

Short-term performance is a meaningless metric

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The market is chock-full of short-term performance chasers. These are investors who steer their capital toward investment managers who have generated recent hot performance. By the way, I consider anything less than five years to be short-term.

Short-term performance chasers tend to be emotional and impulsive. When an investment strategy is not working investors get frustrated. Switching to a different strategy (or manager) is seen as a fix. The problem is that short-term performance-chasing leads to underperformance, not outperformance.

For example, at the peak in the Nasdaq in March 2000, investors piled into growth and technology funds because those funds had terrific one-, three-, and five-year track records. Of the 50 most popular mutual funds – measured by the amount of investor inflows for the 12 months ending in March 2000 – 48 underperformed the average fund over the next five years.

How did the most unpopular funds perform? The 50 funds with the largest outflows in the preceding 12 months gained an average of 21 per cent over the next five years against a 1 per cent gain for the average fund.

There are several reasons why this performance-chasing fails to boost returns.

■Great performance is not coincident with great management

Performance is a lagging indicator of investment decision-making. More often than not when a money manager makes an exceptionally smart stock purchase, the wisdom of that move is not evident for several months or even a couple of years. Multi-bagger stocks often look quite average, even mediocre, during the first year or two of ownership.

■Reversion to the mean

This dynamic – that performance eventually reverts to the average – is an overwhelming force in the market. While it should be a big issue for investors, it is largely ignored. On this I'll be blunt: some money managers are incompetent. The problem for short-term performance chasers is that incompetent managers can have a run of luck. When the luck turns, investors who buy based on a couple of years of hot performance can get blindsided. Since most managers underperform the market over the long term, investors should view short-term outperformance with suspicion.

■Misperception of risk

Short-term performance chasers act based on a flawed understanding of risk. Consider this example: fund manager A pays \$60 each for several stocks that he accurately calculates to be worth \$100 each. This is a good decision. Shortly thereafter, each stock rises to \$100. His rate of return is terrific, at 67 per cent.

Investors react in predictable fashion. They pour money into the fund because fund manager A has produced such a high return. But if the portfolio stays the same, risk has escalated significantly because the assets are no longer held at a big discount to value.

Another manager, fund manager B, also pays \$60 each for several stocks that he accurately calculates to be worth \$100 each. As with fund manager A, this is a good decision. But, shortly thereafter each stock falls to \$45. The fund is down by 25 per cent.

Investors react predictably to a 25 per cent decline and flee fund manager B in droves. The investors have made a mistake. If we assume, like the example above, that the portfolio stays the same, the assets are now very low risk. That is because value now exceeds price by a wider margin than when they were originally purchased. It also follows that investors are fleeing just when their expected return is exceptionally high; eventually the \$45 quote for each stock will migrate to the asset value of \$100.

Short-term performance has nothing to do with the decision-making skills of fund managers A and B. The managers made equally good decisions. One was lucky because quotes quickly jumped to fair value. The other was unlucky because cheap prices got even cheaper.

■Investors see a “cause and effect” in short-term performance

Implicit in the flow of funds into fund manager A and away from fund manager B is that investors think short-term performance is an indicator of skill. In fact, short-term performance is generally a meaningless metric.

Consider the Sequoia Fund, a fund that was led by a superb money manager, Bill Ruane, who passed away last year.

For the first four years of the Sequoia Fund (beginning in 1970), Ruane lagged behind the S&P 500 by a big margin – an average of about 8 per cent a year. Did that indicate that this disciple of value investor Ben Graham was lacking in skill? Not at all.

The long-term performance data tell the story. Through 2004, the Sequoia fund was up 17,069 per cent against 4,689 per cent for the S&P 500. From 1970 to 2004 the fund outperformed the annual return of the S&P 500 only 54 per cent of the time.

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