



CAPITAL PERFORMANCE ADVISORS, LLC

## CAPITAL IDEAS

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### The Problems With Past Performance

Among the most dangerous investment myths is that past performance is a good predictor of future performance. Many investors continue to base their investment decisions on past performance, despite a growing body of research indicating the technique simply doesn't work. In the past, several studies have found that Morningstar's rating system has virtually no predictive value. (Morningstar itself provides this caveat along with its data.) More recently, a study by the Financial Research Corporation (FRC) provided further evidence.

Believing that past performance is a successful predictor causes investors to frequently "change horses," selling one fund or group of funds to chase the latest hot fund(s). Unfortunately, investors cannot buy yesterday's returns, only tomorrow's. Thus, by the time they purchase a hot fund, it is usually too late. FRC found that performance chasing caused investors to miss out on as much as 20 percent of the returns earned by the very funds in which they had invested.

Even worse, FRC's study indicated that fund-hopping behavior appeared to be on the rise, despite the negative consequences. The FRC study observed a dramatic decline in the average holding period for mutual funds, from nearly six years in 1996 to less than three years by early 2001.

Basing its study on the three-year average holding period, FRC calculated 10.92 percent as the mean three-year average annualized return for funds between January 1990 and March 2000. After tracking monthly fund flows and performance, FRC found that the actual return that investors received from the funds was just 8.7 percent — 20 percent less than the average return they could have had.

FRC also looked at fund flows following the best and the worst four quarters for each of Morningstar's 48 investment categories. They found that investors tended to follow a consistent pattern of buying high and selling low — not exactly a prescription for investment success. In the quarters following high returns, an average of \$91 billion in net new cash flowed into funds, meaning that investors were buying at the high price. After the worst-performing quarters, cash inflows dropped to just \$6.5 billion as investors missed out on the opportunity to buy when the stocks were at their low point.

The moral of the study is that, conventional wisdom is not always correct. Investors should be armed with the facts before selecting an investment strategy. If investors cannot identify tomorrow's winning funds by using past performance as a guide, how are they supposed to play the game? We suggest investors simply avoid the game of active investing (i.e., attempting to beat the market via stock-picking or market-timing techniques). They are far better served to accept the rates of return the capital markets provide. The best way to do that is to build a globally diversified portfolio of passive asset class funds, and to regularly rebalance thereafter. It is passive investing and the regular rebalancing process — and not chasing past high returns — that forces the discipline of buying low and selling high. That's a performance we can applaud.

Lee Barney, **Chasing Hot Funds Translates to Diminished Returns, Study Finds.** *TheStreet.com*, January 17, 2001

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