

# The (Un)reliability of Past Performance

Success looks beyond the numbers

How making investment decisions based on past performance—even though this is the information most easily available to investors—can be extremely counterproductive.

## Private Wealth Management Research

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### UNDERSTANDING PATTERNS

All too often we see investment decisions based on strong past performance or near-term underperformance. Allocating to superior investment managers is critical to the long-term success of a portfolio. However, reversion to the mean is a powerful dynamic, and top-performing managers are often unable to sustain their success. Yet, past performance is still useful. It can help us understand the drivers of success and the durability of performance patterns that can be paired with deeper qualitative and quantitative analysis to make well-informed decisions.

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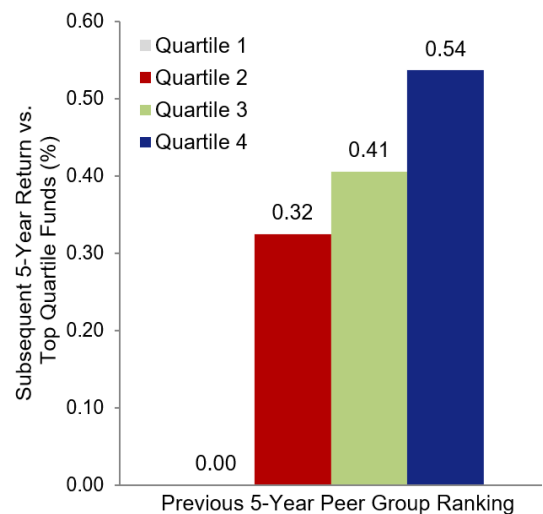
### THE (UN)RELIABILITY OF PAST PERFORMANCE

Past performance is the most widely publicized gauge for active managers, but widespread use does not validate its reliability. In fact, we have found evidence that suggests past performance and future success often have an inverse relationship.

Figure 1 illustrates this concept, showing performance of lower-ranking funds relative to top quartile peers. For this study we grouped mutual funds by 5-year peer group rankings and calculated excess returns for the next five years. Our research covered all nine domestic equity asset classes over 20-years, using rolling 5-year windows to eliminate end-period bias. In total, over 80,000 observations were analyzed.

We found that funds ranked in the lower quartiles actually outperformed their top-quartile peers over the next 5 years, on average. Further, funds in the bottom quartile outperformed top quartile funds by the widest margin amounting to more than 50 basis points per year. The power of “reversion to the mean” is clear and these results illustrate the danger in placing too much emphasis on past performance as a basis for investment decisions.

Figure 1: The Inverse Relationship of Past and Future Performance



## THE CYCLICALITY OF ACTIVE MANAGER PERFORMANCE

The performance of active managers is cyclical and, as such, is subject to misinterpretation. In some periods, active managers can add value with an above-average success rate. In other periods, benchmarks can be incredibly difficult to beat. Individually, manager performance is also cyclical for a variety of reasons.

Investment style plays an important role in determining a pattern of performance, even within the same asset class. For example, a manager focused on stocks with higher dividend yields may fare better or worse compared to peers during different periods. Similarly, a manager with a value bias may struggle when pricier growth stocks outperform by a wide margin. Figures 2 and 3 demonstrate this by separating returns for high dividend stocks and stocks with rich valuation multiples from the rest of the S&P 500 for consecutive three-year time periods.

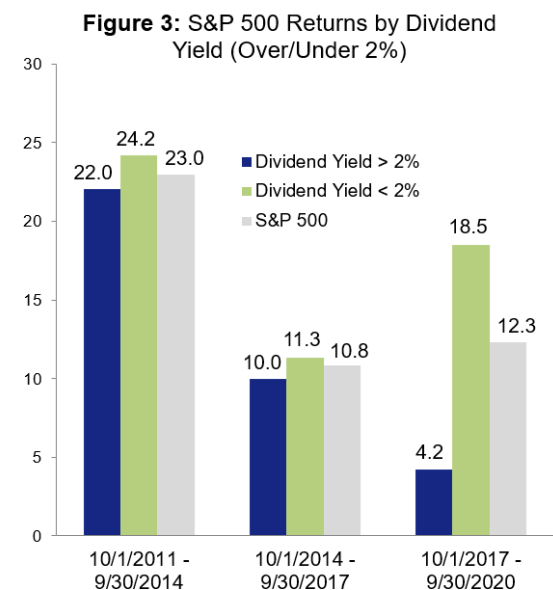
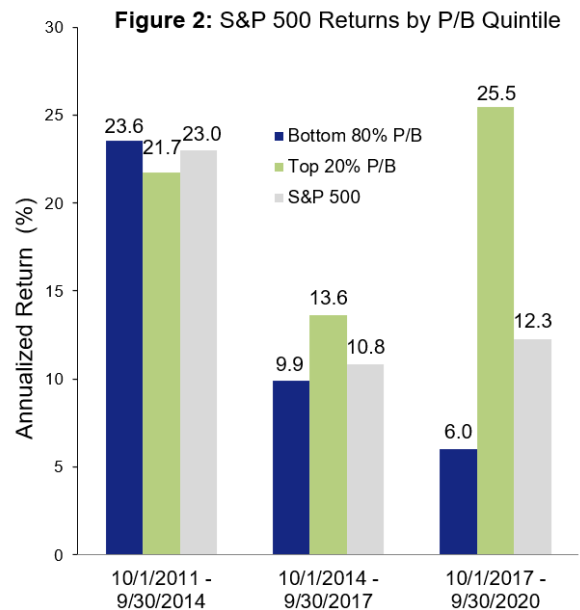
Clearly, an investment strategy focused on stocks with dividend yields of 2% or higher would face headwinds in the most recent period. Similarly, investment managers with a value discipline would be at a serious disadvantage considering the extent to which stocks with the highest Price-to-Book (P/B) ratios drove benchmark returns in recent years.

