Lessons learned from four decades of tracking advisers' returns

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Outline of my presentation

- Overall lesson #1: It is ***extremely*** difficult to beat the market
- Overall lesson #2: There ***are*** rational ways of responding to lesson #1

BREAK/INTERMISSION

- The do's and don'ts of being a contrarian

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What I've been doing for the last 40 years

Since 1980 I have objectively tracked the performance of hundreds of investment advisers

- *I have done this by constructing model portfolios according to the advice provided by those advisers*
- *Trades are executed at the prices anonymous subscribers would be able to act on the advice*
- *Commissions (discount brokerage), dividends, splits, and so forth are taken into account*

The number of advisers who've beaten an index fund is so low that as a practical matter you could conclude that it's not worth the effort to even try

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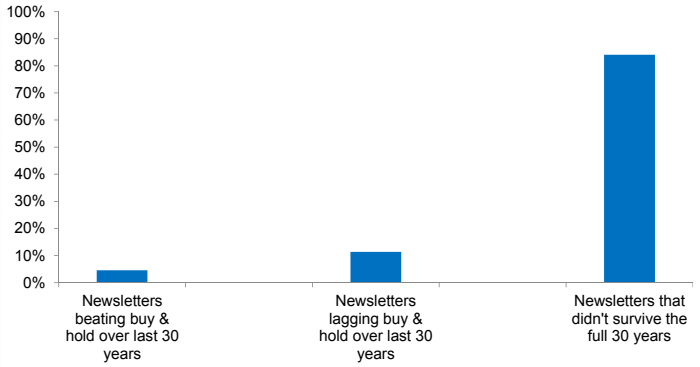
Performance over last 30 years



Performance relative to Wilshire 5000 among all Hulbert-monitored portfolios

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How did mutual funds fare?

According to Lipper, the VFINX has outperformed 67% of all U.S. domestic equity mutual funds over the last 30 years. This is very similar to my results for investment newsletters, due to survivorship bias

- Lipper doesn't have survivorship data over entire 30-year period.
- But, according to Standard & Poor's over the last 5 years, the following percentage of funds didn't survive even 5 years:
  - *38.3% of large-cap funds*
  - *39.1% of mid-cap funds*
  - *45.5% of small-cap funds*

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Lessons learned

- If you were to have picked an adviser at random 30 years ago, you would have had a one-in-twenty chance of bettering the return of a simple index fund
- Corollary: The average thing you do is a mistake

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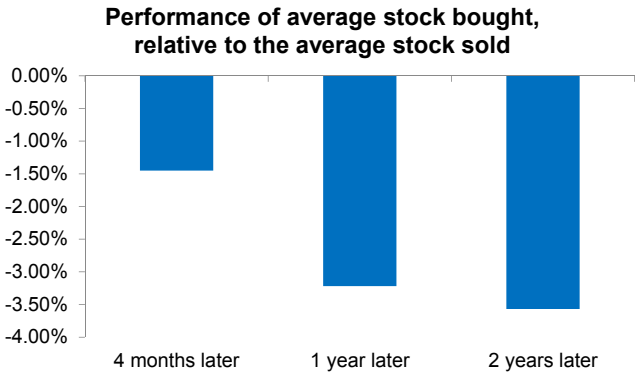
Consider…



Source: UC Berkeley Professor Terrence Odean, based on trading histories of 64,000 accounts at a discount brokerage firm

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Frozen versus actual portfolios

- This is another illustration showing that the average thing we do is a mistake
- Consider what would happen if an adviser had frozen into place his/her portfolio at the beginning of the year
  - *Would this frozen portfolio at the end of the year be ahead or behind his actual trading portfolio?*

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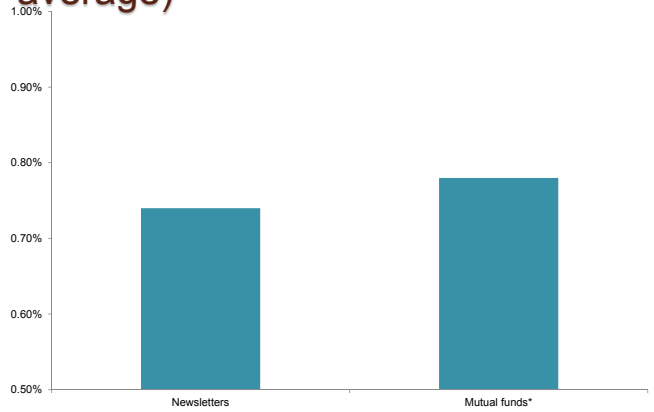
Degree to which frozen portfolios beat actual portfolios (annualized average)



**The Structure and Performance of the Money Management Industry*, by Josef Lakonishok (University of Illinois at Urbana-Champaign;) Andrei Shelifer (Harvard); Robert Vishny (University of Chicago)

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But what about the best performers?

