

# The Subtle Influences of Past Performance

By Mark W. Riepe, CFA

Individual investors are frequently taken to task for chasing performance. Regulators insist on “Past performance is no guarantee of future performance” being plastered on the cover of every prospectus. Professional pundits nod knowingly and offer up with smug certainty, “We know one thing: yesterday’s winners won’t be tomorrow’s.” Whether the past performance of a mutual fund, manager, asset class, or anything else that generates a track record or time series of returns is irrelevant is not the issue today. Instead, I suggest that even those professional investment advisors who profess that past performance is irrelevant are probably being influenced by it through at least six subtle mechanisms.

**Advertising:** Asset management companies advertise not just to retail investors, but also in professional trade publications. An anecdotal check of these ads suggests that advertisers lavish marketing dollars on the product line that has the best recent performance. Believing that marketers choose not to waste money, I presume they’re allocating their dollars in this way because it generates the best response from the professionals reading these publications. In addition, for each dollar that is spent promoting a past winner, that is one less dollar available to create awareness among professional advisors for those investment opportunities that may not look stellar on the performance charts. In this way, past performance helps shape the candidate universe that advisors consider when making their recommendations to clients, or actual investments on their behalf.

**Editorial share of voice:** Asset management companies reinforce the importance of past performance driven by commercial instincts. But the independent financial media seem to pipe the same tune. Who gets invited to speak at conferences? Who gets interviewed? It seems to me that prognosticators and managers with good track records take up the overwhelming number of slots. The leftover slots are allocated to fallen stars. These articles are invariably titled “Has So-and-So Lost the Magic?” and show a table of returns trending in the wrong direction.

For good measure, a photograph of the article’s subject is thrown in with the subject looking like they just left a funeral. The tone of the hagiographies and the hatchet jobs strike me as containing an implicit suggestion that going with who’s hot and avoiding who’s not is the way to go. I find it hard to believe that advisors are completely immune to the overall tone that is set when the financial media chooses to operate their spotlight in this way.

**Consultant/academic studies:** The media bias extends to asset classes as well as individual managers. How often has an asset class or type of investment product (such as hedge funds) done well and, lo and behold, all the trade publications begin providing summaries of studies that purport to show that asset class X or product Y is underweighted in the portfolios of most investors? I’m not saying all of these are bad studies in the sense that their methodologies are intellectually bankrupt. I am saying that studies that are likely to lead to a negative finding tend not to get funded while those that are likely to show a positive finding will get funded, and massive dollars allocated, to get that study distributed. The underlying theme is that this is another way in which past performance is shaping the nature, tone and content that the advisor is reading and hearing about on a daily basis.

**Product development:** It costs money to develop new investment products and those dollars need to generate a rate of return for the manufacturer. The easiest way to get that return is to crank out “me too” products tied to the asset class or investing strategy du jour. Asset management companies are for-profit entities and this approach is consistent with that profile. The effect on the unwary advisor is again to cloud their field of vision. When the advisor decides to investigate the new toys that are lining the shelves at the asset management store, the selection is being determined by the ability of the manufacturer to make a good past performance claim.

**Ongoing due diligence:** I've listed stimuli that are external to the advisor. There are, however, some behavioral tendencies that advisors impose on themselves. Mutual funds provide a good example. I'm sure most readers will periodically review the mutual funds they've recommended to clients. Leaving aside asset class-driven rebalancing decisions, how closely do advisors review those funds that have had good recent performance? I suspect that readers in this situation, if they see good recent numbers and see the same management team in place, will spend little time on ongoing due diligence.

To the extent ongoing due diligence is done, it wouldn't surprise me if 90 percent of the time allocated to such a review is devoted to those funds with poor recent performance. Yet, if past performance is truly of little importance, ongoing due diligence should be spread more evenly across all recommendations irrespective of their recent performance. It also would not surprise me if there are advisors out there who say past performance is but "one of many factors we examine" and then turn around and use past performance as the primary or even sole trigger for all subsequent purchase/sale decisions.

**Client feedback:** To a certain extent, the behavior described above is driven by client demand. It's always seemed to me that the volume of praise one gets for recommending what proves to be a winning investment pales in comparison to the scorn that is heaped upon one for recommending what turns out to be a dog. Unfortunately, but not surprisingly, I'm sure some advisors take the easy way out with some clients and give them what they ask for (instead of what they need) and remove the laggards in the interest of maintaining the relationship.

What does one do, if anything, about all this? First of all, I'm not sure all of this is bad. At least in the area of mutual funds and managed accounts, I'm in the camp that believes past performance, once one has properly controlled for the many other factors, is an important variable to use when making a decision. By extension, the fixation of the media and many investors on past performance is probably overdone, but not wholly without merit. The trick is for advisors to recognize that good past performance is, in effect, a litmus test that an investment must pass to get on the stage. It's a crowded stage, though, and where advisors earn their fees is separating the contenders from the pretenders on the stage and then taking the next step of matching the contenders with the specific needs of individual clients.

But I think it is a mistake for advisors to sort through only the investments that passed the past-performance beauty pageant, given the many other factors that influence performance. It does, however, take courage to recommend something that is simply off the radar screen of those who shape the debate.

Finally, I think advisors need to take a firm hand with clients and even re-think their own practices. Just because an investment has done well doesn't mean it still makes sense in the future. Just because an investment has done poorly doesn't mean it's time to bail. I'm sure every advisor agrees with that previous sentence. The question is whether they engage in day-to-day practices that undermine that principle either in their own analytical work, or in their interaction with clients.