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Rear View Mirror Investing Doesn't Work

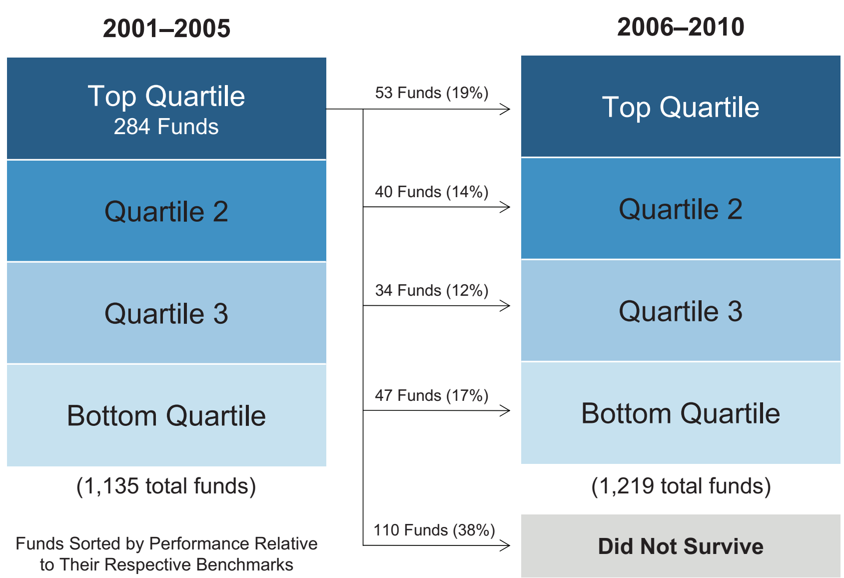
It seems every investor is familiar with the phrase "past performance does not guarantee future results." As a matter of fact, the SEC requires this disclaimer whenever a mutual fund company advertises its results.

Despite the warning as well as numerous academic studies that conclude past performance has very little predictive value, most investors (and many advisors) still use prior performance as the predominant factor in choosing funds. The hope is that looking backwards and identifying funds that have done well will lead to future outperformance.

The problem is that "rear view mirror" investing doesn't work very well. The chart at left shows that actively managed stock funds that achieve top performance in one period typically do not repeat their success in a subsequent period.

In the chart, the boxes on the left show the entire US equity fund universe divided into quartiles, based on performance relative to each fund's benchmark. Performance is based on the five years ending December 2005 and includes only those funds with a complete return history for the period. As shown, the top quartile comprises 284 funds (out of 1,135 total funds).

Subsequent Performance of Top 25% of US Equity Funds [1]
As of December 31, 2010



Source: CRSP Survivor-Bias-Free US Mutual Fund Database.

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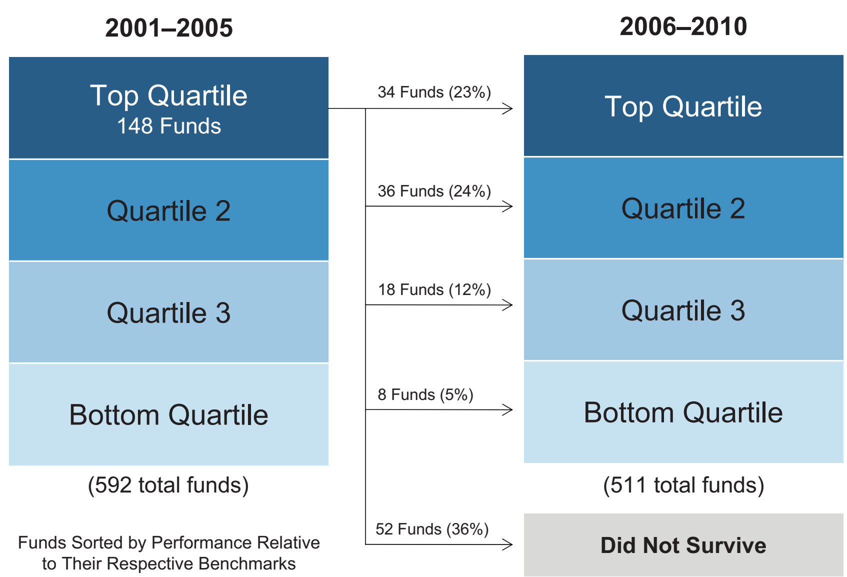
The boxes on the right show how these top-quartile funds performed relative to their benchmarks in the subsequent five-year period, ending in 2010. The arrows indicate the movement of these top funds across quartiles.

Only 19% of the top-quartile funds repeated their top performance in the subsequent five-year period. 43% percent of the funds dropped to the second, third, or bottom quartiles. More significantly, 38% of the original top-quartile funds did not survive the entire period. These top managers, who were perceived as the most skilled in the US equity market, showed no ability as a group to repeat their top-quartile performance. Indeed, almost four out of ten funds did not survive, and the funds that did survive were spread across the sorted universe.

The lesson of this illustration: choosing actively managed stock funds according to past success does not guarantee an equally successful investment outcome in the future.

The results are similar for actively managed bond funds. The chart shown below depicts subsequent five-year performance of the top-quartile of actively managed US bond funds. The stacked graph at left begins with the 148 funds in the top 25% of performance (relative to their respective benchmarks). The arrows show how these top performers fared in terms of quartile rankings in the subsequent five-year period.

Subsequent Performance of Top 25% of US Bond Funds [2]
As of December 31, 2010



Source: CRSP Survivor-Bias-Free US Mutual Fund Database.

Similar to the equity fund analysis, a low percentage (23%) of the top-quartile bond funds repeated their high performance relative to their particular benchmark, while 36% failed to survive the period. The remaining 41% were dispersed in the second, third, and bottom quartiles.

Although investors may attribute a manager's top ranking to superior knowledge and skill, these stock and bond fund illustrations suggest that relative performance among actively managed funds is mostly random, and investors cannot use past returns to predict future winners.

The most effective and consistent approach to build long-term wealth is to own low cost passive and index funds that track the market, in a mix tailored to each investor's individual circumstances.

Notes

1. The left column represents all US equity funds in the CRSP Mutual Fund Database with a complete return history for 2001–2005. The funds are sorted by performance relative to their benchmarks. Funds in the top quartile are then tracked and directed to their subsequent performance quartiles in the following 5-year period (2006–2010), or to the "Did Not Survive" category. Quartiles in the following period reflect all funds with a complete return history. Percentages may not total 100% due to rounding.

2. The left column represents all US bond funds in the CRSP Mutual Fund Database with a complete return history for 2001–2005. The funds are sorted by performance relative to their benchmarks. Funds in the top quartile are then tracked and directed to their subsequent performance quartiles in the following five-year period (2006–2010), or to the "did not survive" category. Quartiles in the following period reflect all funds with a complete return history. Percentages may not total 100% due to rounding.

Disclosures

Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

Rappaport Reiches Capital Management is an investment advisor delivering world-class global investment management and financial planning solutions to individuals and families. As an independent firm, we are beholden only to our clients' best interests.

Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.

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