- These results—which reflect the average across large universes—wouldn't have to be devastating ***if*** there were some way of doing better than average
- That turns out to be a big if.
- There's precious little evidence that going with the past's winners improves your odds of future success
- The most robust correlations exist at the bottom of the rankings

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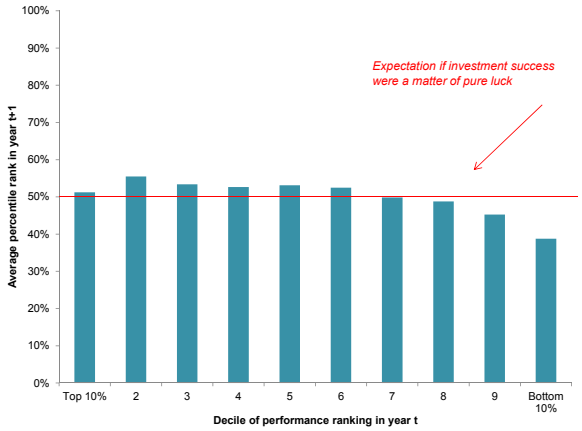
Regression to the mean



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Why are these results so dismal?

- Luck plays a far bigger role in investment performance than skill
- Our psychology makes things even worse

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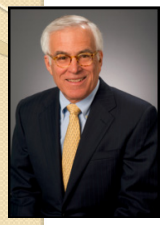
Measuring luck versus skill



- First method comes from Brad Cornell, Visiting Professor of Financial Economics at Caltech
- Approach is elegantly simple:
  - *Compare the variance of returns over shorter and longer periods*
  - *The greater variance of shorter-period performance must be due to luck*

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Professor Cornell's finding

- Among large-cap mutual funds, "approximately 92% of the cross-sectional variation in annual performance is attributable to random chance."
- When I applied Cornell's methodology to invest newsletters, I reached an almost identical result: 91.86% is due to luck.

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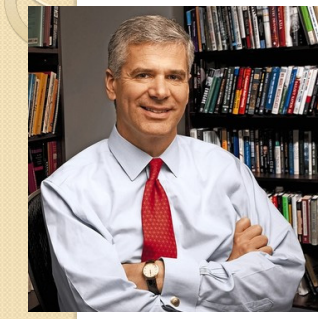
Measuring luck versus skill



- Another approach comes Michael Mauboussin, head of Global Financial Strategies at Credit Suisse
- His insight: The quicker performance regresses to the mean, the greater role that luck must be playing
- Recall that we saw on a previous slide that regression to the mean in investing is almost total from one year to the next

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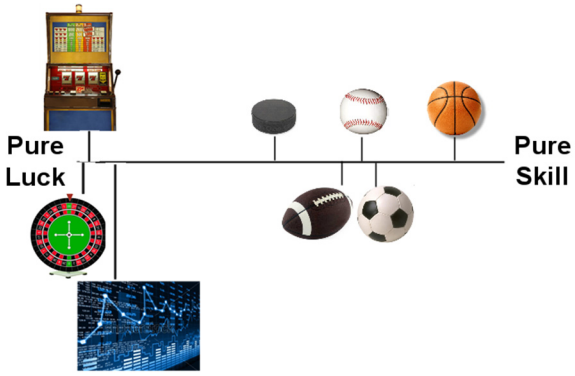
Mauboussin's conclusion



Source: The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing, by Michael Mauboussin

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Benjamin Graham on luck

- "One lucky break, or one supremely shrewd decision—can we tell them apart?—may count for more than a lifetime of journeyman efforts."

