

The Elusiveness of Persistence

By Michael Nairne

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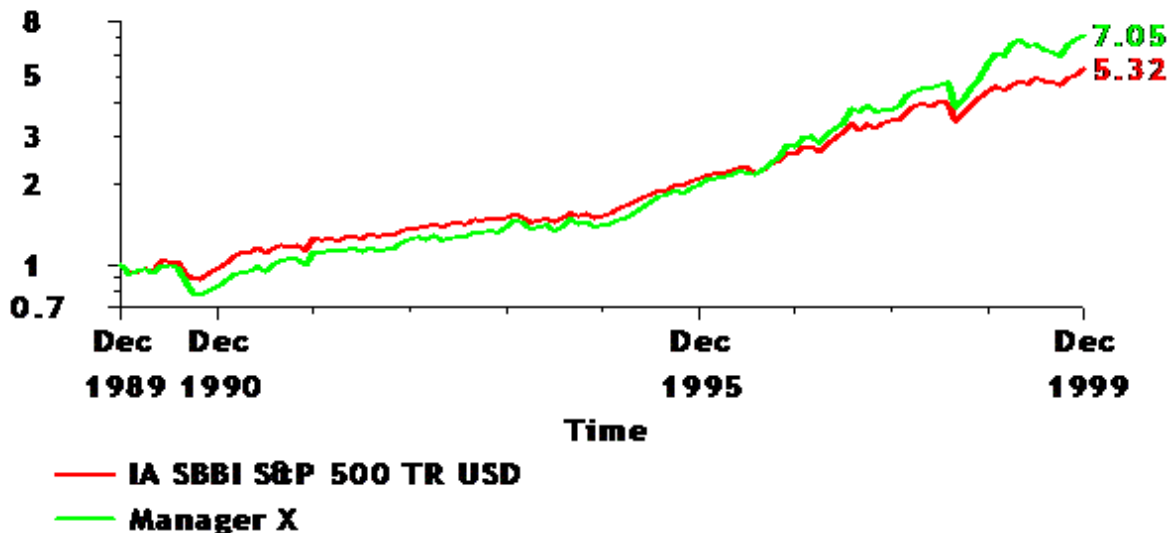
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On January 1, 2000, Jim Smith invested with Manager X. Jim had done his homework: he had compared Manager X's performance over the prior decade against the relevant benchmark. Although Manager X stumbled in 1990, his returns had beaten the S&P 500 every year after that. This outperformance is illustrated in the following graph. If you had invested \$1.00 with Manager X on January 1, 1990, it was worth \$7.05 on December 31, 1999 (see green), far in excess of the \$5.32 earned by the S&P 500 (see red).

Cumulative Portfolio Performance

Index Values (USD)



Jim dug even deeper and reviewed several years of analysts' reports. They were unanimous. Manager X's performance warranted a role as core equity holding. Jim also hired his own financial analyst to analyze Manager's X's performance from a risk-adjusted perspective. Again, Manager X came through with flying colors. Although his returns were more volatile than the S&P 500, his higher

