

INVESTMENTS & WEALTH MONITOR

A reprinted article from September/October 2020

Chasing Performance

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INVESTMENTS & WEALTH INSTITUTE®

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Despite the pervasiveness of the “past performance is no guarantee of future results” disclaimer and decades of research that supports it, many investors often behave as though past performance does predict the future. As a result, they allow recent performance to shape their expectations of future asset class returns and make a similar error when evaluating active investment managers. This article is intended to help investors to recognize their own performance-chasing behavior and presents evidence that shows the lack of a predictable relationship between past performance and future results.

SIGNS YOU MAY BE CHASING PERFORMANCE

When asked, most investors will deny that past performance is part of their decision-making process, but their behavior often suggests otherwise. Here are three questions that can uncover behaviors that indicate an investor may be guilty of chasing performance:

Do you use language that projects past returns into the future?

Saying “the market is going down” rather than “the market went down last quarter” indicates a subconscious tendency to link past and future returns. Similarly, saying that a manager “is underperforming” suggests that you believe the past underperformance will persist. Speaking of performance in the present tense may be benign, but it also may indicate a predilection toward extrapolating returns.

Do you second-guess your asset allocation policy?

Periods of poor performance are inevitable. Thoughtful investors have a well-defined process to determine their asset allocation policies. They should not allow recent performance to tempt them to modify an allocation policy or a portfolio toward one that would have done better. Although it is normal for investors to wish they had invested more in asset classes that have risen significantly and less in ones that have fallen, that regret should not affect investment policies or decisions.

Lowering the future expected returns of asset classes that disappointed us with downside performance and raising the expected returns of asset classes that surprised us with upside performance will result in chasing performance. Investors should use an unbiased process to forecast expected returns and acknowledge that the estimates are the middle of a wide range of potential outcomes. Importantly, they should understand that it is more likely that the poor outcome was due to an unlucky draw from a distribution with a fair average, than it was due to an average draw from a distribution centered around a low return. Adjusting models so that new expectations are more in line with recent performance systematically projects past returns into the future. It implicitly assumes that the news, events, or investor behavior that caused the asset’s price to move will repeat. The better response to an unexpected move

(up or down) is to be sure that the types of events that caused the performance are incorporated into the models used to forecast risks and returns.

There is a similar temptation to extrapolate the performance of active portfolio managers. Their past performance was only one factor in the hiring decision. It should not be the primary reason for firing. Instead, use the manager’s recent performance in conjunction with your other evaluation criteria to update your assessment of the likelihood that the manager will add value in the future.

Do you have a pattern of buying after prices rise and selling after prices fall?

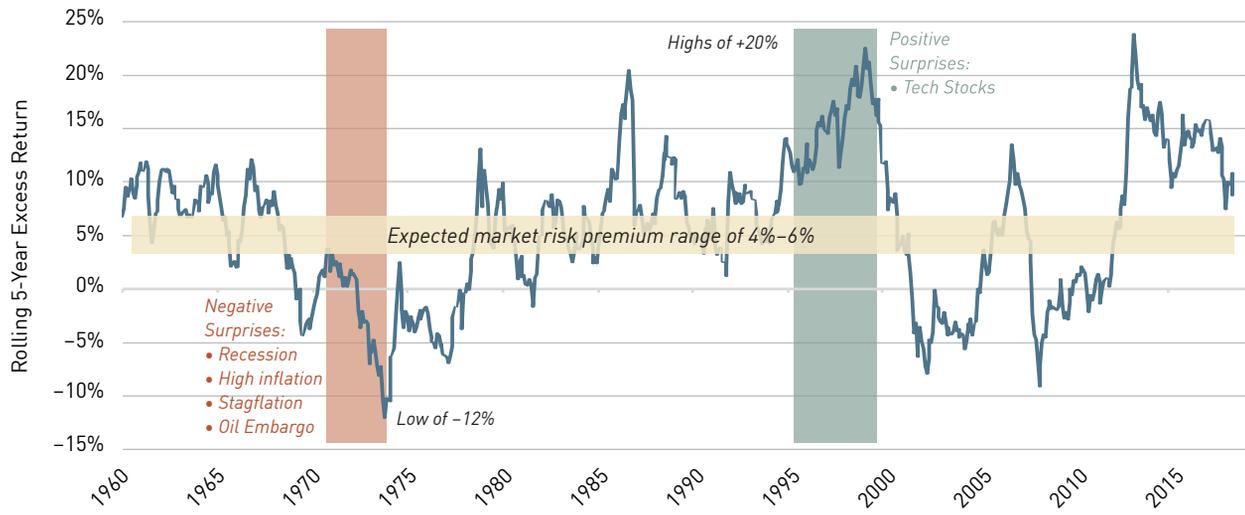
Investors should look at their own past behavior. When you examine past asset allocation changes and manager terminations, do you see a pattern of increasing allocations to asset classes that had risen recently and decreasing allocations after a decline? Similarly, has there been a pattern of quickly terminating managers after a period of underperformance? Both of these are “pro-cyclical” behaviors and each are evidence of extrapolating performance.