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Lessons learned

- Don't so something stupid
  - *Avoiding the biggest mistakes is probably the most important thing we can do*
- The strongest statistical patterns are among the worst performers.
  - *It's a better bet that a terrible performer will remain a terrible performer than that a top performer will remain top-ranked*

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Lessons learned

- Don't just do something, sit there!
  - *The fewer things you do, the better*
- If you nevertheless do decide to do something
  - *Do so for reasons/trading rules you have specified in advance, not how you feel in the moment*

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Another lesson: Patience and discipline

- Patience is essential because no one is able to beat the market all the time
- You shouldn't give up on a strategy just because it lags the market along the way
  - *This is a high hurdle, since losing money and lagging the market are no strangers to market beating advisers*

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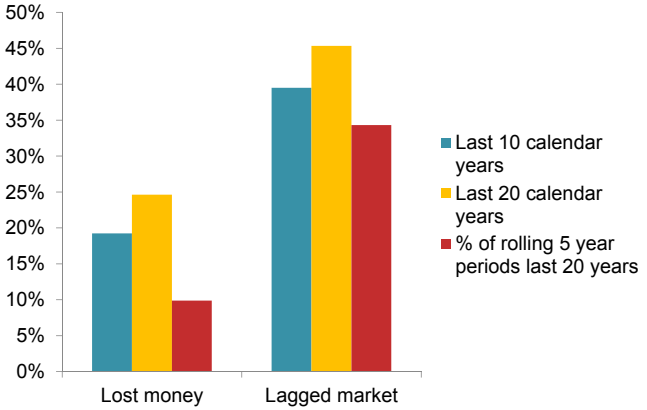
Incidence of lagging/losses among market-beating advisers



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This makes it difficult to conclude statistically that you should get rid of your adviser or strategy

- You need many data points before you can conclude at the 95% confidence level that an adviser has lost his/her touch
- The large variability in short-term results means you need an even larger number of data points before reaching such a conclusion
- Your relationship with an adviser is closer to a marriage than to a one-night stand…

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Consider a strategy that invests in Value Line's Group 1 stocks

- This strategy on balance has outperformed the market by a large margin over the last 40 years
- Since 2009, however, this strategy has significantly lagged the market (see chart on following page)
- Is this several-year period of underperformance enough to conclude that the Value Line ranking system no longer works?

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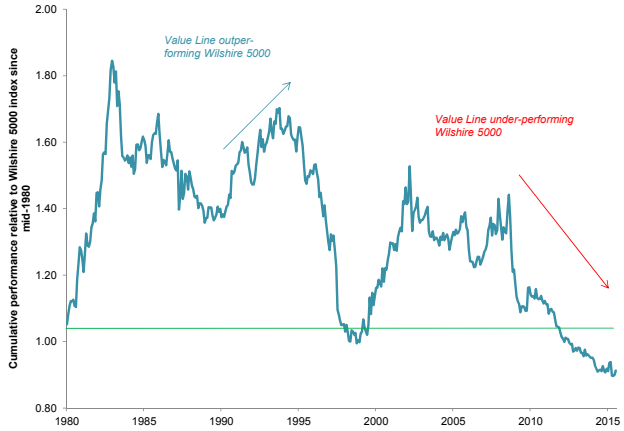
Value Line's Group 1 stocks since 1980



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Premature to give up on it!

- At the 95% confidence level, you cannot conclude that the data series since the 2009 inflexion is different than what came before

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Another lesson: Keep risk low

- Given the predominant role that luck plays in investment performance, it's crucial to keep risk low
- That's because high risk inevitably leads to losses so big that recovery becomes unlikely
- The next slide plots newsletters' returns over the trailing 20 years against their risk levels.
  - *Notice that once risk exceeds that of the overall market's, even the best performers earn very little extra return—and the worst performers lose big*
  - *Notice also that the trendline that best fits the data points is downward sloping*

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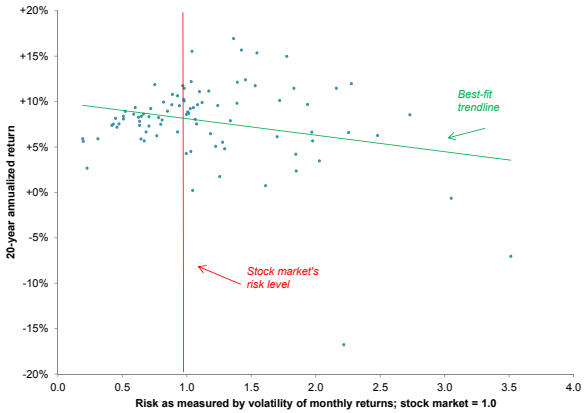
Risk versus reward last 20 years



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Yet another reason to keep risk low

- The future is far more unknowable than we think it is

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How much do we really know about the future?

- We assume that things will work out, so long as we hold on long enough

Source: Jeremy Siegel, Stocks For The Long Run

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But how valid is this assumption?

