Stop Chasing Performance

Clients tend to focus on the best investments they didn't invest in last year. Here's how to break them of the habit. **By Craig L. Israelsen**

It's too bad Moses didn't come off the mountain with stone tablets that included, "Thou shalt not covet last year's best asset class."

Religious readers probably already know that it's a sin to covet, yet nowhere is this form of beat-thyself-up behavior more evident — and with more dire consequences — than in the domain of investing. All too often, clients tend to focus on the best investments that they were not invested in during the previous quarter or year.

This nasty habit of looking back after the year is over and thinking we should have been smart enough to have picked the best asset class 12 months ago is laughably ridiculous — and yet many clients, and even advisors, still do it.

To examine the effect of such performance chasing, I looked at 15 years of returns, broken out by asset class. The Covet This chart on page 96 is a list of 12 asset classes that would be included in a broadly diversified portfolio, including eight equity and equitylike asset classes (U.S. stocks, non-U.S. stocks, real estate, resources, commodities) and four fixed-income asset classes. For each year, the best-performing asset class is highlighted in yellow.

At the end of 1998, for example, large-cap U.S. stocks (as represented by the S&P 500) was the winning asset class among the 12 — although, of course, no one knew for certain that would be the outcome back on Jan. 1, 1998. The next year, the winner was emerging markets stocks, with a one-year return of nearly 62%. In 2000, the winner was real estate. And so on.

CRYSTAL BALL INVESTING

It's easy to see why people would covet that type of performance difference. Assuming a person could accurately pick each year's winning asset class at the start of each year, and devote an entire portfolio to that asset class, that investor's 15-year annualized return would have been an astounding 32.25%, with a standard deviation of annual returns of just under 19%.

By comparison, an investor who simply hunkered down in the S&P 500 for the entire 15-year period experienced an annualized return of 4.39% and a standard deviation of 19.1%.

Of course, it's beyond ridiculous to think a person could accurately pick each year's winner in advance — but again, coveting performance never has been based on logic or actual achievability. Just as we cannot walk on water, we also cannot see the future to pick each coming year's winners.

CHASE THIS

Performance chasing, however, is actually a strategy that can be implemented without a crystal ball: Just invest an entire portfolio in the previous year's best-performing asset class.

Of course, this is a terrible idea. The "perfect" 32.25% annualized 15-year return plunged to 2.71% for an investor using this strategy during the 15-year period, while the standard deviation of annual returns increased to 23.7%.

COVET THIS

ANNUAL PERFORMANCE OF 12 MAJOR ASSET CLASSES, PLUS A "PERFECT" INVESTOR, A PERFORMANCE CHASER AND

Year	Large-Cap U.S. Stocks	Mid-Cap U.S. Stocks	Small-Cap Value U.S. Stocks	Developed Non-U.S. Stocks	Emerging Markets Stocks	REITs	Natural Resources	Commodities	U.S. Bonds	TIPS	Non-U.S. Bonds	Cash
1998	28.67	16.90	4.76	19.60	–18.00	–16.25	–14.61	–27.98	8.56	3.74	17.66	5.34
1999	20.37	15.29	3.35	26.55	61.81	–3.95	26.63	42.81	–0.94	2.19	–6.84	5.01
2000	–9.71	17.37	21.88	–14.46	–27.45	26.46	15.24	24.43	11.49	12.95	–3.29	6.29
2001	–11.81	–0.90	13.70	–21.71	–2.73	12.45	–16.00	–8.68	8.31	7.68	–4.43	4.16
2002	–21.55	–14.37	–14.20	–15.43	–7.29	3.85	–14.37	24.56	10.12	16.33	21.33	1.65
2003	28.16	35.14	37.19	39.68	57.88	35.77	34.73	25.84	3.98	8.18	17.64	0.90
2004	10.69	15.77	23.55	18.94	26.31	30.87	24.69	37.15	4.22	8.30	11.53	1.11
2005	4.86	12.50	6.28	13.32	32.25	11.64	35.63	30.87	2.30	2.59	–9.25	3.01
2006	15.80	9.99	19.23	25.88	29.20	33.49	16.17	16.02	4.21	0.18	6.78	4.88
2007	5.12	7.12	–6.92	9.89	37.32	–16.42	33.71	31.50	6.84	11.95	10.41	5.14
2008	–36.70	–36.34	–32.33	–41.02	–52.29	–37.00	–42.89	–31.74	8.49	–0.55	4.21	2.77
2009	26.31	37.49	30.98	26.84	75.29	30.07	37.07	16.19	3.70	8.94	5.44	0.53
2010	15.04	26.26	25.11	8.25	19.44	28.42	23.35	11.90	6.25	6.13	3.82	0.06
2011	1.89	–2.16	–4.20	–12.26	–18.74	8.56	–7.80	–2.57	7.91	13.27	3.98	0.05
2012	16.02	17.82	18.97	18.82	19.20	17.62	2.02	3.50	3.92	6.39	5.86	0.04
15-Year Average Annualized % Return	4.39	8.81	8.18	4.31	9.55	8.78	7.31	10.53	5.91	7.11	5.29	2.71
15-Year % Standard Deviation of Annual Returns	19.07	18.70	18.64	22.61	36.05	21.62	24.42	22.47	3.29	5.01	9.10	2.25

Source: Lipper data, author calculations. Yellow highlighting identifies each year's best-performing asset class.

