

Why You Shouldn't Chase Last Year's Returns

We all want to back a winner with our investments. But if you're thinking about switching to that top-performing stock or mutual fund your neighbour just told you about, stop and consider this: one of the biggest mistakes that investors make is to chase performance. That exhilarating desire to scoop up today's hot stocks & mutual funds often lands investors in the wrong place at the wrong time.

Buying stocks or funds based on their recent performance or selling them as soon as they begin to decline is a recipe for buying high and selling low — the exact opposite of successful investing. Performance chasers also choose to ignore the frequent warnings that past performance is not indicative of future results.

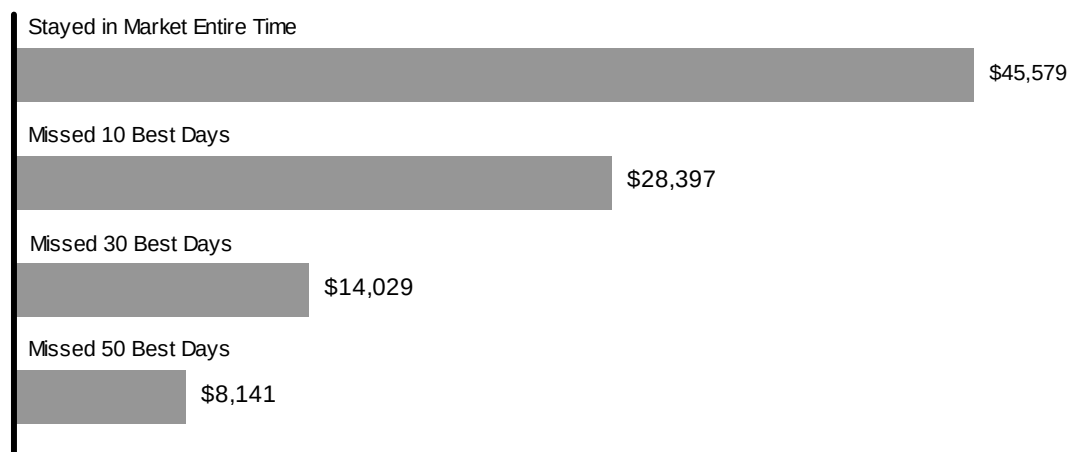
You might be able to predict the future performance of a sports team based on last year's results because you know the team, you know the competition and the environment doesn't change. With investment markets, however, it's more difficult. Factors such as interest rates, exchange rates, commodity prices and environmental issues all come into play at a global and local level to influence performance. As a result, today's best performers could be tomorrow's biggest losers.

A study conducted by Morningstar showed that from 1994 to 2003, only 16% of top five funds made it to the following year's list. The five best performing funds averaged 15% lower returns the following year and barely beat (by 0.3%) the market. The results confirm that the likelihood of successfully timing the market using last year's performance records is remote. Not surprising given that if investing really were that easy, all the big institutions would be doing it.

It is easy to see why attempting to predict future market directions based on recent developments is so strong. Successfully buying low and then selling high at precisely the right moments promises exceptional rewards. What performance chasers may not realise, however, is that this behaviour costs them dearly, leading to increased volatility and below-average results.

Fig 1. Growth of \$10,000 Invested in the S&P 500 Index:

Fifteen years ended December 31, 2006



Source: Bloomberg

Consider the returns of a broad index of U.S. stocks such as the Standard & Poor's 500 Index, as displayed in Figure 1. If you invested a hypothetical \$10,000 in the S&P 500 from December 1991 to December 2006 and didn't touch it, that \$10,000 would have grown to \$45,579. If you missed even the 10 best days of the stock market during that 15-year period, your investment would have grown to only \$28,397. And if you missed the stock market's best 50 days, your \$10,000 investment would have been worth \$8,141.

The illustration shows that missing even a few days of a market turnaround can have a significant effect on your returns. Ironically, those investors obsessed with “beating the market” not only increase the likelihood of underperforming the market, but also of underperforming their own investments. After all, you only earn the reported return over a given time period if you actually remained invested throughout that precise period.