- Consider all the forces that could prevent the equity markets over the next 30 years from equaling their historical average return of 11% annualized
- Might the range of possible consequences of those other forces actually increase with time horizon?
  - *Of course!*

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Climate change: Just one possible long-term force

- Consider first the range of possible economic consequences of climate change over the coming 12 months.
  - *The difference between the most dire scenario and the most benign is virtually undetectable at the 12-month time horizon*
- Now consider the range of possible consequences at the 30- or 50-year time horizon
  - *They range from no impact to catastrophic*

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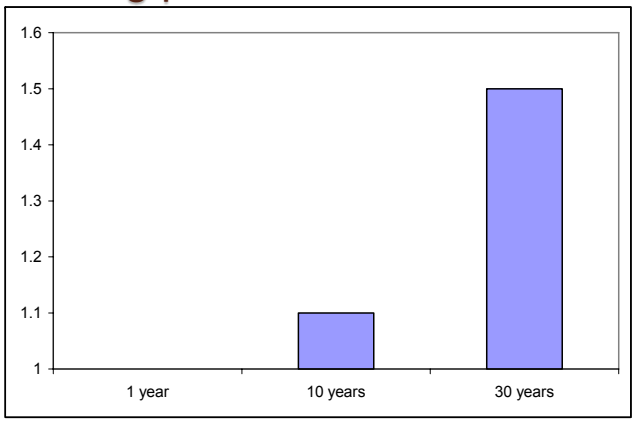
Variance relative to one-year holding periods



Source: Robert Stambaugh (Wharton) and Lubos Pastor (U. of Chicago)

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Lessons learned

- It easily could have turned out differently over the last two centuries that stocks would produce a return of 11% annualized
  - *There was nothing pre-ordained that the US would win two world wars, a cold war, emerge as the dominant world geopolitical and economic power, etc. etc.*
  - *The stock market's long-term return would have been far less under any of a number of alternate scenarios*

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Lessons learned

- The last 200 years in effect represent just one draw from the sample
- To extrapolate the past into the future, you in effect have to bet that events as momentous as winning two world wars, a cold war, etc. etc. will all fall in favor of the U.S. in coming decades
  - *Furthermore, these all will have to be surprises; they can't already be discounted in stock prices*

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Another source of uncertainty about the future: Path dependency

- Your retirement wealth is a function not just of how the stock and bond markets perform over your lifetime
- It's also a function of the path those markets took along the way
- Drawdowns near your retirement age have a far bigger impact than drawdowns earlier in life

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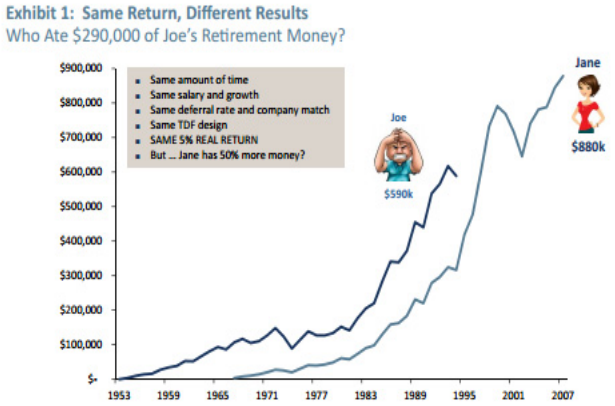
"Who ate Joe's retirement money?"



Source: GMO

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The dos and don'ts of contrarian analysis

- Contrarian analysis in effect exploits the fact that the average thing we do is a mistake
  - Our mistakes are not randomly distributed, in other words; they're worse
- Because of this, to quote Warren Buffett, we should be greedy when others are fearful and fearful when others are greedy

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Make contrarian analysis objective

- The most crucial starting point: Base your analysis on an objective measurement of sentiment
  - *How do you determine when others are greedy, and when they are fearful?*
- Subjective measures are dangerous, as they risk turning contrarian analysis into little more than an excuse for sloppy thinking
  - *Magazine covers*
  - *Subjective determinations of mood*
  - *Voluntary surveys*

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How I measure sentiment

- We average the recommended exposures levels among all short-term market timers on our monitored list
  - *Included are only those that have the electronic means of communicating a change of recommendation*
- The result is a completely objective measurement.
  - *We may not agree with an interpretation of that measurement, but the measurement itself is a fact*

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Tests of contrarian analysis

