The lure of performance-chasing

The refrain “Don’t just sit there, do something!” has become part of daily life. The phrase exhorts us to take action to bring about a change. For investors experiencing below-average mutual fund returns, this advice may seem reasonable. The resulting action plan for such investors frequently involves moving assets from one fund to another fund with a stronger performance track record over the past few years. In short, these investors end up chasing performance.

Research has shown that performance-chasing is not restricted to specific groups or subsegments of investors; rather, both retail and institutional clients have shown an inclination to chase performance (Goyal and Wahal, 2008; Bennyhoff and Kinniry, 2013). Given the intuitiveness and popularity of this behaviour, we decided to take a closer look at its underlying assumptions and historical performance.

In theory, performance-chasing succeeds if past performance can predict future performance. In financial terms, performance-chasing may provide a benefit if there is persistent, that is, repeated and prolonged relative outperformance from year to year. By performance-chasing, investors implicitly or explicitly assume that performance persistence is fairly strong. In contrast, investors who follow a buy-and-hold strategy are assuming that performance persistence is fairly weak and that excess returns are not likely to be gained by chasing performance. This research note compares performance-chasing with buy-and-hold by comparing the returns and risk-adjusted performance of each strategy to determine if taking action based on past performance is worthwhile.

Study sample and ground rules

For our primary analysis we chose the universe of active US equity mutual funds available in any of the nine equity style boxes in Morningstar’s database during the ten years ended December 31, 2013. After filtering the database to include only funds in existence for a minimum of three calendar years at some point during the analysis period, we arrived at a study sample of 3,568 funds.

To compare performance-chasing with buy-and-hold, it’s essential to define the trading/investment rules governing each strategy through time. We settled on a set of rules (see the box on “Trading/investment rules,” on page 2) as a reasonable representation of actual investor behaviour related to each strategy. Using these rules as part of a quantitative historical simulation for the period 2004–2013, we examined the performance of each possible path an investor could have taken within the trading-rule guidelines. We performed the analysis separately in each of the nine equity style boxes to control for size or style influences that might affect the results. Our simulation produced a total of more than 40 million return paths.
One rule in particular, the holding period over which performance is measured, has been the subject of extensive research in terms of performance persistence. We used a three-year rolling performance look-back for the performance-chasing strategy because of the time period’s alignment with the approximate equity mutual fund holding period.\(^1\)

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### Trading/investment rules for this analysis

#### Performance-chasing

**Initial investment:** At the start of the analysis period, we invested in any fund in existence for the full three-year period from 2004 through 2006 that had an above-median three-year annualised return.

**Sell rule:** Using three-year rolling periods of returns, we moved forward one calendar year at a time. Funds that achieved below-median three-year annualised returns at any time were sold, as were funds that were discontinued.

**Reinvestment rule:** After any sale, we immediately reinvested in each fund that achieved an average annualised return within the top-20 performing funds in the style box over the prior three-year rolling period.

#### Buy-and-hold

**Initial investment:** Invest in any fund.

**Sell rule:** Sell only if a fund is discontinued.

**Reinvestment rule:** Reinvest in the median-performing equity mutual fund within the relevant style box.

### Advantages of the methodology

This process of cycling through the performance-chasing and buy-and-hold trading rules generated millions of potential return paths that could have been experienced by investors during the period 2004–2013. Using these return paths, we were able to calculate the median experience as well as the full distribution of potential outcomes for investors engaged in each type of strategy.

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#### The clear winner: Buy-and-hold

Once all possible return paths were created for both the performance-chasing and buy-and-hold strategies, we calculated various statistics such as annualised returns and Sharpe ratios for each path during the full ten-year period. **Figure 1** summarises the basic return results, and **Figure 2** provides more details.\(^2\)

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1. Using US equity fund redemption data from the Investment Company Institute for the 15 years from 1999 through 2013, we estimated that the average mutual fund holding period just exceeded three years. Admittedly, redemption ratios are an imperfect measure of mutual fund holding periods, but given a lack of direct evidence on the holding periods of mutual fund investors, we believe this is a reasonable proxy.

2. Although the results are not displayed in this research note, we performed this analysis using a variety of trading rules and time periods and observed similar outcomes.
In all nine equity style boxes, the returns produced by the buy-and-hold strategy bested those of the performance-chasing strategy (see Figure 2). Even more striking, the buy-and-hold strategy Sharpe ratios (a measure of risk-adjusted performance) also exceeded the performance-chasing Sharpe ratios in all nine equity style boxes. Interpreting these results in relation to our earlier discussion of performance persistence, one can infer that the top-performing mutual funds over a measurement period of three years have demonstrated weak performance persistence in subsequent periods.

We excluded from the analysis the impact of any potential transaction costs or taxes incurred. If included, one could reasonably expect that the results of the active performance-chasing strategy would be even weaker in relation to the static buy-and-hold strategy. These results underscore that investing in mutual funds solely on the basis of their recent performance record is not likely to improve future returns.

Although it may be possible to tweak the performance-chasing rules and scour the historical data to find situations in which a buy-and-hold strategy has underperformed, our analysis supports the difficulty of succeeding with performance-chasing strategies in general. In Vanguard’s view, buying actively managed mutual funds based on a combination of qualitative and quantitative factors and then maintaining a disciplined approach and long-term perspective despite fluctuations in manager performance has been a simpler and more effective approach for increasing returns than chasing active manager performance.

Notes: All returns and Sharpe ratios shown are median annualised; for “Difference,” numbers may not compute because of rounding. Area under the curves represents frequency of returns realised under either strategy, similar in effect to a histogram. Dotted lines represent median return of the distribution. Investors prefer distributions with higher median returns and less dispersion, or volatility, around the median.

Sources: Vanguard calculations, using data from Morningstar, Inc.’s nine equity style boxes.

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Conclusion

Investors are naturally drawn to top-performing actively managed funds. The result for many is a performance-chasing approach in which current funds are sold from the portfolio to make room for recent winners. Vanguard research demonstrates that this behaviour is misguided, as a buy-and-hold strategy has outperformed performance-chasing over the past decade in all nine Morningstar equity style boxes.

Our research furthermore reaffirms the importance of an oft-cited but frequently ignored legal disclaimer about investing: *Past performance is not necessarily indicative of future results.* This statement certainly appears to hold true among recent top-performing funds, and investors are well-advised to remind themselves regularly of it.

To improve the odds of their long-term investment success, investors should understand that some periods of below-average performance are inevitable. At such times, investors should remain disciplined in their investment approach and avoid the temptation to chase performance.

References


