First Ascent Asset Management

WHY INVESTING BASED ON PAST PERFORMANCE IS A TERRIBLE IDEA

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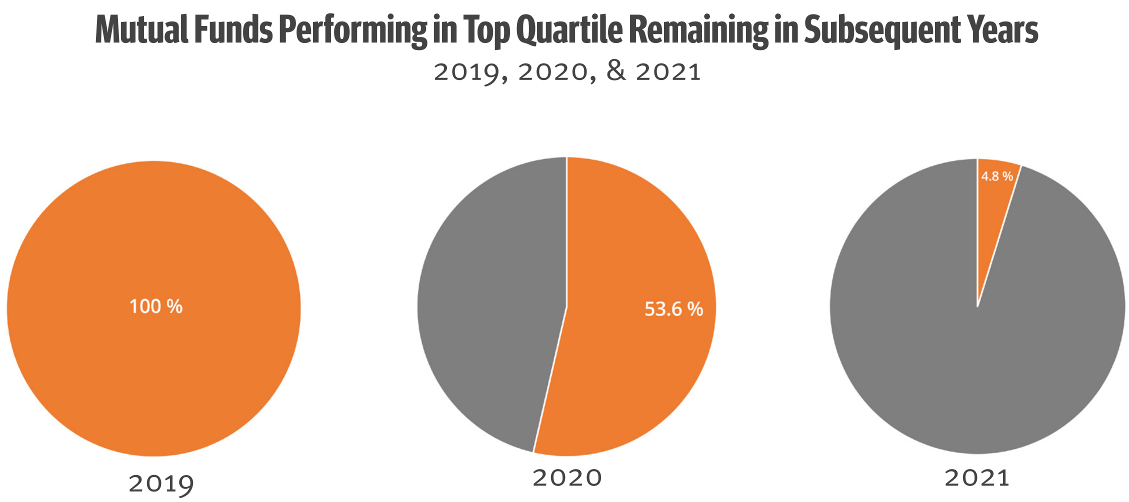
INVESTING BASED ON PAST PERFORMANCE

Both the SEC and FINRA require performance-based advertising and sales literature to include the statement: “past performance does not guarantee future results.” Is that good advice?

Mutual Funds

Research by S&P Dow Jones on the persistence of mutual fund performance shows why this warning label makes sense. Of the domestic equity mutual funds that performed in the top quartile for the year ending June 30, 2019, only 53.6% remained in the top quartile in the subsequent year—almost a coin flip. By June 30, 2021, only 4.8% remained in the top quartile.



Data Source: MorningStar

Expanding the definition of success to simply beating the median fund’s return didn’t help. Fewer than 19% of the top-half equity funds managed to stay in the top half through June 2021.

Widening the time horizon to five years makes the picture even bleaker. Only 2.4% of the domestic equity funds in the top quartile for the year ending June 30, 2017, remained there each year through June 30, 2021. Only 11.0% of the domestic equity funds that performed in the top half for the year ending June 30, 2017, remained there through June 30, 2021.

Another way to view persistence of performance is to examine fund performance compared to a relevant benchmark. For the year ending June 30, 2019, only 628 out of 2,194 domestic equity funds—28.62% of the total—beat the S&P Composite 1500 Index. By June 30, 2020, only 398 of those funds still beat the benchmark. By June 30, 2021, only 98 of those funds beat the benchmark—4.5% of the original universe of 2,194 funds.

A paper published in 2020 by Yale’s James Choi and Kevin Zhao confirmed that investing based on past fund performance is foolish. They found that from 1994 to 2018, a fund’s performance was completely unpredictive of its future returns. “If anything,” Choi said, “over the past two decades, you seem to do a little bit worse if you chase past returns on mutual funds.”

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Stocks

In any given year a diversified portfolio of stocks is going to contain some that generate positive returns, and some that generate negative returns. The presence of winners and losers is to be expected—in fact, it is unavoidable.

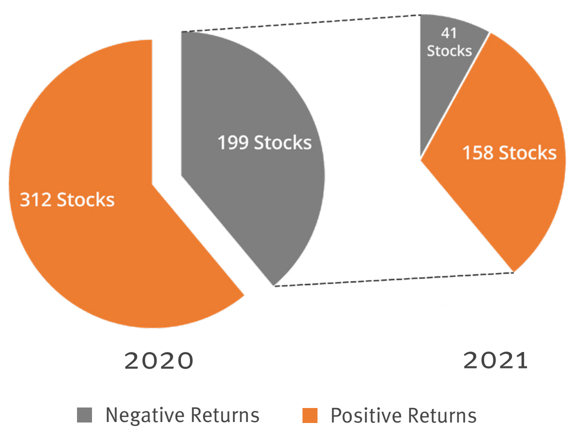
It may be tempting to try to improve the performance of a portfolio by eliminating stocks that have recently experienced negative returns. But screening out stocks based on recent poor performance is unlikely to produce positive investment results.

In 2020, the S&P 500 Index had a great year, returning 18.4%. Yet 199 of the stocks in the index—over a third—had negative returns for the year. Of those 199 stocks, 15 were removed from the index as part of S&P's annual reconstitution, while 184 remained in the index. The remaining 184 "losers" had an average return of -16.4% in 2020.

