Stock Market Perspective: Fund Performance Persistence

It is common for financial publications to show which mutual funds have performed the best over recently completed past periods such as a quarter, a year, three years, or five years. Sometimes, there are also tables of the worst performers for these periods. An unstated implication is that the top performers are worthy of consideration for the readers' investments and the worst ones should be avoided. In a similar vein, Morningstar shows its "star ratings," which are based on investment returns and volatility within a fund's category, and fund companies may show how their funds rank among a group of similar funds, typically using the Lipper rankings.

Financial publications often have lists of the best performing mutual funds. Are they likely to continue in the top groups?

A natural question is whether those types of rankings are a good way to select mutual funds to buy or sell. Equivalently, one can ask whether funds with high or low ranked performance over a period are likely to perform similarly in the next period(s). Twice a year, Standard and Poors (S&P, the publisher of many market indices such as the widely referenced S&P 500) updates and publishes a comprehensive study that addresses this issue. The latest one was released in June:

http://img.en25.com/Web/StandardandPoors/PersistenceScorecard_June10_Final.pdf

[If you don't want to type all of that, you may be able to find it with a search engine, and I will e-mail it to you upon request.]

I will discuss some of its findings and focus on selected data in the report's tables.

S&P points out that they have taken great care to avoid one flaw of many mutual fund performance evaluations: survivorship bias. It occurs when the performance tables include only those funds in existence at the end of the period. The flaw is the funds around at the start of the period that no longer exist—usually because they have been merged into another fund as a consequence of poor performance—at the end of the period are not included in the rankings. If a fund that was highly ranked does very poorly in a subsequent period and its assets drop to a low enough level, the fund company may decide to merge it with one of its larger funds that has similar investment objectives. When this happens, an analysis with survivor bias will not include that fund's poor performance.

The report tables are based on how funds rank in quartiles and in the top and bottom halves for all domestic funds and also in the categories of large-cap, mid-cap, small-cap, and multi-cap funds. There are two overall conclusions in the report. One is that very few funds consistently repeat top-quartile or top-half performance. The percentages that do are less than what would be expected due to random chance. The other finding, which is hardly surprising, is that bottom quartile funds are much more likely than the others to be merged into another fund or terminated by liquidation and return of assets to its holders.

The tables in the latest report are based on performance through the first quarters of several years. They cover one-year performance over three and five consecutive periods, and three and five-year performance, each over two consecutive periods. The basic conclusions described above hold in all cases.

Of the funds in a quartile group for a period, random chance would predict that 25% of them would be in the same quartile for the following period and 6.25% would be the that quartile for both of the following two periods. For funds in the top quartile for the one-year period ended March 31, 2009, only 4.29% of all domestic funds were in the top quartile for each of the next two years. None of the four categories was up to the random expectation; the best were

small-cap at 5.38% and large-cap at 5.32%. Results were similar for top-half persistence with only 15.45% of all funds remaining in the top half for each of the two following years as compared to the random chance of 25%.

Similar results held for the four one-year periods following the one ended March 31, 2007. Small-cap funds in the top-half were a brief exception as 49.1% of them were in the top half the following year and 31.9% were in the top half for the following two periods, better than the random 25%. However, that did not last as only 10.3% (vs. 12.5%) remained for the three one-year periods as of March 31, 2010, and for the four periods, a mere 2.59% were in the top group for all of them, well below the expected 6.25%.

Is longer-term performance a better predictor of relative future performance? Looking at those in the top quartile for the three years ended March 31, 2008, 23.7% were in the top quartile over the following three years, but more, 26.3%, were in the second quartile, and almost as many, 22.6%, were in the bottom group. A possibly surprising 8.2% were merged or liquidated over the following three years. The performance of the bottom quartile group was quite interesting. 26.9% of them were in the top quartile for the following three years, and 25.0% of them were no longer existed by March 31, 2011.

The story for the four categories is similar, but is complicated by a significant percentage of them, particularly mid-cap and multi-cap funds, having a change of style, which means moving to another of the capitalization based categories. S&P shows those moves as a separate outcome and does not count them toward subsequent quartile or half rankings because there is no "right" way to do that. However, that makes the meaningful interpretation of the results at the category levels somewhat conjectural, which is why I am focusing on all domestic funds.

Five-year performance may have some predictive value based on the one case shown in the report. A more extensive analysis considering many more periods would be required in order to have any confidence. For funds in the top-quartile for the five years ended March 31, 2006, 30.4%, well above the expected 25%, were in the top-quartile for the following five years. The number may be slightly higher because 10.2% of the top-quartile funds were merged or liquidated, and it is possible that a few of those actions were due to business reasons other than poor performance. However, top-half persistence was not as strong as 46.5% were in the top half in the five years ended March 31, 2011, 40.2% were in the bottom half, while 13.3% were terminated. Most likely the vast majority of the funds that did not survive had relatively poor performance.

►*I find little value in the lists of top (or bottom) performing funds:* As you probably realize, the above is for educational purposes and has no effect on how I manage accounts. The report does not show any of the investment returns for the groups in the tables. Most mutual funds underperform market indices, so it is reasonable to assume that a broad market index fund would be in the top quartile, and it is almost certainly in the top half. I'll look at the performance of what likely is the leading one, the Vanguard Index 500 fund that tracks the S&P 500 with dividends reinvested less a very small expense fee. At its low on March 9, 2009, it was almost 45% below its value on March 31, 2006, and it had fallen over half from its peak in the summer of 2007. For the five years through March 31, 2011, it gained 13.4%, which is a compounded annual rate of 2.6%. Those figures illustrate in a dramatic fashion why I don't pay attention to the ranking tables, which are mostly aimed at "buy and hope" investors.

As I have discussed many times previously, most of my methods for managing accounts are based on trend following. Like all other methods, they are far from perfect and will

have trades and periods when they do not perform very effectively. However, they are virtually certain to avoid severe drawdowns like those for the index fund, and in the current secular bear market that is a requirement for achieving one’s investment goals.