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The Perils of Performance Chasing

Morningstar Investment Management South Africa
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For Financial Advisors and their Clients

To quote the legendary Warren Buffett, "the investor of today does not profit from yesterday's growth". As much as we have all heard the disclaimer on every investment advertisement that past performance should not be seen as an indication of future returns, many investors still switch to the latest hot offerings just before the inevitable slump in performance.

The start of the new year wasted no time with market volatility and uncertainty, leading to a very busy buying and selling market when compared to previous years. This is to be expected and is human nature - in times of volatile returns, global worries and geopolitical tensions (to name but a few) investors seek out previous winners and switch their investment to include these performers, hoping for the same or a better outcome as in the past.

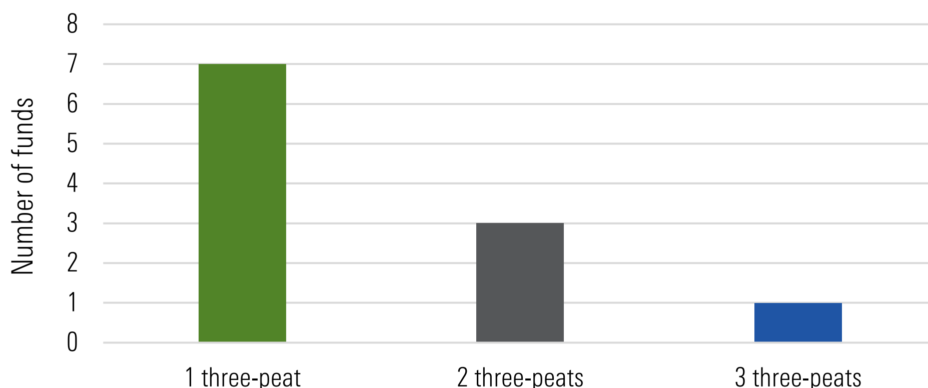
The first thing investors tend to do when looking for a place to invest is to find an investment (be it a fund, company, sector, etc.) that has done well most recently. To quote Carl Richards - "If you are going to hire a contractor to remodel your kitchen, it would be reasonable to go look at the work they have done in the past and expect that quality of work to continue, if not improve". A true statement when it comes to remodelling, however, when it comes to investing, this is not always the case and past performance should not be seen as an indication of future returns – especially not in the short-term. Investments move in cycles and the winners of today might not be the winners of tomorrow.

The three-peat

Every six months, S&P Dow Jones releases a "persistence scorecard" that measures the consistency of active funds. According to the S&P Persistence Scorecard, relatively few funds can consistently stay at the top.

Let's look at local market statistics, starting with the most successful ASISA SA General Equity funds. 19 funds landed in the top quartile of their peer group over the last 10 years ending Feb 28, 2022 (note, this only considers funds with a 10-year track record, excluding fund of funds).

Of these 19 funds, how many landed in their ASISA Category's top quartile three years in a row at some point during those 10 years, and how many times did they pull off a "three-peat"?



Source: Morningstar Direct. Data as at 28 February 2022. Past performance is not an indication of future returns. For illustrative purposes only.

As can be seen in the above graph, of the 19 funds (in the first quartile over 10 years) –

- Only seven funds managed to perform in the top quartile for three consecutive years over the 10-year period.
- only three funds managed to achieve this twice; and
- only one fund achieved three instances of three year consecutive first quartile performance annually (or otherwise known as a "three-peat").

Some additional findings include:

- Nine of the 19 funds spent at least one year (of the 10 years) in the fourth quartile
- Every single fund spent at least one year of the 10 years in the third quartile
- 18 out of the 19 funds spent more than two years in the third quartile (over the 10-year period).
- The 19 funds only spent about 30% (of the total instances over the 10 years) in the first quartile.

What can we conclude from these statistics? Performance chasing rarely works and it is more important to look at the consistency of a manager over the longer term.

The performance chaser

Morningstar conducted research into this area of investor returns and created a hypothetical 'Performance Chaser' portfolio. This portfolio tracks investors switching their investments into the best performing fund from the previous year at the start of each calendar year. This means that an investor sells the fund they are invested in every year, ranks all the funds in the category from best to worst over one year and switches their entire investment to the fund that has done the best over the last year. This is then compared to a portfolio managed by Morningstar – the Morningstar SA Multi-Asset High Equity portfolio (Morningstar Adventurous Portfolio).

