

Of Mice and Men

Wouldn't it be wonderful if, so long as we keep up our end of the bargain and pick an investment adviser responsibly and for all the right reasons, we could count on the relationship being a profitable one?

Alas, to paraphrase the famous Robert Burns poem: "The best laid schemes of mice and men go often askew." Even the best investment adviser has bad years, prompting his clients to agonize over whether they should get rid of him and go with someone else.

My musings are of more than just academic interest—especially for subscribers to NoLoad FundX, a newsletter that used to be at the top of the long-term rankings, but which stumbled badly during the recent bear market. At last month's Money Show in Orlando, I received more questions about this newsletter than about any other single service.

I'm therefore devoting this issue's front-page article to a rigorous statistical analysis of this newsletter's track record. Note, however, that even though this article focuses on just one newsletter in particular, it behooves all of us to pay attention even if we are not subscribers to that service. We can be assured that, at some point in our future, there will be a time when we wonder if our choice of investment adviser was the right one.

On one level, of course, it is not a big mystery why followers of NoLoad FundX are agonizing over whether it might have lost its touch. Going into the 2007-2009 bear market, the newsletter was in first place on a risk-adjusted basis among all HFD-monitored newsletters over the trailing 25-year period. And in the previous bear market, the one that ensued after the Internet bubble burst in 2000, the newsletter's model portfolio held its own even while the broad market averages were losing half their value.

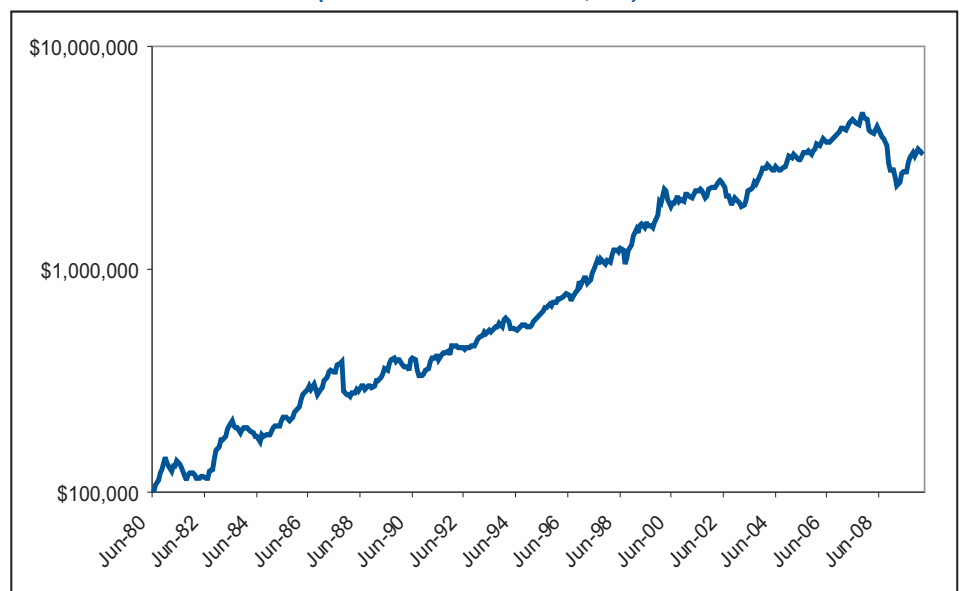
But in the recent bear market, according to the HFD's calculations, the newsletter lost slightly more than the market itself. As you can see from the chart to the right, the 2007-2009 bear market sticks out like a very sore thumb.

Looked at from another perspective, however, it's less clear why subscribers should take their experience during the recent bear market as evidence that the newsletter has lost its touch. After all, that bear market spared few approaches; NoLoad Fund*X was hardly alone in losing big. On the contrary, the carnage was nearly universally shared.

Obviously, no one likes to incur losses. But losses are not, in and of themselves, a good reason to conclude that an approach is a bad bet for future performance. If you find losses intolerable, you shouldn't be investing in equities in the first place.

This may be one of those cases, therefore, in which objective statistical analysis can be a helpful antidote to the conclusions to which our emotions would otherwise lead us.

Chart 1. Three decades' returns for No-Load Fund*X
(6/30/1980 value = \$100,000)



Relative performance

As a first step in analyzing NoLoad FundX's performance, it's helpful to focus on its returns above or below the market itself. Has its market-adjusted performance been better or worse in recent years than it was a few decades ago?

To be sure, this is not always an appropriate question to ask. It all depends on how heavily correlated the newsletter is with the overall market. It would be one thing, for example, if a newsletter's approach jumped around between different asset categories—sometimes invested in stocks but just as likely to be invested in other asset classes such as bonds, gold, commodities, or currencies. Performance relative to the US stock market would, in such a case, not be a very helpful statistic.

But when an approach is focused primarily on the US stock market, relative performance is very helpful. And this is indeed the case for NoLoad FundX. Consider a statistic known as the rsquared, which measures the degree to which changes in one thing (in this case, the Wilshire 5000 index) leads to changes in another (the performance of No-LoadFund*X). The r-squared's theoretically lowest value is 0, which would mean that there is no detectable relationship between the two things; its highest possible level is 1, which would mean that there is complete correlation.

The r-squared for NoLoad FundX is 0.74*, which is quite high and statistically very significant. That means that, had we known in October 2007 that the stock market was soon to fall by nearly 60%, it would have been a good bet that NoLoad FundX would suffer mightily too—which it indeed did.

We can therefore be quite confident that relative performance is the relevant measure for NoLoad FundX, and this is plotted in Chart 2 on this page. Each month's vertical bar in the chart represents the degree to which the newsletter's ten-year annualized return is above or below the comparable return of the Wilshire 5000. A cursory glance at Chart 2 is all that is needed to show that NoLoad FundX has not lost its

touch. On the contrary, to the extent that any conclusion can be drawn from the nearly 30 years of track records that the HFD has calculated for the newsletter, it would be that the newsletter has done better in recent years than it did a few decades ago.

Yet another statistical test

As a reality check on my analysis, especially since so many of my subscribers continue to wonder if NoLoad FundX might have lost its touch, I contacted David Aronson, an adjunct professor of finance at Baruch College, City University of New York, where he teaches a graduate level course in quantitative market analysis and data mining. Aronson also is a principal of Hood River Research, a firm that uses advanced econometric techniques to develop and evaluate predictive models and trading systems.

Aronson and a colleague at Hood River Research took the HFD data for NoLoad Fund*X and searched for any evidence in support of the notion that the newsletter's track record in recent years was different, in a statistically significant way, from its track record in previous years.

Despite testing myriad different possibilities, they came up empty. This analysis doesn't automatically mean you should stick with NoLoad FundX. But, assuming you started following this newsletter because of its past record of beating the market over long periods, you have no good statistical reason to give up on the newsletter now.

Chart 2. No-Load Fund*X's performance relative to Wilshire 5000 index
(Each bar in the chart below reflects the difference between No-Load Fund*X's annualized trailing 10-year return and the comparable return of the Wilshire 5000.)

