WHEN YOU'RE HOT, YOU'RE HOT! OR ARE YOU NOT?

By Mark Hulbert

Many investors persist in the belief that certain advisers have "hot hands." But analysis indicates many of these short bursts of high performance can just as easily be explained as random streaks of good fortune.

Most investors I meet in the seminars I give truly believe in "hot" managers: They have no doubt that hot hands really exist in the advisory arena. Yet the evidence suggests the contrary: Depending on how hot hands are defined, either they simply don't exist or they are so insignificant as to be virtually worthless.

Why do investors nevertheless believe in hot hands? I can think of two reasons. First, to our untrained eyes, it seems obvious that they do exist. We all are aware of advisers who, at various points in their careers, seemingly can do no wrong—times when they particularly are in "synch" with the market. Secondly, believing in hot hands is an easy way of sorting through what otherwise can be an overwhelming amount of performance data. Instead of having to analyze a long historical track record, an investor can focus on what the adviser has done recently—confident that the advisor is likely to continue his hot (or cold) hand.

This article is intended as an antidote to this belief in hot hands. I use the Hulbert Financial Digest's database of investment newsletter performance to test for the existence of hot hands.

TESTING FOR HOT HANDS

The first test I applied to the HFD's database is known as the Wald-Wolfowitz Runs Test. It detects whether a sequence of events exhibits streaks, or runs. The test works equally well regardless of whether those events are coin flips, a baseball team's wins and losses, or periods in which an adviser makes or loses money. This test failed to detect hot hands in the newsletter industry.

How can this be, you might ask? Isn't it the case that at least some advisers beat the market for several months in a row? The Runs Test's answer: A streak of winning months is not enough to prove that the adviser actually is playing a hot hand. Consider coin flipping, for example: If we flip a coin 100 times in a row, there will be times in which we flip several heads in succession. But that doesn't mean we genuinely are playing a hot hand. To pass the Runs Test, an adviser would have to beat the market for more months in a row than can be explained by mere chance alone.

Consider the top-performing newsletter for the trailing 10-year period—the Prudent Speculator, edited by Al Frank. This letter's model portfolio has beaten the Wilshire 5000's total return over these 10 years, 25.0% annualized vs. 18.1%. With this large a measure of outperformance, we would expect that it outperformed the Wilshire more than half the time. And it did (in over 59% of the months, in fact). Furthermore, there were several occasions during these 10 years—in 1989 and 1996, in fact—in which Frank's portfolio outperformed the market for seven months in a row.

But none of this means that Frank was playing a hot hand. According to the

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Wald-Wolfowitz Runs Test, we can't—at the 95% confidence level—dismiss the possibility that the sequence of Frank's market-beating and market-lagging months is merely random.

To be sure, two of the 128 portfolios for which the HFD has 10 years' worth of performance data did pass the Runs Test. (Both portfolios are recommended by MPT Review, edited by Louis Navellier.) But there's less here than meets the eye. At the 95% confidence level, we should expect false positives in 5% of the cases—that is, cases in which we ascribe significance when the sequence of winning and losing months really is random. Therefore, I am unable to disprove the possibility that no hot hands have existed over the last decade among the newsletters the HFD tracks.

By the way, there are a greater number of newsletters (though still not statistically significant) that "passed" the Runs Test, but in a way that is of little help to investors. These additional newsletters are those which had non-random streaks of months in which they *lagged* the market. This information would be of use to us only in the event that we could do the opposite of these cool-hand advisers. But I know from tracking these letters' recommendations that their market-lagging performance is due just as much to transaction costs as it is to poor market timing or stock selection. A strategy of doing the opposite would most likely lag the market also.

MORE 'HOT HANDS'

Let me hasten to add that these results don't in any way imply that Al Frank or Louis Navellier (or, for that matter, any of the other newsletters that didn't pass the test) have no ability. That's not what the Runs Test detects. What these test results are saying is that there is no non-random pattern to the *order* in which these newsletters produced market-beating results.

Investors' typical reaction upon having these results presented to them: Maybe I'm not testing for hot hands in the right way. For example, it might be that hot hands aren't detectable over periods as short as one month. And perhaps a hot hand shouldn't be defined as an unbroken winning streak, but instead as something else.

Let's start by considering the results when hot hands are defined as a sequence of winning calendar quarters. If we do, the negative conclusion is even stronger. Instead of two out of 128 newsletters "passing" the Runs Test when runs were defined in monthly terms, none of the newsletters passed when the streaks were defined quarterly. That is, none of the 128 newsletter portfolios the HFD has tracked over the last decade has had a non-random sequence of market-beating and market-lagging quarters.

What if we define hot hands in terms of years? Here the matter becomes a bit more complicated, since my 18-year database doesn't provide a sample that is large enough to enable the Runs Test to produce very robust conclusions. But I did apply another test, with similar results.

This additional test measures whether there is a correlation between a newsletter's rank for performance in year #1 with its rank in year #2. If hot hands exist when defined in terms of years, this test should detect it. Yet I found a correlation coefficient of just 0.07 by looking at all possible pairs of one-year rankings over the last 18 years (with 0 denoting no relation and 1 denoting a perfect correlation).