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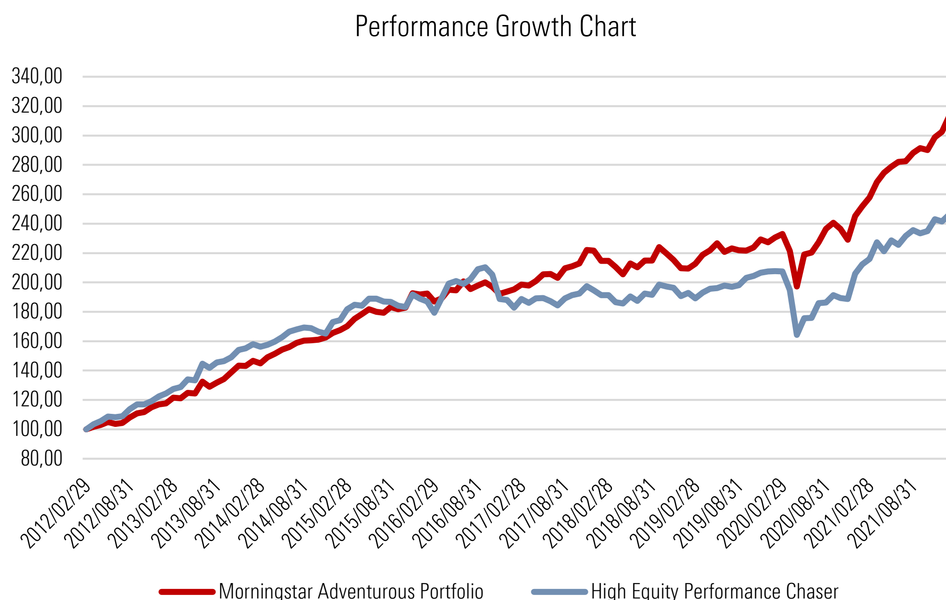
The research aims to illustrate, through comparison, the returns achieved by the performance chasers versus the returns achieved by investors that remained invested in their respective portfolios over the same time frame.

As can be seen in the below graph, the difference in the return was quite astonishing.



Source: Morningstar Direct. Data as at 31 January 2022. Past performance is not an indication of future returns. For illustrative purposes only.

The Morningstar high equity portfolio returned 58% (cumulative) more than the Performance Chaser portfolio over a period of more than eight years. In other words, an investor with an investment of R1 million that stayed the course (and remained invested in the Morningstar high equity portfolio) would have gained an extra R578 975 in returns over the 8 year time period.

The above scenario clearly highlights the benefits of staying invested in a robust and consistent strategy as opposed to backtracking and chasing yesterday's winners.

Let us examine the possible reasons for the underperformance of yesterday's winners:

- The selected funds' good ideas have all paid off and the returns have been realised.
- They may have had an aggressive view that played out in their favour. It's unlikely that the view will continue for the foreseeable future and could potentially be at the top of the return cycle when an investor invests in the fund.
- This view could have been pure luck and not a solid investment thesis that the manager followed. For example, the fund could have been underweight offshore and then the rand strengthened due to a global risk on trade.

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What does this mean for investors?

- Returns don't happen in straight lines and it seldom occurs when one expects it to.
- The long term is just a collection of short runs and having a long-term strategy does not excuse you from the short-term setbacks in markets and funds.
- It's vital to separate emotion from an investment portfolio. Often the most beleaguered investments turn out to be a great opportunity for future returns, as investors can access these investments at a good price.
- Volatility creates opportunity and short-term underperformance can translate into a solid, longer-term upside.

Trying to chase performance can be extremely harmful to an investor's returns over the long term. It's rare (if not impossible), even for professionals, to consistently time investment in and out of the market over time. In addition, one needs to consider the costs of trading funds, which is likely to only make matters worse.

A well-diversified portfolio that is designed to meet your investment goals whilst remaining within your risk tolerance is a far better solution, and much likelier to result in long-term investment success than trying to buy yesterday's winners.

The Bottom line: investing is a marathon and not a sprint. When it comes to investing, patience is rewarded and time in the market remains superior to timing the market. M

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