JACK D. SCHWAGER
AUTHOR OF THE *MARKET WIZARDS* SERIES

MARKET WIZARDS AND NONSENSE

How the Markets Really Work and How They Don't

FOREWORD BY
JOEL GREENBLATT

Contents

Foreword

Prologue

Part One: Markets, Return, and Risk

Chapter 1: Expert Advice

- Comedy Central versus CNBC
- The Elves Index
- Paid Advice
- Investment Insights

Chapter 2: The Deficient Market Hypothesis

- The Efficient Market Hypothesis and Empirical Evidence
- The Price Is Not Always Right
- The Market Is Collapsing; Where Is the News?
- The Disconnect between Fundamental Developments and Price Moves
- Price Moves Determine Financial News
- Is It Luck or Skill? Exhibit A: The Renaissance Medallion Track Record
- The Flawed Premise of the Efficient Market Hypothesis: A Chess Analogy
- Some Players Are Not Even Trying to Win

The Missing Ingredient
Right for the Wrong Reason: Why Markets Are Difficult to Beat
Diagnosing the Flaws of the Efficient Market Hypothesis
Why the Efficient Market Hypothesis Is Destined for the Dustbin of Economic Theory
Investment Insights

Chapter 3: The Tyranny of Past Returns
S&P Performance in Years Following High- and Low-Return Periods
Implications of High- and Low-Return Periods on Longer-Term Investment Horizons
Is There a Benefit in Selecting the Best Sector?
Hedge Funds: Relative Performance of the Past Highest-Return Strategy
Why Do Past High-Return Sectors and Strategy Styles Perform So Poorly?
Wait a Minute. Do We Mean to Imply . . .?
Investment Insights

Chapter 4: The Mismeasurement of Risk
Worse Than Nothing
Volatility as a Risk Measure
The Source of the Problem
Hidden Risk
Evaluating Hidden Risk
The Confusion between Volatility and Risk
The Problem with Value at Risk (VaR)

Asset Risk: Why Appearances May Be Deceiving, or Price Matters
Investment Insights

Chapter 5: Why Volatility Is Not Just about Risk, and the Case of Leveraged ETFs
Leveraged ETFs: What You Get May Not Be What You Expect
Investment Insights

Chapter 6: Track Record Pitfalls
Hidden Risk
The Data Relevance Pitfall
When Good Past Performance Is Bad
The Apples-and-Oranges Pitfall
Longer Track Records *Could* Be Less Relevant
Investment Insights

Chapter 7: Sense and Nonsense about Pro Forma Statistics
Investment Insights

Chapter 8: How to Evaluate Past Performance
Why Return Alone Is Meaningless
Risk-Adjusted Return Measures
Visual Performance Evaluation
Investment Insights

Chapter 9: Correlation: Facts and Fallacies

- Correlation Defined
- Correlation Shows Linear Relationships
- The Coefficient of Determination (r^2)
- Spurious (Nonsense) Correlations
- Misconceptions about Correlation
- Focusing on the Down Months
- Correlation versus Beta
- Investment Insights

Part Two: Hedge Funds as an Investment

Chapter 10: The Origin of Hedge Funds

Chapter 11: Hedge Funds 101

- Differences between Hedge Funds and Mutual Funds
- Types of Hedge Funds
- Correlation with Equities

Chapter 12: Hedge Fund Investing: Perception and Reality

- The Rationale for Hedge Fund Investment
- Advantages of Incorporating Hedge Funds in a Portfolio
- The Special Case of Managed Futures
- Single-Fund Risk

Investment Insights

Chapter 13: Fear of Hedge Funds: It’s Only Human

A Parable
Fear of Hedge Funds

Chapter 14: The Paradox of Hedge Fund of Funds Underperformance

Investment Insights

Chapter 15: The Leverage Fallacy

The Folly of Arbitrary Investment Rules
Leverage and Investor Preference
When Leverage Is Dangerous
Investment Insights

Chapter 16: Managed Accounts: An Investor-Friendly Alternative to Funds

The Essential Difference between Managed Accounts and Funds
The Major Advantages of a Managed Account
Individual Managed Accounts versus Indirect Managed Account Investment
Why Would Managers Agree to Managed Accounts?
Are There Strategies That Are Not Amenable to Managed Accounts?

Evaluating Four Common Objections to Managed Accounts
Investment Insights

Postscript to Part Two: Are Hedge Fund Returns a Mirage?