- I have constructed four different sentiment indices.
  - General domestic equity
  - NASDAQ
  - Gold
  - Domestic bonds
- Econometric tests confirm the contrarian hypothesis: On average, the market does better following extreme low index readings than after extreme high ones
  - *This tendency applies to the short-term—of one to three months at most*

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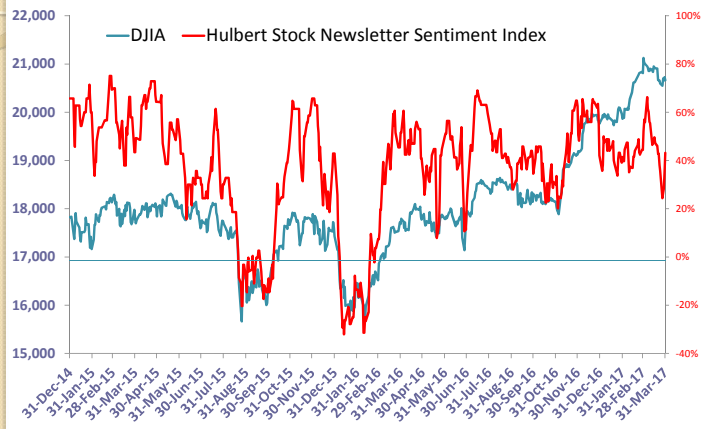
Average exposure among domestic equity market timers



Source:

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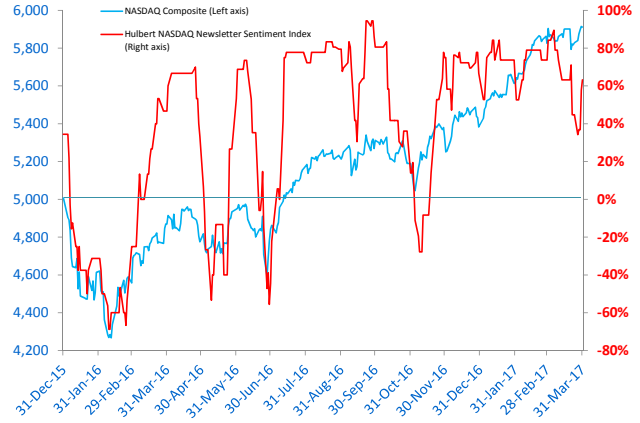
Average exposure among NASDAQ market timers



Source:
www.HulbertRatings.com

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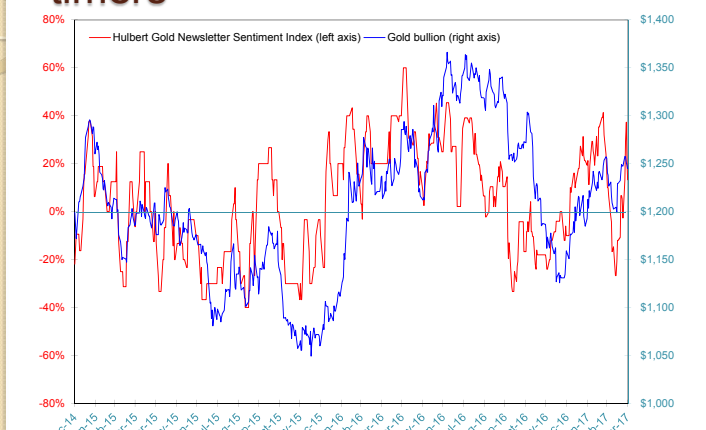
Average exposure among gold timers



Source:

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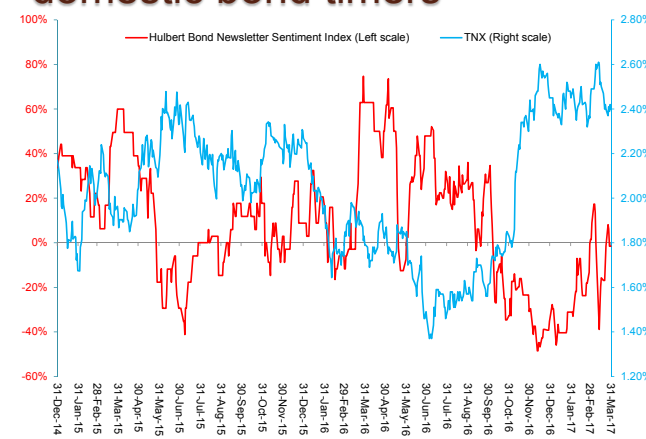
Average exposure among domestic bond timers



Source:
www.HulbertRatings.com

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