Chasing Performance Can Lead Investors to a Calamitous Fall

▸ The results of moving investments to the latest market winner are so terrible that investors are better off putting their money into the latest market loser for long-term returns.

By Craig L. Israelsen

Chasing performance. It's a really bad idea, but investors often do it.

One of the persistent challenges faced by advisors is managing the "regret" of clients – specifically the regret of not being invested in last year's best asset class. This type of regret obviously suggests that advisors should have known which of the many asset classes (e.g., mutual funds) in the marketplace would be the star performer in the coming year. Seriously? If people had that sort of perfect knowledge, why in the world would they be financial advisors? Those people would be sitting on their own island somewhere.

Nevertheless, let's examine how performance chasing would have played out over the past 15 years (from Jan. 1, 1999, to Dec. 31, 2013).

Performance Chasing

This investing behavior is like returning to a bad habit – we know we shouldn't but we do it anyway. One version of performance chasing would consist of moving all of the portfolio assets into last year's best-performing asset class. This is performance chasing at its "finest" (aka worst).

In this analysis, there were 12 asset classes to monitor and "chase" (as shown in Chart 1). Here's how this works: In 1998, the best-performing asset class among the 12 was large-cap U.S. stock. Thus, at the start of 1999, the entire portfolio was shifted to large-cap U.S. stock. The return of large-cap U.S. stock in 1999 was 20.37 percent – a great outcome. But this approach collapsed the following year. The best-performing asset class in 1999 was emerging non-U.S. stock – so the entire portfolio was shifted into emerging stock at the start of 2000. Bummer. In 2000, emerging stock got rocked with a -27.45 percent return. The annual returns of this performance-chasing portfolio are shown in Chart 2.

Understandably, this version of performance chasing may represent the extreme – but extremes happen far too often.

The outcome of this "momentum investing" approach over the past 15 years was an annualized return of 0.66 percent and a standard deviation of return of 23 percent. A $10,000 initial investment on Jan. 1, 1999, was worth only $11,043 by the end of 2013. It's possible that there might be some time frames in which performance chasing seemingly works out (such as the period from 2003 to 2006). That's why bad ideas don't completely disappear – sometimes they work out. But a person's investment portfolio needs to work out for decades – not just a few years.

Dogs of the Dow

Here's another wacky idea: How about investing completely in last year's worst-performing asset class? This bold approach actually performed better than

Losing the Chase

Chart 1 shows the performance of 12 individual asset classes. **Chart 2** shows the (rather poor) 15-year performance if an investor moved money annually to the best performer of the previous year. **Chart 3** shows that even investing in the previous year's loser produces a better result than chasing best performance. The chart compares results of chasing best performance, chasing worst performance and equally diversifying in the 12 asset classes.

CHART 1 15-YEAR PERFORMANCE OF 12 ASSET CLASSES: 1999-2013

12 Asset Classes (1999-2013)	15-Year % Annualized Return	15-Year Standard Deviation of Monthly Returns	Growth of $10,000
Large-Cap US Stock	4.58	19.39	19,590
Mid-Cap US Stock	9.75	19.54	40,374
Small-Cap US Stock	10.11	19.79	42,406
Developed Non-US Stock	4.42	22.68	19,125
Emerging Non-US Stock	10.64	35.33	45,564
REIT	10.24	20.45	43,160
Natural Resources	9.50	23.46	38,988
Commodities	12.38	20.33	57,569
US Bonds	5.18	3.80	21,337
TIPS	6.22	6.41	24,710
Non-US Bonds	3.90	8.75	17,758
Cash	2.35	2.23	14,174

Performance figures above are based on actual ETFs and are reflective of the following indexes: S&P 500, S&P MidCap 400, Russell 2000 Value, MSCI EAFE, MSCI EM, Dow Jones US Select REIT, S&P North American Natural Resources Sector, Deutsche Bank Liquid Commodity - Optimum Yield, Barclays US Aggregate Bond, Barclays US TIPS, Barclays Global Treasury ex US, and US Treasury Bills 3 Months.

CHART 2 THE ANNUAL RETURNS OF A "PERFORMANCE CHASING" PORTFOLIO

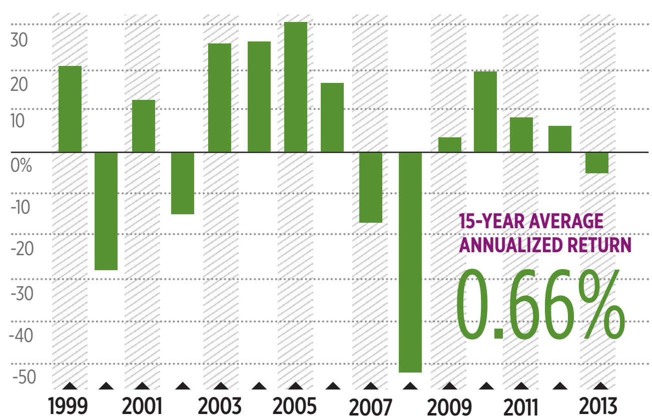
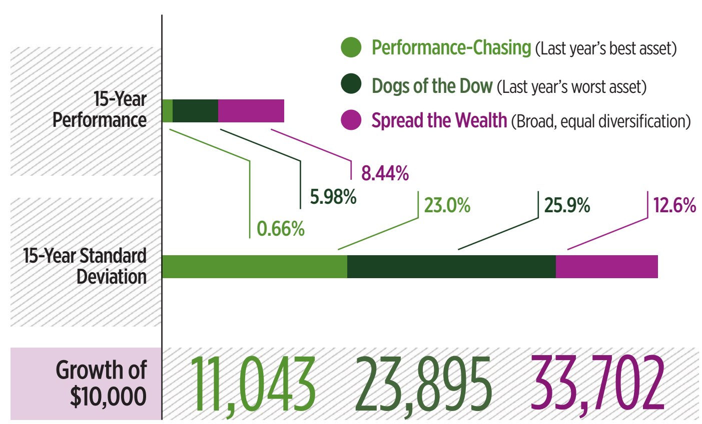


CHART 3 SUMMARY OF PERFORMANCE: 1999-2013

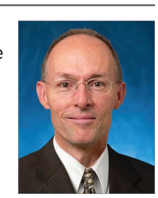


chasing last year's winner. By investing completely at the start of each new year in last year's worst-performing asset class (among the 12), the 15-year annualized return was 5.98 percent and produced an ending account balance of $23,895. Not a super-impressive outcome, but a lot better than chasing last year's winner.

Spread the Wealth: Broad Diversification

What if an advisor simply built a broadly diversified portfolio that invested equally in 12 asset classes and rebalanced them annually? While broad-based diversification may not be very exciting, this approach produced a 15-year annualized return of 8.44 percent with a standard deviation of 12.6 percent. Building a strategic, multi-asset portfolio produced an outcome that was better than six of the individual asset classes shown in Chart 1 – including large cap U.S. stock (i.e., the venerable S&P 500 Index). Investing solely in the S&P 500 grew $10,000 into $19,590 over this 15-year period, whereas the 12-asset 7Twelve Portfolio turned $10,000 into $33,702.

A summary of the performance for each approach is shown in Chart 3. As boring as it is, simple broad-based diversification is very hard to beat over time. If clients want to bet the farm on wild cards, tell them to play the lottery. When it comes to their investment portfolio, boring is best.



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