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Does Performance Matter? -- II

There are two approaches to investing: performance and process.

Performance investing involves exaggerated attention to tables showing the hot stock or manager over the last quarter or year. Performance investing encourages excessive cheerfulness near market tops and unwarranted depression at market bottoms. Performance is a “black box” -- that is, it is a conclusion (better performance) rarely accompanied by a satisfactory description of a repeatable process. Consequently, an investor will have little faith in that process and no emotional reserves when things go bad. If a fund you bought primarily because of its past performance starts to underperform, what analysis do you apply to decide whether to sell, hold, or buy more? Performance investing leads you to focus too much on the market and not enough on yourself and your needs. Performance investing inherently leads to a lack of serenity, because no matter what you own, there’s always something somewhere that’s going up more or down less.

*A tailor would not tell you
to become obese because
he had a lot of fabric*

Process investing means applying a consistent, reasonable approach that adapts the market to your circumstances rather than changing your plans to meet the market. Too many investors, not to mention their advisers, follow an investment style akin to ordering a suit of clothes and having the tailor tell you “Gosh, we have a lot of fabric here, why don’t you gain 50 pounds.” Think about what it is you want the markets to give you, and then develop a long term plan for getting there. What *you* say is more important to your financial future than what Alan Greenspan says.

The problem with most long term investment plans is that they don’t survive short term fluctuations. Your long term plan may be conservative, but will you stick to it when you hear the loudmouths at cocktail parties bragging about how they’ve quintupled their money this year? Or you may have a reasonably aggressive plan for a far-off retirement, but will your emotions permit it to survive a nasty, account-shrinking bear market?

Unfortunately, performance numbers tell you nothing about the risks assumed to attain that performance, risks that tend to show up later. Of 1995’s 20 top performing mutual funds (out of more than 7800 funds in our database), only three performed better than the S&P 500 index in 1996, while ten performed worse than money funds. Of 1995’s 20 *worst* performing funds, six performed better than the S&P 500 index in 1996. Your odds of “beating the market” were twice as good if you used 1995’s worst performing funds than if you used the

best. In the bull market of 1996, six of 1995's top performers actually *lost* money.

Performance numbers also don't tell you how much money investors actually made. Successful gurus in each cycle tend to start with a tiny band of followers. As their success is reported, they attract additional investors to their fund, newsletter, or whatever. When they blow up, more money is lost by more people than was made in aggregate on the way up. In the investing world, when a ship goes down, it usually has more hands on deck than it did when it left the port.

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Does performance matter then? Of course it does, but the paradox is that the greater your obsession with performance, the smaller your chance of achieving it.

Striving too much for performance can lead you unknowingly to assume risks that are destabilizing emotionally when they become apparent. Stretching for the last 0.1 percent annual return can lead you into making a 50 percentage point mistake. Investment performance is like gravy -- it is a by-product of a more important process. Nobody walks into a clean kitchen and says "Hey, let's make some gravy!" Before you talk about rates of return, you need to discuss lifetime goals and risk tolerance.

Even if an investment adviser has a rational process, they have to get their clients to trust it. Despite a prevalent vague sense of insecurity, most investors have no idea how they will react emotionally to a bear market because they've never experienced one. Until we have virtual reality glasses that enable people to relive the 1929 crash, the best we can do is try to assess the risk tolerances of our clients and help them understand how emotions can destroy an investment program.

As we showed you last month, investment performance pales in comparison to investor behavior as a factor in how much money you wind up with. Some day, when the media is explaining why things will never get better, when market pundits are extolling the virtues of treasury bills and academicians are publishing studies showing how stocks and bonds have always been poor investments, Sigma will be there to help our clients focus on what's really important to them. Now, when nobody needs to be convinced of the virtues of investing, we are there to help explain the risks to our clients and keep them from getting too greedy in the anomalous market of the past few years.

If you would like this kind of help, call Sigma Investment Management Company.