Why God would be fired as a Portfolio Manager

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Every once in a while we come across statistics that we think are worth bringing to our investors' attention. Based on much of the feedback that I have received over the years, I thought I would have a little fun and ask a simple question: if God is omnipotent, could He create a fund that was so good that He could never get fired? No. It turns out even God would most likely get fired as an active investor. Read on for the reasons why……..

Strategy Background

We compute the 5-year "look ahead" return for all common stocks for the 500 largest NYSE/NASDAQ/AMEX firms. For simplicity, we eliminate any firms that do not have returns for a full 60 months. We looked at gross returns, and all returns are total returns including dividends. Next we create decile portfolios based on the forward five-year compound annual growth rate (CAGR).

We rebalance the portfolio on July 1st every fifth year. The first portfolio formation is July 1, 1926 and is held until June 30, 1931. The second portfolio is formed on July 1, 1931 and held until June 30, 1936. This pattern repeats every fifth year. To be clear, we know with 100% certainty the performance of the top 500 stocks over the next 5 years.

We are <u>explicitly</u> engaging in look-ahead bias.

Returns are analyzed from 1/1/1927 to 12/31/2009. Portfolios are value-weighted returns for month *t,* and are weighted using the market capitalization at the end of month *t-1*. All returns are gross of transaction costs, taxes, and fees.

Decile Portfolios

We first look at the decile portfolios rebalanced every 5 years. These portfolios highlight what perfect foresight can achieve. The Decile 10 portfolios represent value-weighted portfolios sorted on future top 5-year performers and the Decile 1 represent value-weighted portfolios sorted on future bottom 5-year performers.

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As expected, a portfolio formed on the names that have the best 5 -year performance, have the best 5-year performance. Duh. But the details are interesting…

Summary Statistics*	5 year High MOM VW	SP500
CAGR	28.89%	9.63%
Standard Deviation	21.81%	19.40%
Downside Deviation (MAR=5%)	15.52%	14.44%
Sharpe Ratio	1.12	0.39
Sortino Ratio (MAR=5%)	1.48	0.42
Worst Drawdown	-75.96%	-84.59%
Worst Month Return	-32.69%	-28.73%
Best Month Return	44.20%	41.65%
Profitable Months	69.18%	61.45%

The 29% CAGR is obviously awesome for the look-ahead portfolio. Expected.

But how about the drawdown associated with a perfect foresight portfolio? Can't be that bad if you know the future, right?

Wrong! The worst drawdown for the look-ahead portfolio is devastating: **-76%**! (Aug 1929 to May 1932).

But the pain doesn't end there…here is a table of the top 10 drawdowns:

Rank	Date Start	Date End	5 year High MOM VW	SP500
1	8/30/1929	5/31/1932	-75.96%	-84.59%
2	3/31/1937	3/31/1938	-44.04%	-51.11%
3	5/31/2008	2/28/2009	-42.18%	-45.72%
4	3/31/2000	3/31/2001	-34.03%	-21.48%
5	10/31/1973	9/30/1974	-30.74%	-38.91%
6	8/31/1987	11/30/1987	-27.94%	-29.58%
7	3/31/1962	6/30/1962	-23.35%	-20.64%
8	11/30/1980	9/30/1981	-22.89%	-13.69%
9	4/30/1940	5/31/1940	-19.16%	-23.13%
10	5/31/1946	10/31/1946	-19.09%	-21.97%

What the chart highlights is that even GOD HIMSELF, with perfect foresight into the next 5-years of returns, would more than likely get fired multiple times over. The performance on the perfect fund would get crushed on many different occasions by the passive index.

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These results highlight the fickle nature of assessing relative performance over short horizons.

Takeaways:

1. Keynes was right: Markets can remain irrational longer than you can remain solvent
2. Active investors MUST have a long-horizon…and few investors actually have horizon.
3. It is critically important that if you decide to invest in the equity markets, you do so with the patience and temperament required to be successful. A good financial advisor can be the solution to that!

I hope you found this little piece fascinating. Next time the emotional roller coaster of the financial markets have you running for the hills, it may be helpful to pull this out and remember that staying invested is half the battle and jumping from strategy to strategy over any 1, 2, or 3 years period is truly a recipe for disaster in your portfolio,

As always, if you have any additional questions please do not hesitate to get in contact.

Sincerely,
Jim Tassoni
President/CIO
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