Part Three: Portfolio Matters

Chapter 17: Diversification: Why 10 Is Not Enough
The Benefits of Diversification
Diversification: How Much Is Enough?
Randomness Risk
Idiosyncratic Risk
A Qualification
Investment Insights

Chapter 18: Diversification: When More Is Less
Investment Insights

Chapter 19: Robin Hood Investing
A New Test
Why Rebalancing Works
A Clarification
Investment Insights

Chapter 20: Is High Volatility Always Bad?
- Investment Insights

Chapter 21: Portfolio Construction Principles
- The Problem with Portfolio Optimization
- Eight Principles of Portfolio Construction
- Correlation Matrix
- Going Beyond Correlation
- Investment Insights

Epilogue: 32 Investment Observations

Appendix A: Options—Understanding the Basics

Appendix B: Formulas for Risk-Adjusted Return Measures
- Sharpe Ratio
- Sortino Ratio
- Symmetric Downside-Risk Sharpe Ratio
- Gain-to-Pain Ratio (GPR)
- Tail Ratio
- MAR and Calmar Ratios
- Return Retracement Ratio

Acknowledgments

About the Author

Index

Other Books by Jack D. Schwager

Hedge Fund Market Wizards: How Winning Traders Win

Market Wizards: Interviews with Top Traders

The New Market Wizards: Conversations with America's Top Traders

Stock Market Wizards: Interviews with America's Top Stock Traders

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Schwager on Futures: Fundamental Analysis

Schwager on Futures: Managed Trading: Myths & Truths

Getting Started in Technical Analysis

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Market Sense and Nonsense

How the Markets Really Work (And How They Don't)

Jack D. Schwager

John Wiley & Sons, Inc.

Cover design: John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data

Schwager, Jack D., 1948-

Market sense and nonsense : how the markets really work (and how they don’t) / Jack D. Schwager.

p. cm.

Includes index.

ISBN 978-1-118-49456-1 (cloth); 978-1-118-50934-0 (ebk); 978-1-118-50943-2 (ebk); 978-1-118-52316-2 (ebk)

1. Investment analysis. 2. Risk management. 3. Investments. I. Title.

HG4529.S387 2013

332.6—dc23

2012030901

No matter how hard you throw a dead fish in the water, it still won’t swim.

—Congolese proverb

With love to my children and our times together:
To Daniel and whitewater rafting in Maine (although I could do without the emergency room visit next time)
To Zachary and the Costa Rican rainforest, crater hole roads, and the march of the crabs
To Samantha and the hills and restaurants of Lugano on a special weekend
I hope these memories make you smile as much as they do me.
With love to my wife, Jo Ann, for so many shared times: 5,000 BTU × 2, cashless honeymoon, Thanksgiving snow in Bolton, Minnewaska and Mohonk, Mexican volcanoes, the Mettlehorn, wheeling in Nova Scotia and PEI, weekends at our Geissler retreat, the Escarpment, Big Indian, Yellowstone in winter, Long Point and Net Result.

Foreword

I was initially flattered when Jack asked me to consider writing the Foreword for his new book. So, at this point, it seems ungrateful for me to start off with a complaint. But here goes. I wish Jack had written this book sooner.

It would have been great to have had it as a resource when I was in MBA school back in the late 1970s. There, I was learning things about the efficient market theory (things that are still taught in MBA school to this day) that made absolutely no sense to me. Well, at least they made no sense if I opened my eyes and observed how the real world appeared to work outside of my business school classroom. I sure wish that back then I'd had Jack's simple, commonsense explanation and refutation of efficient markets laid out right in front of me to help direct my studies and to put my mind at ease.

It would have been nice as a young portfolio manager to have a better understanding of how to think about portfolio risk in a framework that considered all different aspects of risk, not just the narrow framework that I had been taught in school or the one I used intuitively (a combination of fear of loss and hoping for the best).

I wish I'd had this book to give to my clients to help them judge me and their other managers not just by recent returns, or volatility, or correlation, or drawdowns, or outperformance, but by a longer perspective and deeper understanding of all of those concepts.

I wish, as a business school professor, I could have given this book to my MBA students so that the myths and misinformation they had already been taught or read about could be debunked before institutionalized nonsense and fuzzy thinking set them on the wrong path.

I wish I'd had this book to help me on all the investment committees I've sat on over the years. How to think about short-term track records, long-term track records, risk metrics, correlations, benchmarks, indexes, and portfolio management certainly would have come in handy! (Jack, where were you?)