Given this rather dire reality check, what would represent an achievable level of performance? Would an average result do?

The ending outcome of simply investing in all 12 asset classes each year (and then rebalancing at year's end back to equal allocations) resulted in a 15-year annualized return of 7.95% and a standard deviation of 12.8% — far better than what the S&P 500 by itself generated. True, it is a paltry outcome compared with perfection — but welcome to mere mortality, where perfect foresight is in very short supply.

Let's now examine the growth of a sample retirement portfolio. Think of a client who started out at 35 years old,

making $50,000 each year. She got a 3% raise each year, and was willing to save 3% of her gross income each year.

Over the 15-year period, from 1998 through 2012, if she were able to use the "Crystal Ball Portfolio" — picking each year's winning asset class at the start of the year and allocating her entire portfolio to that asset class — she would have accumulated $416,702. This represents a benchmark of portfolio perfection.

Any sane advisor would say that this is nonsense, but investors do a lot of nonsensical things that are driven by nonsensical aspirations. Nevertheless, we now have our "covet" target: $416,702.

How could this sample client hit the same target if she were not capable of picking each year's winning asset class? She could invest in one asset class and get lucky, or she could invest in a wide variety of asset classes and rebalance each year — but she would need to save more than 3% of her income each year. There are certainly other strategies, but let's consider those two.

SAVINGS RATE
As shown in the Paths to Perfection table on the next page, it would have been possible to accumulate $400,000 during this particular 15-year period using any of the individual asset classes or a combination of all of them — but

A BALANCED PORTFOLIO.

	Perfect Investor: Picks Best Asset Class Each Year	Performance Chaser: Picks Last Year's Best Asset Class	Strategic Investor: Equal-Weighted Average of All 12 Asset Classes
	28.67	28.67	2.37
	61.81	20.37	16.02
	26.46	-27.45	6.77
	13.70	12.45	-1.66
	24.56	-14.20	-0.78
	57.88	25.84	27.09
	37.15	26.31	17.76
	35.63	30.87	12.17
	33.49	16.17	15.15
	37.32	-16.42	11.31
	8.49	-52.29	-24.62
	75.29	3.70	24.90
	28.42	19.44	14.50
	13.27	8.56	-1.01
	19.20	6.39	10.85
	32.25	2.71	7.95
	18.87	23.7	12.76

PATHS TO PERFECTION

HOW MUCH WOULD A CLIENT HAVE NEEDED TO SAVE ANNUALLY TO EQUAL THE BALANCE OF THE "PERFECT PORTFOLIO"?

Asset Class or Portfolio	Needed Annual Savings Rate to Match the "Perfect Portfolio"	Ending Account Balance After 15 Years (1998-2012)
Large U.S. Stock	32%	$419,565
Midcap U.S. Stock	23%	$409,936
Small Cap Value U.S. Stock	24%	$418,032
Developed Non-U.S. Stock	33%	$417,614
Emerging Non-U.S. Stock	18%	$409,910
REIT	20%	$420,484
Natural Resources	24%	$421,339
Commodities	19%	$411,651
U.S. Bonds	29%	$420,996
TIPS	26%	$423,315
Non-U.S. Bonds	30%	$422,542
Cash	39%	$418,433
Equal-Weighted Portfolio using all 12 Asset Classes	24%	$415,239

Source: Lipper data, author calculations

it would require the client to save at a much higher rate.

If she chose to invest in a portfolio of 100% large-cap U.S. stocks, for instance, she would have needed to save 32% of her income each year to match the result of the coveted perfect portfolio. If she decided to invest exclusively in a mutual fund that tracks the mid-cap U.S. stock market, she would have needed to save 23% of her income each year.

And if she were a disciple of diversification she may have decided to build a multi-asset portfolio that utilized all 12 asset classes — but in this case, she would have needed to save 24% of her income each year to have an ending balance that was essentially the same

as the perfect portfolio.

That 3% savings rate, which more or less simulates the typical savings rate in the U.S., just didn't cut it. (And remember that her income grew 3% each year.)

So portfolio perfection is indeed possible, but it will take a lot more sacrifice than most clients are willing to commit to. If your client covets an outcome that assumes that a portfolio can be built with perfect foresight, a 3% or 5% savings rate will not get the job done.

If anyone actually has perfect foresight and can pick each year's best asset class in advance, a 3% savings rate would suffice (but those individuals may be down at the racetrack rather than reading this article).

For everyone else, the path to portfolio perfection is far more rigorous. Clients would need to build a diversified portfolio and save roughly 20% to 25% each year. If they do this, they can give up the coveting, replace it with old-fashioned sacrifice, and get to the same place.

Here's the ironic part: There is, of

course, no perfect portfolio. But it probably serves the long-run purpose to continue assuming that there is one. If clients' coveting is based on a belief that they could or should have picked the right asset class at the start of each year, and they come to realize that it's just not possible, the only logical choice is to save more money each year in order to simulate the investment outcome that they covet.

So tell your clients to keep on coveting — but save 20% (or more) of their income in a diversified portfolio along the way. FP

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