every adviser, strategy, software program, day-trading system, and so forth that exists. In that case, you could compare any conceivable advertising claim to what the HFD has independently been able to verify.

Even absent that perfect world of third-party verification of all advertising claims, however, it is possible to subject any investment performance claim to a reality check. In this column, I review a number of rules of thumb that I have distilled from the HFD's 32 years of monitoring more than a thousand distinct investment portfolios.



Maximum Realistic Long-Term Return

Perhaps the most important rule of thumb to remember is that stellar short-term returns do not last. The maximum sustainable return over very long periods of time appears to be around 15% annualized.

This knowledge immunizes you to the otherwise alluring claims of performance well in excess of this level. It allows you to know that one of two things must be true about the adviser or strategy making such a claim: Either the performance was turned in over too short a period of time to be a reliable guide to the future, or the claim was false.

Interestingly, it matters relatively little which of these two possibilities turns out to be the true explanation. The correct course of action in either case remains the same: Run, not walk, the other way.

Figure 1 supports of the notion that 15% annualized is the maximum realistic return you can expect over the long term. It reports the return of the top-ranked mutual fund and investment newsletter over various periods of time. Notice that, by the time the measurement period extends to 20 years and more, the best returns are remarkably close to the 15% threshold to which I have been referring. (The equity mutual fund with the best 30-year record, according to Lipper, is Fidelity Select Health Care [FSPHX], with a 14.8% annualized return through November 30, 2011. The best performing investment newsletter, according to the HFD: The Prudent Speculator, with a 14.7% annualized return.)

To be sure, Warren Buffett has done better over the last three decades than 15% annualized. In fact, Berkshire

Hathaway's book value since 1980 has grown at a 20% annualized rate.

But, I would submit, Buffett is the exception that proves the rule. What are the chances that the adviser whose investment ad you have just received is going to be the next Warren Buffett?

In any case, notice that even Buffett—widely assumed to be the most successful investor alive today—didn't make more than 20% per year. Many of the outrageous investment advertisements that come across my desk claim returns well in excess of "just" 20% per year; some claim returns in the triple digits, and a few even more than that.

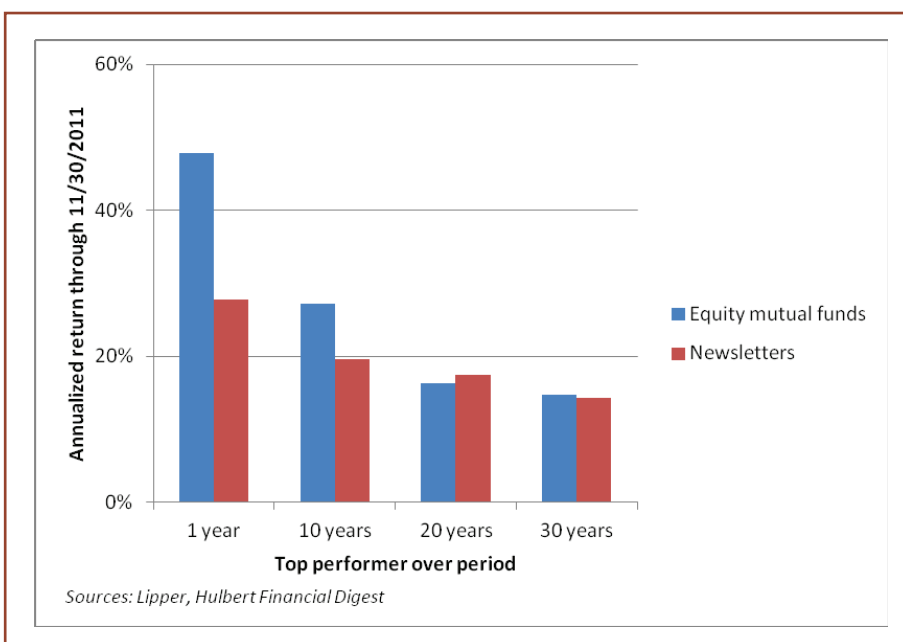
Related Rules of Thumb

Knowing that returns in excess of 15% per year over the long term are vanishingly rare should be all you really need to protect yourself from outrageous advertising. But hope springs eternal, especially since it's theoretically possible to do a lot better and it is therefore impossible to be absolutely certain that a particular adviser or strategy hasn't lived up to what otherwise appears to be exaggerated performance claims. Even though believing such claims almost always represents a triumph of hope over experience, I present a few additional rules of thumb for those who nevertheless succumb to the temptation.

One such rule is to be on the lookout for advisers who pick and choose past periods in order to truthfully report performance that is misleadingly good. Since even stopped clocks are right twice a day, advertisers usually have no difficulty finding some period in which their clients looked like geniuses.

Advertisers who are guilty of this sleight of hand rarely report the time period over which they are reporting performance. Instead, they only vaguely or ambiguously report that period, referring to it with phrases such as "recently" or "over a recent three-year period."

Figure 1. Performance of the Top-Ranked Mutual Fund and Investment Newsletter



Such phrasing is usually a dead giveaway that the advertiser is not providing you with the full and unvarnished truth.

Another trick is when the performance period doesn't encompass the entire time that the adviser has been in business.

Consider the investment newsletter that has one of the very best returns over the last five years in the HFD's ranking. That fact is impressive enough, as far as it goes. But the newsletter in question has been around for decades, and its long-term return is far more dismal. Over the 30 years through November 30, 2011, in fact, it lags a simple buy-and-hold strategy by more than three percentage points per year on an annualized basis.

To immunize yourself from this trick, do some digging to see how long the adviser has been in business—and insist on seeing performance over that entire period.

Finally, another trick can still be played: Reporting only one of several portfolios that were simultaneously

maintained by the same adviser or investment manager.

This has become a bigger problem in recent years through the proliferation of multiple portfolios. Some of the newsletters monitored by the HFD now offer more than a dozen portfolios, and some investment software programs offer several hundred different portfolios. With that many portfolios, of course, it is relatively easy to find one that has genuinely had stellar long-term returns. But that doesn't necessarily mean that the adviser is worth following.

To immunize yourself from this trick, do your homework and find out how many different portfolios or approaches the adviser has recommended, either now or in the past.

Conclusion

You've heard it countless times, but it remains very good advice nonetheless: If an advertisement makes an investment strategy appear too good to be true, it probably is. ▲

Mark Hulbert is editor of the *Hulbert Financial Digest*, a newsletter that ranks the performance of investment advisory newsletters. It is published monthly and is located at 5051B Backlick Rd., Annandale, Va. 22003; 703/750-9060. Find out more at www.aaii.com/authors/mark-hulbert.