The list of reasons why two portfolios perform differently can be extensive. However, it is important to recognize that performance is not always a direct extension of an investment manager's skill. The headwind of an out-of-favor investment style can be difficult to overcome, but those headwinds may dissipate or reverse providing a tailwind for stronger performance in the future. Deeper analysis is needed to determine the extent to which strong or weak performance is attributable to investment style, execution, or a multitude of other factors beneath the surface.

## HOW TO AVOID COSTLY DECISIONS

In our opinion, maximizing the return from your investment managers requires both the aptitude to select above-average managers and the fortitude to maintain a disciplined approach.

Understanding, analyzing, and monitoring the many investment options available to our clients is a daunting task that requires Baird to adhere to a strict, multi-faceted due diligence process conducted by full-time portfolio analysts. Our goal is not to hire investment managers that have already done well, it is to identify those that present the best prospects for future success.



The following are some key tenets that Baird’s due diligence team follows and advice for clients to ensure that they do not fall victim to the same habits that cost many investors:

1. **Understand that past performance is exactly that.** It has already been earned and the same pattern is unlikely to continue in perpetuity.
2. **It often pays to be contrarian.** As the saying goes, “the time of maximum pessimism is the best time to buy.” If nothing has changed with your investment manager, the performance may be cyclical and poised to rebound.
3. **Be skeptical about hiring after peak performance.** Baird evaluates managers over many holding periods, not just the most recent. A manager that is competitive over many periods is more attractive than one that looks strong because of recent outperformance.
4. **Understand how a manager achieved performance.** This is more important than the performance itself. Baird spends considerable time determining what elements drive a manager’s success – people, investment process or even luck.
5. **An investor’s biggest folly is to buy high and sell low.** Yet, we see clear evidence of this in the marketplace. Do not be quick to terminate a manager if underperformance is related to style and not skill – sometimes patience is the best option.
6. **Set a rebalancing schedule.** This helps to automate the countercyclical process of adding to positions that are struggling and skimming from those that are performing well.
7. **Work with a professional Financial Advisor with access to top-notch due diligence resources.** The qualitative and quantitative story behind the past performance numbers is what can give investors an edge.

In-depth review of Baird’s investment manager due diligence process is beyond the scope of this note, although Figure 4 highlights key aspects that are considered. Performance is an important piece of the mosaic, yet it must be taken in context and paired with more information to develop truly forward-looking investment decisions.

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Figure 4: Portfolio Evaluation Guidelines

What to look at before investing...	
<b>Organization</b>	<ul style="list-style-type: none"> <li>History and ownership structure</li> <li>Reputation, culture and compliance</li> <li>Growth objectives and trajectory</li> </ul>
<b>People</b>	<ul style="list-style-type: none"> <li>Key decision-makers</li> <li>Experience of team</li> <li>Incentive structure</li> <li>Cohesion and stability</li> </ul>
<b>Philosophy &amp; Process</b>	<ul style="list-style-type: none"> <li>Competitive edge</li> <li>Decision-making process</li> <li>Repeatability of process</li> </ul>
<b>Portfolio Management</b>	<ul style="list-style-type: none"> <li>Portfolio construction and suitability for clients</li> <li>Behavioral biases</li> <li>Effectiveness of sell discipline</li> </ul>
<b>Performance</b>	<ul style="list-style-type: none"> <li>Where is value derived?</li> <li>Record of holdings and transactions</li> <li>Best/worst environments</li> <li>Comparisons with peers</li> </ul>

### END NOTES

1. Mutual fund gross returns were collected from the nine domestic style boxes as defined by Morningstar and compared to a widely-recognized Russell benchmark that corresponds to that specific asset class. The rolling 5-year gross returns of each fund was sorted by asset class and ranked into quartiles. These 5-year calculations were repeated each quarter for the 20 year period ending September 2020 (n=61). After each return was ranked, the subsequent 5-year excess return was calculated. The subsequent 5-year excess returns for each quartile was compared to 5-year excess returns top quartile funds across each asset class and shown in aggregate in Figure 1.
2. Performance attribution was calculated using FactSet to split the S&P 500 by price-to-book ratio (P/B). Returns were shown in aggregate for stocks representing the top 20% of the index (i.e. highest P/B ratios) and also for the bottom 80% of the index (i.e. lower P/B ratios). The calculation was repeated for successive three-year time periods between 10/1/2011 through 9/30/2020.
3. Performance attribution was calculated using FactSet to split the S&P 500 by dividend yield. Returns were shown in aggregate for stocks having dividend yield of 2% or higher, and for stocks with dividend yield below 2%. This calculation was repeated for successive three-year time periods between 10/1/2011 through 9/30/2020.

### DEFINITIONS

**S&P 500:** The S&P 500 Index is a representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally \$7 billion plus market cap) companies having growth and value characteristics.

**P/B:** Price-to-book value is a ratio used to gauge the underlying value of a stock relative to its trading price. The price for one share of a stock is divided by the book value per share of that stock. Book value is a company's total assets and liabilities as entered into the company's balance sheet.

**Dividend Yield:** Dividend yield is a company's annualized dividend per share divided by the share price on any given day.

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