This result means that one-year rankings have statistical significance but very little investment value. Its statistical significance derives from the fact that, at the 95% confidence level and given the size of the HFD's database, you can't dismiss a 0.07 correlation as random. So there is a slight correlation between a

TABLE 1. LONG-TERM HOT HANDS
THE TOP NEWSLETTERS: 6/30/80 TO 3/31/98

(Ranked by Risk-Adjusted Performance)

Newsletter	Phone	15-Year Annual Gain (%)	Risk (Volatility)* Market=100	Sharpe Ratio** Market=100
Growth Stock Outlook	301/654-5205	12.37	55.5	93.4
The Value Line Investment Survey	800/833-0046	17.63	123.5	90.8
The Chartist	562/596-2385	17.83	130.3	88.7
**NoLoad Fund*X	415/986-7979	15.01	100.0	83.1
The Prudent Speculator	714/497-7657	20.98	252.4	78.3

**As measured by standard deviation of monthly returns*
***A measure of risk-adjusted performance, showing performance above the T-bill rate per unit of risk.*

newsletter's performance rank last year and how it will rank this year, but to an investor seeking high-ranking newsletters next year, this in practical terms translates into virtually no predictive power.

LONG-TERM HOT HANDS

At this point some investors suggest that hot hands should be defined over even longer periods. While I'm sympathetic to this suggestion, I don't think we can call a long-term phenomenon a "hot hand." After all, "hot hands" are short-term. You wouldn't say that a blackjack player is playing a hot hand if he has lost the last five rounds, even if he's ahead for the entire evening.

Whatever we call it, however, a correlation between past and future does begin to creep in as we define performance over periods progressively longer than a year. Let me illustrate: Let's imagine that five years ago you were picking a newsletter to follow for the next five years (from then until now). Then, in 1993, you would have had nearly 13 years of HFD performance data to use in your decision making. It turns out that you would have performed far better by going with the best long-term performers than by going with the worst.

Here are the data: Had you picked among the five best performers over this nearly-13-year period, your average annualized return over the last five years would have been 17.8%. In contrast, had you picked among the five worst, your average annualized return would have been a *loss* of 1.3%. The conclusion: Performance over very long periods appears to do a good job of separating advisers with ability from those without.

With this in mind, Table 1 presents the top performers over the trailing nearly 18-year period, which is the length of time over which the HFD has tracked newsletter performance.

Call it a hot hand if you want. But these newsletters are a far better bet for future performance than those whose long-run performance is poor but whose recent performance is good enough to catch the attention of the unsuspecting. ◆

CURRENT INVESTMENT BOOKS

The following books have not been reviewed by the *Journal*. Please check with your local bookstore or with the publisher if you are interested in a book. Prices do not include charges for shipping, handling, or taxes.

Independently Wealthy: How to Build Financial Security in the New Economic Era, by Robert Goodman, Ph.D.; John Wiley & Sons; (800) 225-5945; www.wiley.com; 240 pages paperback; $16.95. Robert Goodman focuses on the present economy to propose investing ideas. He stresses the importance of providing financial security for yourself rather than depending on the government. Suggested strategies include: investing for the long term, buying and holding, investing regularly, and being an owner instead of a lender. Goodman also touches upon investment and savings plans.

A Woman's Guide to Savvy Investing: Everything You Need to Know to Protect Your Future, by Marsha Bertrand; Amacom (American Management Association); (800) 433-3635; www.amanet.org; 288 pages; $24.95. This book was written with the statistic that 80%–90% of women will be solely responsible for their financial security at some point in their life in mind. The author offers a guide to investing basics, explaining stocks, bonds, mutual funds, buying and selling, and commission charges. She uses fictional case studies and includes reports from top female investors who contribute their personal philosophies.

Measuring Investment Performance: Calculating and Evaluating Investment Risk and Return, by David Spaulding; McGraw-Hill Company, (800) 262-4729; www.books.mcgraw-hill.com; 224 pages; $50.00. Spaulding's guide covers both the basics and subtleties involved in measuring investment performance. He briefs investors on how to anticipate and avoid short-term figures, which may go against the goal of the investor's portfolio. Spaulding instructs how to calculate market value investments as well as evaluate the decisions of a money market manager. The book also advises on ways to determine a manager's success and measure risk.

Only Yesterday: An Informal History of the 1920s, by Frederick Lewis Allen; John Wiley & Sons; (800) 225-5945; www.wiley.com; 304 pages; $21.95. Part of Wiley's Investment Classics series, this book, originally published in 1931, recounts details from the post-World War I era through the market crash of 1929 and the following Great Depression. Allen delves into the intimacies of the Crash with an hour-by-hour account. He also reports on the major economic happenings of the time which include: Harding's oil scandals, the birth of the auto industry, and the long bull market of the late 1920s.

Global Equity Investing, by Alberto Vivanti and Perry Kaufman; McGraw-Hill Company; (800) 262-4729; www.books.mcgraw-hill.com; 320 pages; $39.95. This resource offers information on how to use the world stock markets and index markets to try to improve returns and lessen risk. It provides a synopsis of significant policies and strategies as well as clarifies how stock markets differ in the U.S., Europe, and Japan. The authors also explore methods for controlling portfolio risk, ways to grow investments, and trend-following techniques.