



The Paradox of Performance I: Illusion with a Chaser

Everyone with a portfolio desires investment performance. Many investors, however, perceive or understand performance in a way that, paradoxically, destroys it. They either: (1) place too much emphasis on performance; or (2) do not consider performance at all. This month, we will focus on the first group.

Investment performance is equivalent to shadows on a wall. Reality is the fundamental condition of, and prospects for, the businesses underlying stock prices, while stock price movements are the shadows that imperfectly suggest this reality. Your shadow can make you look sixteen feet tall, but the appearance does not change your height.

Good investors attempt to discern reality, while amateur investors chase the shadows of trailing performance. Since there are more amateurs than good investors, the financial industry “creates” good trailing performance. They carefully select the time periods over which they advertise performance. They merge worse-performing funds into better-performing funds in the same family, so the surviving performance records look outstanding. They change 401(k) plan offerings, deleting funds with slow recent performance and adding funds with good recent performance. They create new investment products in whatever market sector has been favored lately. They compare trendy stocks to previous winners – several thousand stocks have been “the next Microsoft.” The financial industry knows investors tend to chase performance, so they manufacture performance to be chased.

An obsession with investment performance paradoxically destroys investment performance.

Investors chase performance because our brains are wired to extrapolate the recent past. This is a good rule in many areas of our lives. If you like grapes today, you will probably like them tomorrow. Grapes, however, are part of reality. Stock prices, an illusion, can stretch only so far away from the reality of underlying business fundamentals. When they go too far (e.g. technology stocks in late 1999), the future may be like a rubber band snapping back in the opposite direction. In the stock market, what is true today may very well be untrue tomorrow.

Investors chasing performance obsess over tables showing the hot stock or manager over the last quarter or year. They jump from investment to investment, disturbing what may be a well-devised portfolio to buy what it “hot.” Investors chasing performance are excessively cheerful near market tops and depressed at market bottoms. They focus too much on the market and not enough on their needs. They lack serenity, because no matter what they own, there’s always something somewhere that’s going up more or down less.

Does chasing performance make sense? Let us examine the best and worst performing mutual funds of 2002. Eliminate duplicate classes of fund shares, bear market funds and precious metal funds, and about 6,000 funds remain. The 20 top performing funds in 2002, as a group, underperformed this universe in 2003. Four did better than the Standard & Poor’s 500 Index, while 16 did worse. In contrast, the 20 funds that did the worst in 2002 averaged gains of over 68 percent in 2003. Only two did worse than the S&P 500, while 18 did better. Your chances of beating the S&P 500 in 2003 were four and a half times as great if you selected from among 2002’s worst performing funds than if you selected from among the best performing funds.

This pattern repeats, but investors stubbornly throw new money at the assets, investment managers and sectors with the most momentum and excitement while yanking money away from assets, managers and sectors that lost the recent performance sweepstakes. Trustees for 401(k) plans add funds with stellar recent performance to their plans and insist on dumping the “losers.” When was the last time a broker called you and tried to sell you a seasoned mutual fund that performed poorly last year, or a stock that recently declined? These might be attractive investments, but they are hard to sell. The industry will sell investors products that are easy to sell.

“What ails the truth is that it is mainly uncomfortable, and often dull. The human mind seeks something more amusing, and more caressing.” – H. L. Mencken

The result is a gap between investment performance and investor performance. Money flows to the areas that are about to experience bad performance and away from areas about to experience good performance. Trailing performance numbers are not dollar-weighted, hiding that fact that more money is “there” for the bad performance than was there to

enjoy the previous good performance. More money is lost by more people on the way down than was made in aggregate on the way up.

You desire investment performance, but the greater your obsession with it, the smaller your chance of achieving it. Like good health, we achieve investment performance as the result of a process. While we desire good health, we do not directly create it. Good health is the likely result of a process of getting enough sleep, eating right, avoiding stress and exercising. If you decide to take a shortcut and just strive for “health” (e.g. taking ephedra), you make good health less likely. Investment performance is the likely result of rational asset allocation, careful selection of managers or investments, and the discipline to stick to your plan through all kinds of markets. Shortcuts are alluring, “process” is boring, but reality is reality.

Your investment goal should be having enough money for your needs, not getting an adrenaline rush when you watch the stock market report. The next time you are tempted to invest in something because it is “hot,” lie down, put soothing music on the stereo, apply a cool cloth to your forehead and think about having Sigma add a rational investment process to your portfolio. We can be reached at (503) 419-3938.