Perhaps, most important, for friends and family it would have been great to hand them this book to help them gain the lifelong benefits of understanding how the markets really work (and how they don't).

So, thanks to Jack for writing this incredibly simple, clear, and commonsense guide to the market. Better late than never. I will recommend it to everyone I know. *Market Sense and Nonsense* is now required reading for every investor (and the *sooner* they read it, the better).

Joel Greenblatt

August 2012

Prologue*

Many years ago when I worked as a research director for one of the major Wall Street brokerage firms, one of my job responsibilities included evaluating commodity trading advisors (CTAs).[1] One of the statistics that CTAs were required by the regulatory authorities to report was the percentage of client accounts that closed with a profit. I made the striking discovery that the majority of closed accounts showed a net loss for virtually all the CTAs I reviewed—even those who had no losing years! The obvious implication was that investors were so bad in timing their investment entries and exits that most of them lost money—*even when they chose a consistently winning CTA!* This poor timing reflects the common investor tendency to commit to an investment after it has done well and to liquidate an investment after it has done poorly. Although these types of investment decisions may sound perfectly natural, even instinctive, they are also generally wrong.

Investors are truly their own worst enemy. The natural instincts of most investors lead them to do exactly the wrong thing with uncanny persistence. The famous quote from Walt Kelly's cartoon strip, *Pogo*, "We have met the enemy, and it is us," could serve as a fitting universal motto for investors.

Investment errors are hardly the exclusive domain of novice investors. Investment professionals commit their own share of routine errors. One common error that manifests itself in many different forms is the tendency to draw conclusions based on insufficient or irrelevant data. The housing bubble of the early 2000s provided a classic example. One of the ingredients that made the bubble possible was the development of elaborate mathematical

models to price complex mortgage-backed securitizations. The problem was that there was no relevant data to feed into these models. At the time, mortgages were being issued to subprime borrowers without requiring any down payment or verification of job, income, or assets. There was no precedence for such poor-quality mortgages, and hence no relevant historical data. The sophisticated mathematical models failed disastrously because conclusions were being derived based on data that was irrelevant to the present circumstances.[2] Despite the absence of relevant data, the models served as justification for attaching high ratings to risk-laden subprime-mortgage-linked debt securitizations. Investors lost over a trillion dollars.

Drawing conclusions based on insufficient or inappropriate data is commonplace in the investment field. The mathematics of portfolio allocation provides another pervasive example. The standard portfolio optimization model uses historical returns, volatilities, and correlations of assets to derive an optimal portfolio—that is, the combination of assets that will deliver the highest return for any given level of volatility. The question that fails to be asked, however, is whether the historical returns, volatilities, and correlations being used in the analysis are likely to be at all indicative of future levels. Very frequently they are not, and the mathematical model delivers results that precisely fit the past data but are worthless, or even misleading, as guidelines for the future—and the future, of course, is what is relevant to investors.

Market models and theories of investment are often based on mathematical convenience rather than empirical evidence. A whole edifice of investment theory has been built on the assumption that market prices are normally distributed. The normal distribution is very handy for analysts because it allows for precise probability-based assumptions. Every few years, one or more global markets

experience a price move that many portfolio managers insist should occur only “once in a thousand years” or “once in a million years” (or even much rarer intervals). Where do these probabilities come from? They are the probabilities of such magnitude price moves occurring, *assuming prices adhere to a normal distribution*. One might think that the repeated occurrence of events that should be a rarity would lead to the obvious conclusion that the price model being used does not fit the real world of markets. But for a large part of the academic and financial establishment, it has not led to this conclusion. Convenience trumps reality.

The simple fact is that many widely held investment models and assumptions are simply wrong—that is, if we insist they work in the real world. In addition, investors bring along their own sets of biases and unsubstantiated beliefs that lead to misguided conclusions and flawed investment decisions. In this book, we will question the conventional wisdom applied to the various aspects of the investment process, including selection of assets, risk management, performance measurement, and portfolio allocation. Frequently, accepted truths about investment prove to be unfounded assumptions when exposed to the harsh light of the facts.

*Some of the text in the first two paragraphs has been adapted from Jack D. Schwager, *Managed Trading: Myths & Truths* (New York: John Wiley & Sons, 1996).

[1]Commodity trading advisor (CTA) is the official designation of regulated managers who trade the futures markets.

[2]Although the most widely used model to price mortgage-backed securitizations used credit default swaps (CDSs) rather than default rates as a proxy for default risk, CDS prices would have been heavily influenced by historical default rates that were based on irrelevant mortgage default data.

