Adding Your Two Cents May Cost a Lot Over the Long Term
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Gotham Asset Management managing partner and Columbia professor Joel Greenblatt explains why investors who 'self-managed' his Magic Formula using pre-approved stocks **underperformed** the professionally managed systematic accounts.

Wow. I recently finished examining the first two years of returns for our Formula Investing U.S. separately managed accounts. The results are stunning. But probably not for the reasons you're thinking. Let me explain.

Formula Investing provides two choices for retail clients to invest in U.S. stocks, either through what we call a "self-managed" account or through a "professionally managed" account. A self-managed account allows clients to make a number of their own choices about which top ranked stocks to buy or sell and when to make these trades. Professionally managed accounts follow a systematic process that buys and sells top ranked stocks with trades scheduled at predetermined intervals. During the two year period under study[1], both account types chose from the same list of top ranked stocks based on the formulas described in The Little Book that Beats the Market. But before I get to the results, let me rewind a little and review how we got here in the first place.

In 2005, I finished writing the first edition of ***The Little Book that Beats the Market*** and I panicked. The book contained a simple formula to pick stocks that encapsulated the most important principles that I use when making my own stock selections. The problem was that after I finished, I realized that the individual investors I was trying to help might try to follow the book's advice but use poor quality company information found over the internet or a miscalculation of the formula to make unsuccessful stock investments (or possibly worse, they might use the book to learn how to write run-on sentences). I quickly put together a free website called ***magicformulainvesting.com*** that used a high quality database and that performed the calculations as I had intended. Unfortunately, it still wasn't that easy to keep track of all the stocks, trades and timing that are necessary to follow the plan outlined in the book. In fact, my kids and I ended up having a tough time keeping track, too.

So after hundreds of emails from readers asking for more help in managing their portfolios, I had an idea. It was based on an idea I had long ago about creating a "benevolent" brokerage firm that sought to protect its customers from the most common investing errors. The firm would still let clients pick individual stocks, but those stocks would have to be selected from a pre-approved list based on the principles and formula outlined in the book. We would encourage clients to hold a portfolio of at least 20 stocks from this list to aid in the creation of a diversified portfolio and to send them reminders to make trades at the proper time to help maximize tax efficiency. We wouldn't allow margin accounts so that customers could pursue this investment strategy over the long term.

At the last minute after creating the site, Blake Darcy, the CEO of the new venture and the founder of pioneering discount broker DLJdirect (in other words, he knows a thing or two about individual investors) suggested we make one simple addition. He said, why don't we give customers a checkbox which essentially says "just do it for me"? In other words, this "professionally managed" account would follow a pre-planned system to buy top ranked stocks from the list at periodic intervals. No judgment involved, just automatically follow the plan.

So, what happened? Well, as it turns out, the self-managed accounts, where clients could choose their own stocks from the pre-approved list and then follow (or not) our guidelines for trading the stocks at fixed intervals didn't do too badly. A compilation of all self-managed accounts for the two year period showed a **cumulative return of 59.4% after all expenses**. Pretty darn good, right? Unfortunately, the S&P 500 during the same period was actually up 62.7%.

"Hmmm....that's interesting", you say (or I'll say it for you, it works either way), "so how did the 'professionally managed' accounts do during the same period?" Well, a compilation of all the "professionally managed" accounts earned **84.1% after all expenses** over the same two years, beating the "self managed" by almost 25% (and the S&P by well over 20%). For just a two year period, that's a huge difference! **It's especially huge since both "self-managed" and "professionally managed" chose investments from the same list of stocks and supposedly followed the same basic game plan.**

Let's put it another way: on average the people who "self-managed" their accounts took a **winning system and used their judgment to unintentionally eliminate all the outperformance and then some!** How'd that happen?

Well, here's what appears to have happened:

(You might consider this a helpful list of things NOT to do!)

1. Self-managed investors avoided buying many of the biggest winners.

How? **Well, the market prices certain businesses cheaply for reasons that are usually very well known.** Whether you read the newspaper or follow the news in some other way, you'll usually know what's "wrong" with most stocks that appear at the top of the magic formula list. That's part of the reason they're available cheap in the first place! Most likely, the near future for a company might not look quite as bright as the recent past or there's a great deal of uncertainty about the company for one reason or another. Buying stocks that appear cheap relative to trailing measures of cash flow or other measures (even if they're still "good" businesses that earn high returns on capital), usually means **you're buying companies that are out of favor. These types of companies are <u>systematically avoided</u> by both individuals and institutional investors.** Most people and especially professional managers want to make money now. A company that may face short term issues isn't where most investors look for near term profits. Many self-managed investors just eliminate companies from the list that they just know from reading the newspaper face a near term problem or some uncertainty. But many of these companies turn out to be the biggest future winners.

2. Many self-managed investors changed their game plan after the strategy

underperformed for a period of time.

Many self-managed investors got discouraged after the magic formula strategy underperformed the market for a period of time and simply sold stocks without replacing them, held more cash, and/or stopped updating the strategy on a periodic basis. **It's hard to stick with a strategy that's not working for a little while.** The best performing mutual fund for the decade of the 2000's actually earned over 18% per year over a decade where the popular market averages were essentially flat. However, because of the capital movements of investors who bailed out during periods after the fund had underperformed for awhile, the average investor (weighted by dollars invested) actually turned that 18% annual gain into an 11% LOSS per year during the same 10 year period.[2]

3. Many self-managed investors changed their game plan after the market and their self-managed portfolio declined (regardless of whether the self-managed strategy was outperforming or underperforming a declining market).

This is a similar story to #2 above. Investors don't like to lose money. Beating the market by losing less than the market isn't that comforting. Many self-managed investors sold stocks without replacing them, held more cash, and/or stopped updating the strategy on a periodic basis after the markets and their portfolio declined for a period of time. It didn't matter whether the strategy was outperforming or underperforming over this same period. Investors in that best performing mutual fund of the decade that I mentioned above likely withdrew money after the fund declined regardless of whether it was outperforming a declining market during that same period.

4. Many self-managed investors bought more AFTER good periods of performance.

You get the idea. Most investors sell right AFTER bad performance and buy right AFTER good performance. This is a great way to lower long term investment returns.

So, is there any good news from this analysis of "self-managed" vs. "professionally managed" accounts? (Other than, of course, learning what mistakes NOT to make—which is pretty darn important!) Well, I can share two observations that are, at the very least, fun to think about:

First, most clients ended up asking Formula Investing to "just do it for me" and selected "professionally managed" accounts with over 90% of clients choosing this option. Perhaps most individual investors actually know what's best after all!

Second, the best performing "self-managed" account didn't actually do anything. What I mean is that after the initial account was opened, the client bought stocks from the list and never touched them again for the entire two year period. **That strategy of doing NOTHING outperformed all other "self-managed" accounts.** I don't know if that's good news, but I like the message it appears to send—simply, when it comes to long-term investing, doing "less" is often "more". Well, good work if you can get it, anyway.

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[1] The study reviewed the period May 1, 2009 to April 30, 2011. Past performance is not indicative of future results.

[2] Source: Morningstar study quoted in The Wall Street Journal, December 31, 2009, "Best Stock Fund of the Decade."

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