Grading the Performance of Market-Timing Newsletters

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Many investment newsletters offer market-timing advice; that is, they are supposed to recommend increased stock market weights before market appreciations and decreased weights before market declines. Examination of the performance of 326 newsletter asset-allocation strategies for the 1983–95 period shows that as a group, newsletters do not appear to possess any special information about the future direction of the market. Nevertheless, investment newsletters that are on a hot streak (have correctly anticipated the direction of the market in previous recommendations) may provide valuable information about future returns.

If investment newsletters can "time the market," they should recommend that their subscribers increase the portion of funds invested in the stock market prior to market increases and decrease the portion dedicated to stocks prior to market declines. Graham and Harvey (1994, 1996) found strong evidence that as a group, newsletters cannot time the stock market, but their emphasis was on evaluating newsletters as a group; they did not investigate whether individual newsletters can give valuable investment advice. This study focuses on techniques that can be used to identify superior individual newsletters. Importantly, these techniques can be used to evaluate the performance of a wide variety of investments and are not specific to newsletters.

We studied the recommendations made by 326 investment newsletters between 1983 and 1995, a much larger sample than we used in Graham and Harvey (1996). We first investigated whether, on average, newsletters increase their recommended equity weights prior to market rises and decrease their recommended weights prior to market declines. Our evidence indicates that newsletters, on average, do not alter their recommendations appropriately, but we also identified an intriguing phenomenon: Newsletters that are on a "hot streak" (e.g., they increased equity weights in their previous three recommendations and the stock market yielded a positive return each time) showed substantial ability to time the market, and those that are on a "cold streak" continued to give poor investment advice. This finding suggests that investors can potentially earn superior returns by following "hot" advice.

We investigated whether this apparent "hot hands phenomenon" is misleading in that it implies some newsletters give valuable investment advice, when in fact, they do not provide any new information. For example, if a newsletter makes its recommendations based solely on the index of leading economic indicators, which is available to the public at no cost, then an investor could simply invest based on the leading indicators and avoid paying a newsletter subscription fee. Using a regression analysis that determines whether newsletters provide any information beyond that which is publicly available, we found that between 8 percent and 15 percent of the investment newsletters do provide useful investment advice. The problem is how to identify those superior advisors.

We propose two new performance measures that, after controlling for risk, identify investment advisors that give superior advice.[1] The idea of controlling for risk is very important but sometimes overlooked. For example, an advisor could recommend that an investor margin his or her investment so as to be 200 percent exposed to the market at all times. Such an investment would yield approximately twice the return from going 100 percent the market, but it would also subject an investor to substantial risk. Our performance measures adjust for risk and consequently penalize a 200 percent long strategy before comparing it with a 100 percent long strategy. The advice given by investment advisors, however, is much more interesting than simply "always go 200 percent long the market," and our measures are designed to evaluate a wide variety of scenarios involving changing asset allocation weights, selecting specific stocks or

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