PART ONE

MARKETS, RETURN, AND RISK

Chapter 1

Expert Advice

Comedy Central versus CNBC

On March 4, 2009, Jon Stewart, the host of *The Daily Show*, a satirical news program, lambasted CNBC for a string of poor prognostications. The catalyst for the segment was Rick Santelli's famous rant from the floor of the Chicago Mercantile Exchange, in which he railed against subsidizing "losers' mortgages," a clip that went viral and is widely credited with igniting the Tea Party movement. Stewart's point was that while Santelli was criticizing irresponsible homeowners who missed all the signs, CNBC was in no position to be sitting in judgment.

Stewart then proceeded to play a sequence of CNBC clips highlighting some of the most embarrassingly erroneous forecasts and advice made by multiple CNBC commentators, each followed by a white type on black screen update. The segments included:

- Jim Cramer, the host of *Mad Money*, answering a viewer's question by emphatically declaring, "Bear Stearns is fine! Keep your money where it is." A black screen followed: "Bear Stearns went under six days later."
- A *Power Lunch* commentator extolling the financial strength of Lehman Brothers saying, "Lehman is no Bear

Stearns.” Black screen: “Lehman Brothers went under three months later.”

- Jim Cramer on October 4, 2007, enthusiastically recommending, “Bank of America is going to $60 in a heartbeat.” Black screen: “Today Bank of America trades under $4.”
- Charlie Gasparino saying that American International Group (AIG) as the biggest insurance company was obviously not going bankrupt, which was followed by a black screen listing the staggeringly large AIG bailout installments to date and counting.
- Jim Cramer’s late 2007 bullish assessment, “You should be buying things. Accept that they are overvalued. . . . I know that sounds irresponsible, but that’s how you make the money.” The black screen followed: “October 31, 2007, Dow 13,930.”
- Larry Kudlow exclaiming, “The worst of this subprime business is over.” Black screen: “April 16, 2008, Dow 12,619.”
- Jim Cramer again in mid-2008 exhorting, “It’s time to buy, buy, buy!” Black screen: “June 13, 2008, Dow 12,307.”
- A final clip from *Fast Money* talking about “people starting to get their confidence back” was followed by a final black screen message: “November 4, 2008, Dow 9,625.”

Stewart concluded, “If I had only followed CNBC’s advice, I’d have a $1 million today—provided I started with $100 million.”

Stewart’s clear target was the network, CNBC, which, while promoting its financial expertise under the slogan “knowledge is power,” was clueless in spotting the signs of the impending greatest financial crisis in nearly a century. Although Stewart did not personalize his satiric barrage, Jim Cramer, whose frenetic presentation style makes late-night

infomercial promoters appear sedated in comparison, seemed to come in for a disproportionate share of the ridicule. A widely publicized media exchange ensued between Cramer and Stewart in the following days, with each responding to the other, both on their own shows and as guests on other programs, and culminating with Cramer's appearance as an interview guest on *The Daily Show* on March 12. Stewart was on the attack for most of the interview, primarily chastising CNBC for taking corporate representatives at their word rather than doing any investigative reporting—in effect, for acting like corporate shills rather than reporters. Cramer did not try to defend against the charge, saying that company CEOs had openly lied to him, which was something he too regretted and wished he'd had the power to prevent.

The program unleashed an avalanche of media coverage, with most writers and commentators seeming to focus on the question of who won the "debate." (The broad consensus was Stewart.) What interests us here is not the substance or outcome of the so-called debate, but rather Stewart's original insinuation that Cramer and other financial pundits at CNBC had provided the public with poor financial advice. Is this criticism valid? Although the sequence of clips Stewart played on his March 4 program was damning, Cramer had made thousands of recommendations on his *Mad Money* program. Anyone making that many recommendations could be made to look horrendously inept by cherry-picking the worst forecasts or advice. To be fair, one would have to examine the entire record, not just a handful of samples chosen for their maximum comedic impact.

That is exactly what three academic researchers did. In their study, Joseph Engelberg, Caroline Sasseville, and Jared Williams (ESW) surveyed and analyzed the accuracy and impact of 1,149 first-time buy recommendations made by

Cramer on *Mad Money*.[1] Their analysis covered the period from July 28, 2005 (about four months after the program's launch) through February 9, 2009—an end date that conveniently was just three weeks prior to *The Daily Show* episode mocking CNBC's market calls.