In 2021, 158 of those 199 stocks had positive returns. Almost 80% of 2020's losers became winners in 2021. The average return of that same 199 stocks in 2021 was +29.5%, beating the return of the index itself.

S&P 500 Individual Stocks Positive and Negative Returns in Subsequent Years

2020 & 2021

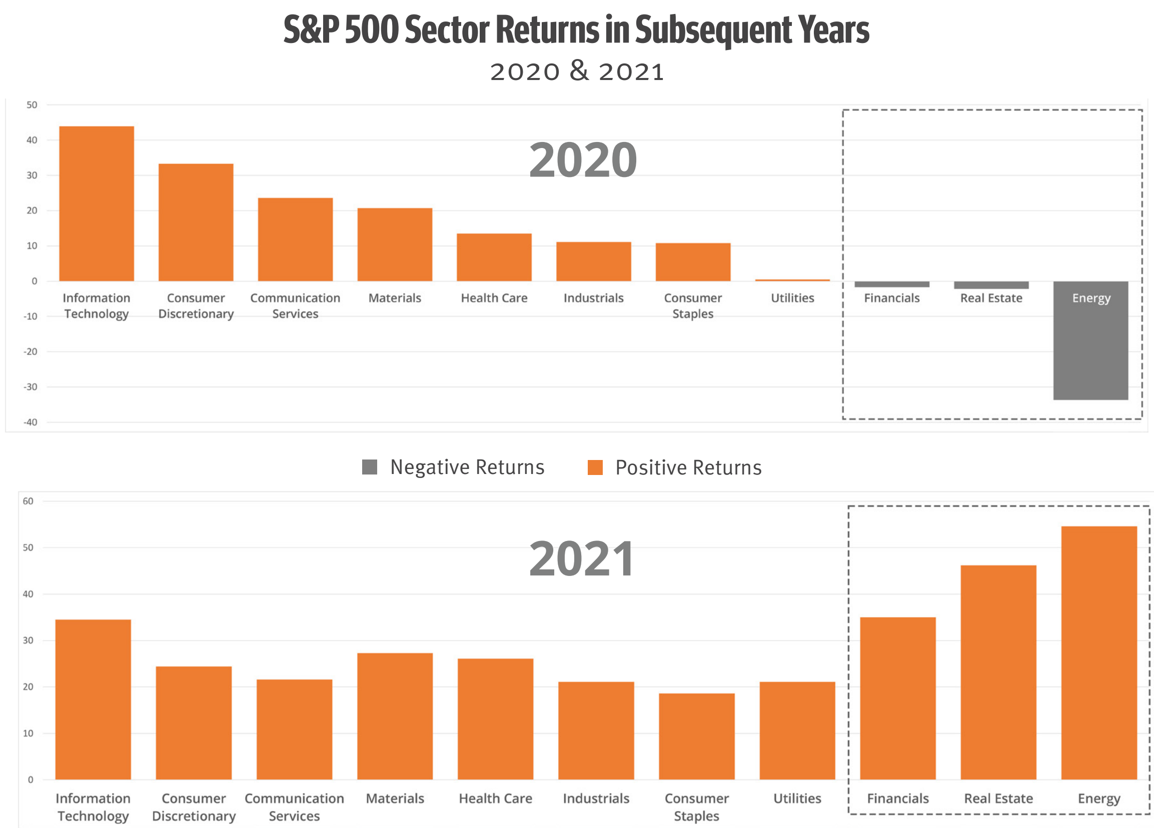


Data Source: MorningStar

Over the last forty years (1982-2021) investors who didn't worry about screening out the losers would have done quite well. More than 400 stocks were removed from the S&P 500 Index during this period and hundreds of others experienced negative returns. Despite the presence of all these losers, the index grew a cumulative 10,131% and averaged +12.27% annually.

Industry Sectors

We see the same thing if we analyze the S&P 500 Index based on industry sectors. In 2020, three of the eleven industry sectors represented in the S&P 500 Index had negative returns. They were Financials -1.7%, Real Estate -2.2%, and Energy -33.7%. Investors who screened those sectors out of their portfolios would have been sorry. Their returns in 2021 were Financials +32.6%, Real Estate +42.5%, and Energy +47.7%.



Data Source: MorningStar

The same pattern was repeated in 2018 when the S&P 500 Index lost -4.38% overall and eight of its industry sectors experienced negative returns. The next year, 2019, all eight of those industry sectors experienced positive returns that averaged +29.69%.

From 2010 through 2021 there were twenty-three instances where an industry sector had a negative return. In only three of those did an industry sector have consecutive negative years. In most cases—87% of the time—screening out a sector based on the previous year's poor performance would have eliminated a positive performer and not avoided another down year.

A Final Word

The examples cited above are focused on periods that end in 2021. While the exact stocks, sectors, or managers that excel or struggle will change over time, the general concepts will stay the same. Eliminating under-performing investments from your portfolio or chasing yesterday's top performers is unlikely to produce positive results.

There's a good reason financial regulators require the warning label: "Past performance does not guarantee future results." Basing investment decisions on past performance is a bad idea.