Investment newsletters should be read with care

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Note

Canada's investment newsletter industry is alive and well. Armed with sophisticated computer programs and analytical tools, these monthly and quarterly bulletins claim an ability to add value to your decision-making process.

They profess to have access to special information and unique insights that enable them to predict when markets will rise and fall. However, the bulk of academic research in this area strongly challenges the validity of these claims. To those who purchase these publications, I am compelled to say, caveat emptor.

Buyer beware.

Over the last few months, since the Asian financial crisis hit, I have noticed with some alarm that a number of these newsletters have advised readers to sell all or a portion of their Canadian equity funds and move into more defensive cash or bonds. Of late, several have urged investors to dump their American equity funds, citing an imminent market correction.

Whether or not these predictions eventually come true is of little concern to me. After all, make enough predictions and a few are bound to come true.

Indeed, you occasionally come across a publication that boasts about a recent home run -- a gem of a prediction that actually came to pass. But when you read the prediction as it originally appeared, you find it was hedged and qualified, and buried among dozens of other forecasts that didn't prove out. Most annoying is when a newsletter's stinker predictions are ignored in future editions, as if they never existed. I find this ploy particularly insulting!

Why do so many of these publications fail to deliver on their promises?

The simple fact is, market timing is just too difficult to do consistently and over extended periods. In what has become a classic research paper on the subject, William F. Sharpe, professor of finance at Stanford , wrote in 1975 that investors would have to be correct seven times out of ten for market timing to be profitable.

of Calgary professors Jess Chua and Richard Woodward went one step further and suggested that achieving consistently positive gains requires a minimum forecasting accuracy of 80 per cent. Their paper, published in Financial Analysts Journal, declares that while market timers may do well in predicting bear markets, after selling off they tend to stay out of the market too long and miss the inevitable bull market recovery.

The losses these timers avoid in bear markets are not sufficient to cover the extraordinary returns they miss in bull markets. Anything less than 80 per cent accuracy in buying back into the rising market, Chua and Woodword suggest, and you end up underperforming a simple buy-and-hold strategy.

With this overwhelming evidence against the practice of market timing, John Graham and Campbell Harvey, both professors at Duke , studied the performance of 326 newsletters over the period 1983-95.

They concluded that, as a group, newsletters don't appear to possess any special information about the future direction of the market. Indeed, some high-profile and expensive newsletters performed remarkably poorly for extended periods of time.

While they found that a few publications every now and then got on a hot streak, there was no way to tell in advance which ones that would be. Further, these streaks of accuracy were fleeting, dissipating as quickly and as unexpectedly as they had arrived.

I can think of no other investment strategy that has been so thoroughly discredited as market timing. And yet, we continue in our relentless search for a magical solution that will take the uncertainty away from investing. Unfortunately, the inevitable disappointments of this search only intensify our desire to find some system or market indicator that will make it all clear. If such a system exists at all, it continues to elude us. Caveat emptor!

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Investment Tips

Investing is an emotional activity and there's no way to banish pride, fear, impatience and regret. To keep passions in check, try to be aware of their influence. A few guidelines:

Do recognize the natural tendency to try to "get even." Don't tie up your money by refusing to sell a losing investment, especially if there are tax benefits in accepting the loss.

Don't think you can beat the market. Overconfident investors tend to trade too much, hurting their long-term performance.

Don't assume that a one-year or even a five-year track record for a mutual fund or a stock is enough evidence to indicate where the investment is headed next year.

Don't equate "good" companies" -- those that show up on most- admired lists, for example -- with good stocks. Popularity boosts prices, so an ugly duckling may be a better value than a swan.

Ran with "Investment Tips" which has been appended to the end of this story

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