



## Hot Hands' Investing Profits Require Discipline: John Wasik

Aug. 18 (Bloomberg) -- When you have a hot hand, you tend to keep playing to maintain a winning streak. Athletes from cyclist Lance Armstrong to golfer Annika Sorenstam know this.

The same strategy applies to investing. When searching for growth in the stock market, there is a way of profiting from momentum. That's so even in this still-troubled economy, though you'll need discipline to achieve it.

Werner De Bondt, a behavioral finance professor at DePaul University in Chicago, has produced new research with Professor Hsiu-Lang Chen of the University of Illinois-Chicago that shows how momentum investing works.

In studying Standard & Poor's 500 index member stocks from 1976 through 2000, De Bondt found that by tracking stocks and investment styles that have been successful recently, you can boost the overall return of a portfolio.

Investors could benefit from chasing investment styles that were successful over the previous 3 to 12 months," De Bondt says.

To find growth niches, though, you have to ignore broad stock market averages and dig deeper. A practical application of De Bondt's research is found in the "hot hands" strategy.

### Vanguard's Findings

In the newsletter Independent Adviser for Vanguard Investors, editor Daniel Wiener has found that investing in the best-performing mutual fund within the second-largest fund group has delivered market-beating returns in 16 of the past 21 years.

For example, Vanguard's Global Equity fund returned negative 9.05 percent last year, according to Bloomberg data. While that's not an appealing return, it handily beat the Wilshire 5000 index, a proxy for most U.S. listed stocks, by 16 percentage points during that period.

For every year since 1983, the hot-hands funds had two straight years of positive returns. Even in years in which major stock indexes lost money, the hot funds prevailed. The Small-Cap Value Index fund rose 21.9 percent in 2000 and was up 14 percent in 2001. The S&P 500 lost 10 percent in 2000 and 13 percent in 2001. The U.S. Growth Fund was up 4.6 in 1990 and rose 47 percent the following year, while the Wilshire 5000 Index lost almost 11 percent in 1990 and gained about 31 percent the next year.

Strategies that buy stocks with characteristics that are currently in favor and that sell stocks with out-of-favor characteristics continue to perform well for periods of one year," De Bondt adds.

### Bandwagon Bargains?

As an economist who studies human behavior, De Bondt says the results of his study may reflect mass investor psychology in motion. It may have nothing to do with fundamentals, cash flow or risk perception. Investors may just be jumping on the bandwagon," he says.

Andy Pilara, who manages the \$350 million RS Partners Fund, is a case in point. Pilara's specialty is buying bargains among small companies, which lately have done well when large companies have faltered.

Over the past five years through July 25, Pilara's fund is in the top 3 percent of all funds with an 11 percent return, and in the elite 1 percent with a 23 percent return over three years, according to Bloomberg data.

Although Pilara's stock picking certainly shows evidence of a winning streak, he's also benefited from a market preference for small, undervalued stocks. Is it still worth investing in his fund if the small-cap value cycle has run its course?

"I don't know where we're at in the cycle, it might be the fourth or fifth inning," said Pilara.

## Tracking Returns

How would De Bondt's findings work in real life? While he hasn't tested it using real dollars, there are several possible ways:

-- Watch the returns of style and sector categories of mutual funds -- large, mid- and small-cap growth or value stocks -- and invest in the lowest-cost funds that closely match the winning styles over the last six to nine months. You can track fund categories by return on <http://www.morningstar.com>. Go to "funds," then "category" returns. For example, if large-growth funds show positive momentum, find the best fund that embodies that style.

-- Monitor returns of exchange-traded funds, which track investing styles and company sectors at a low cost. These funds are baskets of securities packaged as stocks and listed on stock exchanges. The Vanguard group, <http://www.vanguard.com> and <http://www.iShares.com> are good places to start.

Although it's generally not a good idea to look at returns that are more than a year old to try to pick a winner, according to De Bondt's research, if you had chosen funds with upward momentum in the first six months of their ascent, you would have reaped the gains over the next six months.

## Style vs Timing

There's one powerful caveat in this school of momentum investing that bears repeating: It takes a lot of discipline to make it work. De Bondt admits that, "I'm not sure if individuals can do this systematically enough. It's difficult to do."

Also don't confuse style investing with timing the stock market at large. Investors who jump in and out of stocks consistently lose money and can't pull the trigger to get out of losers.

A recent study from Dalbar Inc., a research firm, shows that the average stock investor trying to time the market earned a paltry 2.57 percent annually compared to inflation of 3.14 percent and 12 percent for the S&P 500 stock index for the last 19 years."

If you don't have the time, gumption or a diligent fee-only investment adviser to do the work for you, keep a passive portfolio in stock-index funds that invest in U.S. large, mid- sized and small value-and-growth companies; international and real estate stocks.

While hot hands can turn cold, keep in mind it's important to stay in the market. You can't win unless you're

still playing.

*Last Updated: August 18, 2003 00:11 EDT*