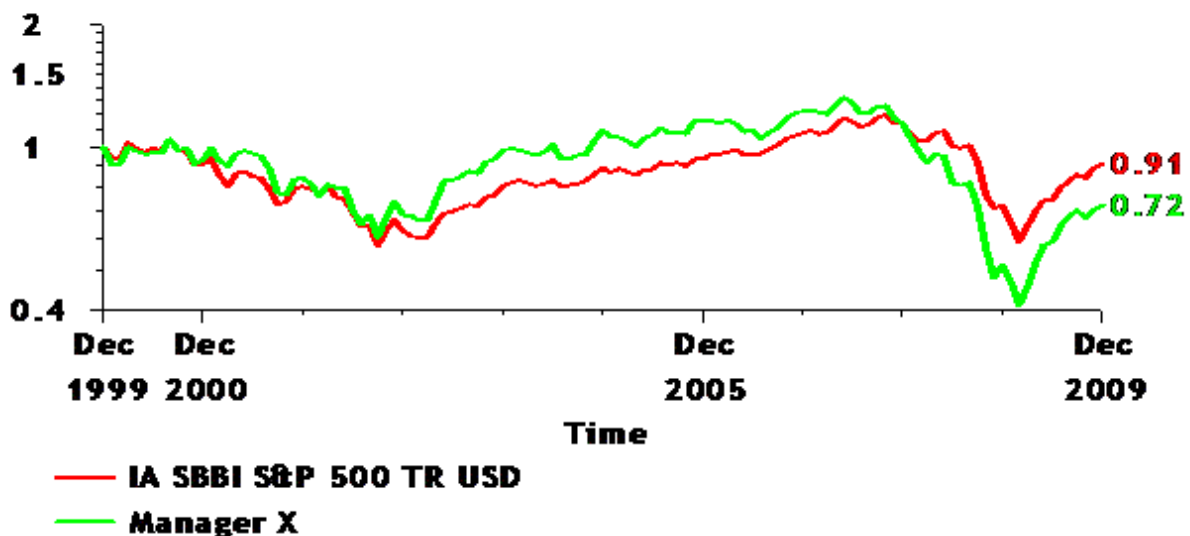


returns more than compensated for the bumpy ride. With his homework done, Jim confidently selected Manager X as his core U.S. equity manager and allocated him a sizeable portion of his portfolio.

Fast forward to December 31, 2009, and Jim is ruefully assessing the results of his selection decision. Although Manager X's performance had outstripped the S&P 500 through the first half of the decade, he suffered massive losses in the market meltdown. Every \$1.00 Jim invested with Manager X in 2000 was worth 72 cents (see green) at the end of the decade, more than 20% less than the 91 cents yielded by the S&P 500 (see red).

Cumulative Portfolio Performance

Index Values (USD)



Analysts' reports now say this manager is too volatile to be a core holding. Jim's own financial analyst ran the numbers and now concludes that Manager X's recent risk-adjusted performance is poor. Jim wonders where he went wrong.

Jim's experience highlights the critical question of persistence in manager performance – whether a manager's past performance is predictive of his or her future performance. Certainly, considering the avalanche of media articles on top winning funds and the endless sales pitches to investors trumpeting “best in class” managers, one would assume that there is some reasonable level of persistence in performance.

Fortunately, we can garner insights based on empirical evidence, not puffery. Over the past half a century, there have been over 100 academic studies on the



question of persistence in managed money performance. In 2003, the Fund Management Research Centre undertook a sweeping review of 49 of the most recent or robust of these studies from the U.S., U.K. and Australia in a reportⁱ to the Australian Securities and Investment Commission.

The report's major conclusions provide serious investors with some clear answers:

1. Good past performance is, at best, an unreliable and weak predictor of future good performance over the medium to long-run. Approximately 50 percent of the studies found no correlation at all between good past performance and good future performance. Where persistence was found, it tended to be short-term, i.e. only one to two years.
2. In those studies that found some level of persistence in positive performance, the outperformance tended to be small and in many cases, would be swamped by the cost of swapping between funds.

The report's authors hypothesized some reasons for the lack of persistence in past performance – style cyclicity; the erosion of competitive advantage as managers battle it out for better staff and methods, and; the negative impact of large capital inflows on outperforming managers.

The implications for investors are clear. An analysis of past performance alone is not sufficient for the selection of an investment manager. The chance of a given outperforming manager repeating this performance is almost random. An investor might as well use a dartboard if he or she is selecting managers solely on past return numbers.

If active managers are to be used in a portfolio, extensive investigation far beyond a simple review of past performance is required. A recent studyⁱⁱ, for example, suggests that analysis of a manager's portfolio holdings and the extent of their deviation from the benchmark as well as historic returns might point the way to managers who are more likely to exhibit positive performance persistence. However, once adjusted for style, size and momentum factors, much of this positive performance disappears and hence, more research is needed to validate these findings.

Finally, since managers as a group underperform the market by their fees and costs, the absence of positive performance persistence by active managers in general suggests that low cost, tax efficient index funds should form the core of a



portfolio and that active managers, if included, should be used in a satellite role. Jim Smith wishes he had taken this approach in 2000.

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- ⁱ Allen, D., T. Brailsford, R. Bird, and R. Faff. 2003. A review of the research on the past performance of managed funds. ASIC REP 22, Australian Securities and Investment Commission.
- ⁱⁱ K.J. Martijn Cremers, Antti Petajisto, *How Active is Your Fund Manager? A New Measure That Predicts Performance*, Yale School of Management, October 3, 2007.