Research demonstrates that chasing performance is suboptimal, and the following behaviors suggest that an investor may have a propensity for making decisions based on past returns:

1. Using language that projects past returns into the future.

Figure 1

U.S. STOCK MARKET ROLLING FIVE-YEAR EXCESS RETURNS



Sources: Robert Shiller, CRSP, Ibbotson Associates, Alan Biller and Associates, December 31, 1960-December 31, 2019

2. Focusing on missed opportunities.
3. Making pro-cyclical investment decisions.

Investors should examine their behavior and modify their investment processes if they find that they have been acting as if they believe that past performance is predictive of future results.

RETURNS RESULT FROM SURPRISES THAT ARE UNLIKELY TO REPEAT

Investors hold risky assets because they expect them to rise in value. Realized returns, however, are seldom precisely what investors anticipated. In the near- to medium-term, stock market returns are determined primarily by surprises—unexpected news and events that cause investors to revise their outlooks. Because there is a constant flow of both positive and negative news and surprises, changes in expectations are as likely to reverse as to continue. As a result, returns are not persistent, suggesting that chasing performance is unlikely to add value. Acknowledging the relationship between surprises and returns is a vital component of a sound investment process.

Figure 2

U.S. VS. INTERNATIONAL ROLLING FIVE-YEAR RELATIVE RETURN



Sources: Bloomberg L.P., Alan Biller and Associates, January 1, 1986-December 31, 2019

Figure 1 shows the historical excess return of the U.S. stock market over rolling five-year periods. Economists estimate that the expected stock market risk premium, its return over cash, is in the range of 4–6 percent per annum. Figure 1 shows that realized five-year returns fluctuated far from that range, from a low of -12 percent to more than 20 percent. This volatility of long-term returns, and the fact that the bull and bear markets coincided with—rather

than preceded—news and events, provides compelling evidence that the returns were shaped by revisions to expectations. The alternative explanation is that investors are able to predict the swings in stock market returns but do not adjust their portfolios to avoid down markets or to increase their participation in up markets. It is hard to believe that investors would sit on their hands if they thought they saw a bull or bear market coming.

Figure 3

TRAILING VS. FUTURE STOCK-CASH RETURN (EXCESS OF LONG-TERM AVERAGE)



Sources: Bloomberg L.P., Alan Biller and Associates

The stock market fell sharply between 1970 and 1974. The period was dominated by a steady flow of bad news including a recession, high inflation, stagflation, and an oil embargo. Price-to-earnings multiples contracted as the bad news led to increased risk and risk aversion. If rather than being surprised, investors had foreseen those events, they would have sold their stocks in advance. In that case, the selling would have caused stock prices to fall earlier, and the return during 1970–1974 would have been more in line with the long-term risk premium. Instead, the severe bear market coincided with the ongoing bad news, indicating that most investors were surprised.