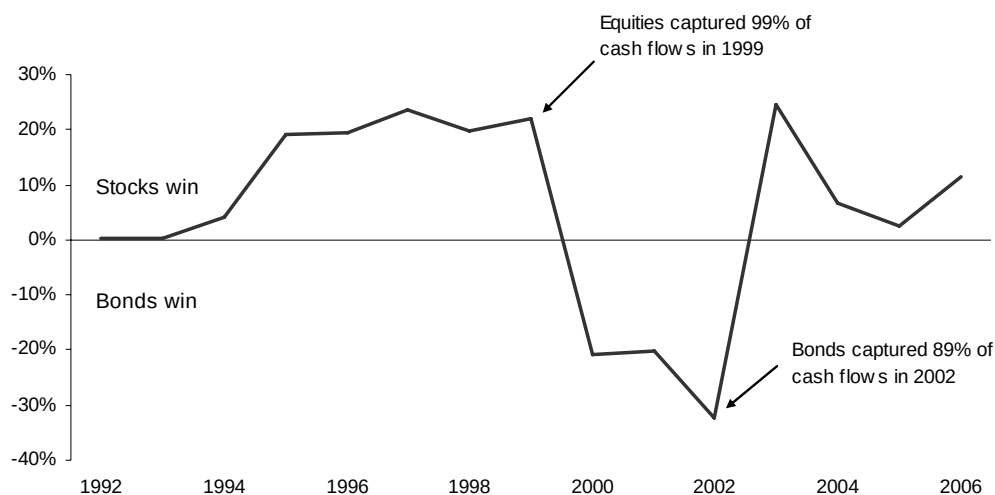
Just because a fund goes up 15% in a year doesn't mean that each investor in the fund makes that much. If you bought high and sold low, you almost certainly have not done as well as a fund's reported return implies. Buying high and selling low cost the average equity investor almost 10% of potential earnings over the 19 years ended 2002, according to a well-known study conducted by DALBAR Inc., a leading financial services market research firm.

Specifically, DALBAR found that the average equity investor earned a meagre 2.6% annual return compared to a 3.1% inflation rate and a 12.2% return from the S&P 500 over the exact same time period. Not only did investors fail to keep up with the market, they also lost money to inflation. Meanwhile, the average fixed income investor earned 4.24% annually, compared to the long-term government bond index return of 11.70% over the same 19-year period.

The study found that performance chasing and the resulting poor market timing as the main reason for the disparity. Investors put money into mutual funds after they have experienced significant price appreciation. Then, as strong performance trails off, investors cash out in search of the next hot fund.

Numerous academic studies verify that the flows into and out of mutual funds are strongly correlated to previous measures of excess returns. Figure 2 shows that at the end of 1999, the S&P 500 Index had returned more than 20% for five consecutive years. At the same time, the second-worst bond market in history occurred in 1999. Investors responded by chasing performance. In 1999, stock funds captured 99% of mutual fund cash flows.

Fig 2. S&P 500 Index versus Lehman Brothers Aggregate Bond Index: Annual Excess Returns, 1992 through 2006



Source: Bloomberg

As it often does, performance-chasing led investors to buy high and sell low. From December 1999 through September 2002, bonds outperformed stocks by a cumulative margin of more than 70 percentage points. By the time investors began buying bonds, the fixed income market had already reached its peak.

Market cycles tend to run every 2 to 5 years. Most investors wait until they are tired of hearing how much money their friends and relatives are making before investing, usually right at the

peak of the cycle. When the market goes through the downside, they get scared and frustrated and jump put somewhere at the bottom of the cycle.

It is much easier to stomach market losses if you were lucky enough to have enjoyed the previous gains, or you have the patience to hang onto your investments long enough to benefit from a full market cycle. Market volatility can be unnerving, but fear of short-term loss is a flawed reason for taking action.

If you sell to simply avoid negative performance, you're in danger of being on the sidelines during market upswings. The magnitude of investor underperformance due to poor timing is greater the more volatile the asset. So before you buy a highly volatile fund, make sure you're the kind of investor who will stay put, rather than bail after a period of poor performance.

Diversifying your money across a range of asset classes can help you ride out the performance troughs in the market by offsetting the poor returns with better performing asset classes. A well-diversified investment portfolio will probably always have some stake in a top sector.

Research has shown that over 90 percent of the long-term return of any portfolio is determined by its asset allocation, the selection of what types of assets make it up. Only 4.6 percent is determined by the choice of specific investments, while other factors – market timing included – accounted for a mere 3.9 percent of portfolio performance.

Ironically, investors typically focus 90 percent of their attention on trying to identify the best stock or mutual fund – a quest that determines about 10 percent of their performance – while they spend almost no time on asset allocation – which makes 90 percent of the difference.

The most successful investors are ones who map out an asset allocation plan that's appropriate for their goals, investment time frames and tolerance for risk, and then stick with it over the long haul. Enlisting the help of an advisor to create an asset allocation plan will also keep you from chasing the latest “top” performers, only to be disappointed later.

Regular rebalancing ensures that your portfolio continues to match your objectives and risk profile and forces you to buy low and sell high, even if tempted to do the opposite. Ideally you want to review your portfolio only about once a year. The more often you look at a portfolio, the more likely you will feel the need to take some action.

So, the next time you are tempted to dive into whatever mutual fund, stock or bond is performing well in the current market environment, remember that investment strategies based on market-timing and performance-chasing rarely deliver long-term success. Research and studies have proven this fact, yet the majority of investors choose to ignore this warning. Let me evangelize these words for you. Past performance does not predict future results!