ESW began by examining a portfolio formed by the stocks recommended on *Mad Money*, assuming each stock was entered on the close before the evening airing of the program on which it was recommended—a point in time deliberately chosen to reflect the market's valuation prior to the program's price impact. They assumed an equal dollar allocation among recommended stocks and tested the results for a variety of holding periods, ranging from 50 to 250 trading days. The differences in returns between these recommendation-based portfolios and the market were statistically insignificant across all holding periods and net negative for most.

ESW then looked at the overnight price impact (percentage change from previous close to next day's open) of Cramer's recommendations and found an extremely large 2.4 percent average abnormal return—that is, return in excess of the average price change of similar stocks for the same overnight interval. As might be expected based on the mediocre results of existing investors in the same stocks and the large overnight influence of Cramer's recommendations, using entries on the day after the program, the recommendation-based portfolios underperformed the market across all the holding periods. The annualized underperformance was substantial, ranging from 3 percent to 10 percent. The worst performance was for the shortest holding period (50 days), suggesting a strong bias for stocks to surrender their "Cramer bump" in the ensuing period. The bottom line seems to be that investors would be better off buying and holding an index than buying the *Mad Money* recommendations—although,

admittedly, there is much less entertainment value in buying an index.

I don’t mean to pick on Cramer. There is no intention to paint Cramer as a showman with no investment skill. On the contrary, according to an October 2005 *BusinessWeek* article, Cramer achieved a 24 percent net compounded return during his 14-year tenure as a hedge fund manager—a very impressive performance record. But regardless of Cramer’s investment skills and considerable market knowledge, the fact remains that, on average, viewers following his recommendations would have been better off throwing darts to pick stocks.

The Elves Index

The study that examined the *Mad Money* recommendations represented the track record of only a single market expert for a four-year time period. Next we examine an index that was based on the input of 10 experts and was reported for a period of over 12 years.

The most famous, longest-running, and most widely watched stock-market-focused program ever was *Wall Street Week* with Louis Rukeyser, which aired for over 30 years. One feature of the show was the Elves Index. The Elves Index was launched in 1989 and was based on the net market opinion of 10 expert market analysts selected by Rukeyser. Each analyst opinion was scored as +1 for bullish, 0 for neutral, and −1 for bearish. The index had a theoretical range from −10 (all analysts bearish) to +10 (all analysts bullish). The concept was that when a significant majority of these experts were bullish, the market was a buy (+5 was the official buy signal), and if there was a bearish consensus, the market was a sell (–5 was the official sell signal). That is not how it worked out, though.

In October 1990 the Elves Index reached its most negative level since its launch, a −4 reading, which was just shy of an official sell signal. This bearish consensus coincided with a major market bottom and the start of an extended bull market. The index then registered lows of −6 in April 1994 and −5 in November 1994, coinciding with the relative lows of the major bottom pattern formed in 1994. The index subsequently reached a bullish extreme of +6 in May 1996 right near a major relative high. The index again reached +6 in July 1998 shortly before a 19 percent plunge in the S&P 500 index. A sequence of the highest readings ever recorded for the index occurred in the late 1999 to early 2000 period, with the index reaching an all-time high (up to then) of +8 in December 1999. The Elves Index remained at high levels as the equity indexes peaked in the first quarter of 2000 and then plunged. At one point, still early in the bear market, the Elves Index even reached an all-time high of +9. Rukeyser finally retired the index shortly after 9/11, when presumably, if kept intact, it would have provided a strong sell signal.[2]

Rukeyser no doubt terminated the Elves Index as an embarrassment. Although he didn't comment on the timing of the decision, it is reasonable to assume he couldn't tolerate another major sell signal in the index coinciding with what would probably prove to be a relative low (as it was). Although the Elves Index had compiled a terrible record—never right, but often wrong—its demise was deeply regretted by many market observers. The index was so bad that many had come to view it as a useful contrarian indicator. In other words, listening to the consensus of the experts as reflected by the index was useful—as long as you were willing to do the exact opposite.

Paid Advice

In this final section, we expand our analysis to encompass a group that includes hundreds of market experts. If there is one group of experts that might be expected to generate recommendations that beat the market averages, it is those who earn a living selling their advice—that is, financial newsletter writers. After all, if a newsletter's advice failed to generate any excess return, presumably it would find it difficult to attract and retain readers willing to pay for subscriptions.