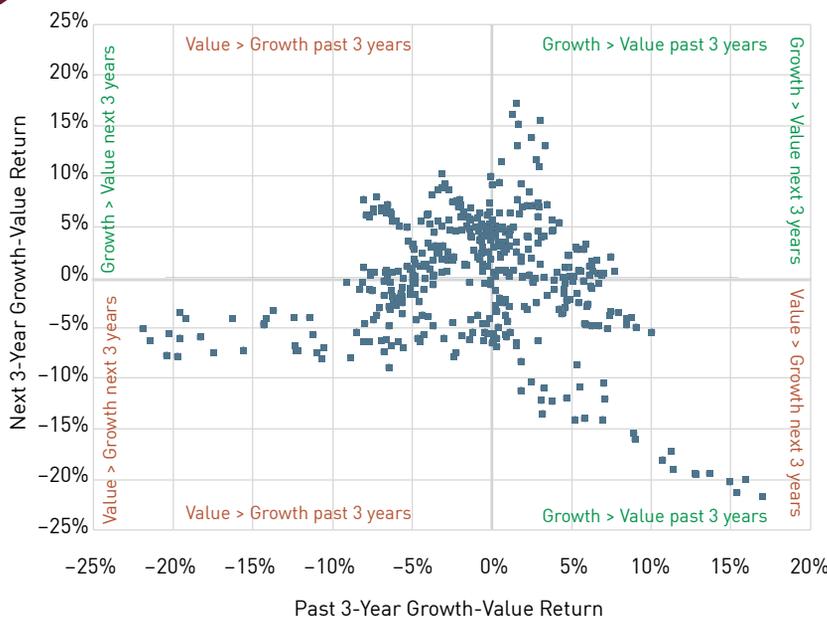
The five years before the tech bubble burst is an example of a period with persistent positive surprises. During that period, economic news turned out to be much more positive than investors had been expecting. Stocks outperformed cash by more than 20 percent per annum. Again, if rather than having been surprised, investors had anticipated the strong economy and shift in investor sentiment, they would have increased their allocation to stocks. That would have driven up prices in advance of the events, and the return during the late 1990s would have been more in line with the long-term average.

Figure 2 shows rolling five-year returns of U.S. stocks relative to international stocks. As with figure 1, we see significant volatility versus the expectation of similar returns. Moreover, the relative performance generally coincides with—rather than precedes—news and events. Consistent with what we observed with the U.S. stock market, it is evidence that the relative performance was driven by surprises.

Because stock market returns are determined by surprises (i.e., unexpected news and events), it's logical to ask whether unexpected news and events repeat from period to period. Investors that chase performance implicitly

Figure 4

GROWTH VS. VALUE



Sources: Bloomberg L.P., Alan Biller and Associates

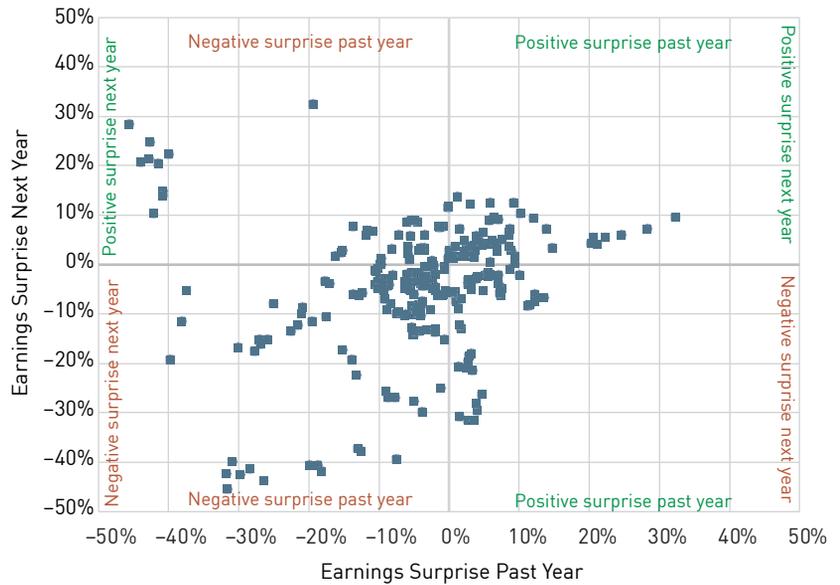
assume that the surprises will persist—that good news follows good and bad news follows bad. That was the case in the early 1970s and the late 1990s, but those periods were the exceptions.

Figure 3 compares the U.S. stock market’s excess return for one three-year period to the subsequent three-year period. If the flow of news and economic surprises were persistent, the data points would cluster in a cloud running from the lower left quadrant (bad news followed by bad news) to the upper right (good news followed by good news). Instead, we see a relatively even distribution among the four quadrants. Four data points are circled. The one in the lower left is the early 1970s when the bear market caused by the oil embargo was followed by more bad news—out-of-control inflation. The point in the upper left was a period when bad news, the 2008 Global Financial Crisis (GFC), triggered a bear market amid a recession and fears of a depression, was followed by good news, we didn’t fall into a depression, leading to a bull market as the fears abated. The point in the upper right quadrant was the post-GFC period when good news about the economy persisted from one period to the next. The point in the lower right started with good news as investors’ expectations rose and the tech bubble inflated, followed by expectations returning to earth and the bubble bursting.

