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Chasing past fund returns a mug's game

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Kim Kyung-Hoon/Reuters

They're back! After fading from sight for several years, those tantalizing fund ads trumpeting rocketing returns are in the media again. It's no wonder. Last year, a number of mutual funds that focus on Canadian small-company stocks sported returns in the 40%-to-50% range. Some hedge funds did even better — several more than doubled in value.

Small-cap stocks weren't the only big winners. Here in Canada, materials stocks were up 37%. Real estate investment trusts achieved a lusty 23% return while gold delivered similar numbers. Even the more broadly diversified S&P/TSX composite ended the year with a handsome 18% return.

Like a flame luring moths, these lucrative returns can exert an irresistible pull on investors. In fact, a recent survey in Canada found that bullish investors now outnumber bears by almost three to one. Throw in improving economic news and this is the perfect environment for investors to start chasing returns.

Behavioural finance studies have found that investors tend to be myopic, overly fixating on recent occurrences while ignoring the longer-term picture. They are also predisposed to overconfidence and overestimate their ability to forecast events. Hence, investors not only tend to invest more money following periods of strong market performance but also pour money into the hottest performing assets. Invariably, when markets turn down, many of these investors dump their latest acquisitions forswearing those “risky managers” — until the next cycle.

Unfortunately, this behaviour is costly. Investors’ ill-timed purchases and sales mean they typically underperform the funds in which they are invested. Morningstar found that by “buying high and selling low,” investors cost themselves 1.5% a year in returns last decade. Bubbly assets can lead to even greater shortfalls. One study found that whereas U.S. fund investors lagged fund returns by 1.2% a year from 1984-1990, this performance gap climbed to 2.7% a year over the period 1991 to 2003 as the tech boom sparked even more return chasing. Today’s hot commodity market evokes memories of those days.

Hence, cautionary lights are blinking. Instead of chasing returns, investors should be taking a hard look at their portfolios to ensure their risk exposure is in keeping with both their capacity and tolerance for risk. Risk capacity deals with the situational ability to accept risk — time horizon, liquidity and cash- flow needs. Risk tolerance is about the psychological ability to handle risk — the degree of mental distress that will be caused by varying levels of portfolio decline.

Both need careful review. A family’s situation may support a more aggressive portfolio strategy than their appetite for risk may tolerate. We encourage our clients to picture themselves in the recessionary market of 1973-74, when stocks declined nearly 50% over a tortuous two-year period. If they aren’t reasonably comfortable with the beating their portfolio would have taken over this lengthy bear market, a more conservative asset mix is likely in order.

Given the strong performance of many asset classes over the past year, many investors should find that their portfolios are taking on excessive risk exposure. Rebalancing is required — selling the over-weighted asset classes, typically the latest winners, and buying the underweighted classes until the target mix is restored.

As challenging as it to sell the winners, through disciplined rebalancing, investors not only keep their portfolios within prescribed risk parameters but also can benefit from “selling high and buying low.” In markets such as today’s characterized by tremendous swings in equity prices, rebalancing can enhance overall portfolio returns.

So the next time you get that urge to buy a recent hot performer, get a risk checkup first. It just might save you a lot of money.

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