Do the financial newsletters do better than a market index? To find the answer, I sought out the data compiled by the *Hulbert Financial Digest*, a publication that has been tracking financial newsletter recommendations for over 30 years. In 1979, the editor, Mark Hulbert, attended a financial conference and heard many presentations in which investment advisers claimed their recommendations earned over 100 percent a year, and in some cases much more. Hulbert was skeptical about these claims and decided to track the recommendations of some of these advisers in real time. He found the reality to be far removed from the hype. This realization led to the launch of the *Hulbert Financial Digest* with a mission of objectively tracking financial newsletter recommendations and translating them into implied returns. Since its launch in 1981, the publication has tracked over 400 financial newsletters.

Hulbert calculates an average annual return for each newsletter based on their recommendations. Table 1.1 compares the average annual return of all newsletters tracked by Hulbert versus the S&P 500 for three 10-year intervals and the entire 30-year period. (The newsletter return for any given year is the average return of all the newsletters tracked by Hulbert in that year.) As a group, the financial newsletters significantly underperformed the S&P 500 during 1981–1990 and 1991–2000 and did moderately better than the S&P 500 during 2001–2010. For the entire

30-year period, the newsletters lagged the S&P 500 by an average of 3.7 percent per annum.

Table 1.1 Average Annual Return: S&P 500 versus Average of Financial Newsletters

Source: Raw data on investment newsletter performance from the *Hulbert Financial Digest*.

Time Period	S&P 500	Average of Financial Newsletters	Newsletters Minus S&P 500
1981–1990	14.5%	9.0%	−5.5%
1991–2000	18.2	10.0	−8.2
2001–2010	3.5	6.3	2.8
All Years (1981–2010)	**12.1**	**8.4**	**−3.7**

Perhaps if the choice of newsletters were restricted to those that performed best in the recent past, this more select group would do much better than the group as whole. To examine this possibility, we focus on the returns generated by the top-decile performers in prior three-year periods. Thus, for example, the 1994 returns would be based on the average of only those newsletters that had top-decile performance for the 1991–1993 period. Table 1.2 compares the performance of these past better-performing newsletters with the S&P 500 and also includes comparison returns for the past worst-decile-return group. Choosing from among the best past performers doesn't seem to make much difference. The past top-decile-return newsletters still lag the S&P 500. Although picking the best prior performers doesn't seem to provide much of an edge, it does seem advisable to avoid the worst prior performers, which for the period as a whole did much worse than the average of all newsletters.

Table 1.2 Average Annual Return: S&P 500 versus Average of Financial Newsletters in Top and Bottom Deciles in Prior Three-Year Periods

Source: Raw data on investment newsletter performance from the *Hulbert Financial Digest*.

Time Period	S&P 500	Average of Top Decile	Average of Bottom Decile	Top Decile Minus S&P 500	Bottom Decile Minus S&P 500
1984–1990	15.2%	8.2%	5.0%	–7.0%	–10.2%
1991–2000	18.2	16.7	–0.7	–1.5	–18.9
2001–2010	3.5	3.4	6.1	–0.1	2.6
All Years (1984–2010)	**12.0**	**9.6**	**3.3**	**–2.4**	**–8.7**

Perhaps three years is a look-back period of insufficient length to establish superior performance. To examine this possibility, Table 1.3 duplicates the same analysis comparing the past five-year top- and bottom-decile performers with the S&P 500. The relative performance results are strikingly similar to the three-year look-back analysis. For the period as a whole, the past top-decile performers lagged the S&P 500 by 2.6 percent (versus 2.4 percent in the three-year look-back analysis), and the bottom-decile group lagged by a substantive 9.5 percent (versus 8.7 percent in the prior analysis). The conclusion is the same: Picking the best past performers doesn't seem to provide any edge over the S&P 500, but avoiding the worst past performers appears to be a good idea.

Table 1.3 Average Annual Return: S&P 500 versus Average of Financial Newsletters in Top and Bottom Deciles in Prior Five-Year Periods

Source: Raw data on investment newsletter performance from the *Hulbert Financial Digest*.

Time Period	S&P 500	Average of Top Decile	Average of Bottom Decile	Top Decile Minus S&P 500	Bottom Decile Minus S&P 500
1986–1990	13.9%	1.7%	6.7%	–12.2%	–7.2%
1991–2000	18.2	15.6	–4.9	–2.6	–23.1
2001–2010	3.5	5.7	6.4	2.2	2.9
All Years (1986–2010)	**11.5**	**8.9**	**2.0**	**–2.6**	**–9.5**