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

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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

[1]Engelberg, Joseph, Caroline Sasseville, and Jared Williams, *Market Madness? The Case of* Mad Money (October 20, 2010). Available at SSRN: http://ssrn.com/abstract=870498.

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

[2]"Louis Rukeyser Shelves Elves Missed Market Trends Tinkering Didn't Improve Index's Track Record for Calling Market's Direction (MUTUAL FUNDS)," *Investor's Business Daily*, November 1, 2001. Retrieved March 29, 2011, from AccessMyLibrary: www.accessmylibrary.com/article-1G2.106006432/louis-rukeyser-shelves-elves .html.

(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

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

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**

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

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

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**

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

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.

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

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

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**

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

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.

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.

Some of the newsletters tracked by Hulbert did indeed add value, delivering market-beating recommendations over the long term. Picking these superior newsletters ahead of time, however, is no easy task. The complicating factor is that while some superior past performers continue to do well, others don't. Simply selecting from the best past performers is not sufficient to identify the newsletters whose advice is likely to beat the market in a coming year.

Investment Misconception

Investment Misconception 1: The average investor can benefit by listening to the recommendations made by the financial experts.

Reality: The amazing thing about expert advice is how consistently it fails to do better than a coin toss. In fact, even that assessment is overly generous, as the preponderance of empirical evidence suggests that the experts do worse than random. Yes, that means the chimpanzee throwing darts at the stock quote page will not merely do as well as the experts—the chimpanzee will do better!

Investment Insights

Many investors seek guidance from the advice of financial experts available through both broadcast and print media. Is this advice beneficial? In this chapter, we have examined three cases of financial expert advice, ranging from the recommendation-based record of a popular financial program host to an index based on the directional calls of 10 market experts and finally to the financial newsletter industry. Although this limited sample does not rise to the level of a persuasive proof, the results are entirely consistent with the available academic research on the subject. The general conclusion appears to be that the advice of the financial experts may sometimes trigger an immediate price move as the public responds to their recommendations (a price move that is impossible to capture), but no longer-term net benefit.

My advice to equity investors is either buy an index fund (but not after a period of extreme gains—see Chapter 3) or, if you have sufficient interest and motivation, devote the time and energy to develop your own investment or trading methodology. Neither of these approaches involves listening to the recommendations of the experts. Michael Marcus, a phenomenally successful trader, offered some sage advice on the matter: "You have to follow your own light. . . . As long as you stick to your own style, you get the good and the bad in your own approach. When you try to incorporate someone else's style, you often wind up with the worst of both styles."[3]

[3]Jack D. Schwager, *Market Wizards* (New York: New York Institute of Finance, 1989).