Figure 4 displays the performance of the Russell 1000 Growth Index relative to the Russell 1000 Value Index for consecutive three-year periods. As in figure 3, if the flow of news and economic surprises that caused growth to out- (under-) perform value were persistent, the data points would form a cloud running from the lower left quadrant (bad news for growth stocks followed by more bad news) to the upper right (positive news for growth stocks followed by more positive news). Instead, we see more of an even distribution among the four quadrants. The concentration of points in the lower left quadrant is the result of growth

Figure 5

SURPRISE VS. SURPRISE



Sources: Bloomberg L.P., Alan Biller and Associates, January 1996-June 2020

stocks underperforming value on average over this period. The array of points in the lower right and upper left quadrants show a number of periods when the leadership sharply reversed.

Because returns are determined by changes in investors’ expectations, another way to examine persistence is to look at the persistence of earnings surprises, the difference between actual earnings and earnings expected at the start of the year. Using rolling 12-month periods from January 1996 through June 2020, figure 5 shows the earnings surprise for the S&P 500 for one year versus the surprise the next year.

Similar to what we see in figures 3 and 4, there were periods of persistence and periods of reversal. Overall, the correlation between the surprise in one period and the surprise in the next was slightly positive. The data points in the far lower left quadrant are from the period when the economy was going into a recession due to the GFC. Bad news in 2008 was followed by more bad news in 2009. The data points in the far upper left quadrant are from the period when the economy was coming out of the GFC-related

recession. Bad news in 2009 was followed by good news in 2010.

Stock markets move primarily due to news that causes investors to revise their expectations. Return-chasing behavior implicitly assumes that the news and investors’ reactions to it will reliably repeat. The evidence is that they do not. Chasing returns will help when the news flow persists. However, investors are likely to be whipsawed when the sentiment reverses. Importantly, deviations from well-designed asset allocation and manager selection processes are likely to detract from performance.

RECOMMENDATIONS FOR IMPROVING THE INVESTMENT DECISION-MAKING PROCESS

The first step toward a better investment decision-making process is to acknowledge the lack of persistence in returns.

Behavior: Examine your language and past portfolio changes for signs that you have a predilection for or have been chasing performance.

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CHASING PERFORMANCE

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Asset allocation: Do not second-guess your asset allocation just because another mix would have done better. Large returns are caused by news and events that are unpredictable by most investors. With hindsight, investors always can identify a portfolio mix that outperformed their own. Develop a sound asset allocation process and stick to it.

Evaluating active managers: Separate managers' active positioning from the effects of their style. Use the former to evaluate their skill and the latter to evaluate a strategy's portfolio construction and risk control. For example, managers of international equity funds with emerging-market exposure will outperform a developed-market benchmark when emerging markets do well, and they will underperform when emerging markets do poorly. That component of relative performance provides no insight into the manager's security selection

skill. Even if a manager has underperformed the appropriate benchmark recently, examine the underperformance using a Bayesian mindset. You believed the managers had skill when they were hired. Given the active risk that the managers take and their style, was the underperformance material enough to call their skill into question? Importantly, past performance is only one piece of information about the manager's ability to add value in the future. Do not give it disproportionate weight.

CONCLUSION: STRATEGY VERSUS TACTICS

Good decisions should consider all potential outcomes, but the actual outcome is known only with hindsight, and that outcome likely resulted from unexpected news and surprises. Instead of focusing on what happened recently and assuming it will repeat, remain focused on the long term. Concentrate on refin-

ing the processes used to develop your asset allocation and investment strategy.

Develop a robust investment process and stick to it. Past gains and losses, absolute or relative, tell us little, if anything, about how investments will perform in the future. Revisions in investors' expectations stemming from news and surprises drive markets. To add value, investors must forecast the changes, not react to them. Resist the temptation to second-guess or sour on investment decisions that resulted in underperformance. The evidence is that, at least in the short- to medium-term, there is too much randomness for investment results to tell us much about the quality of the decision-making process. 

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