Cutting Through the Noise: Keep a Long-Term Perspective

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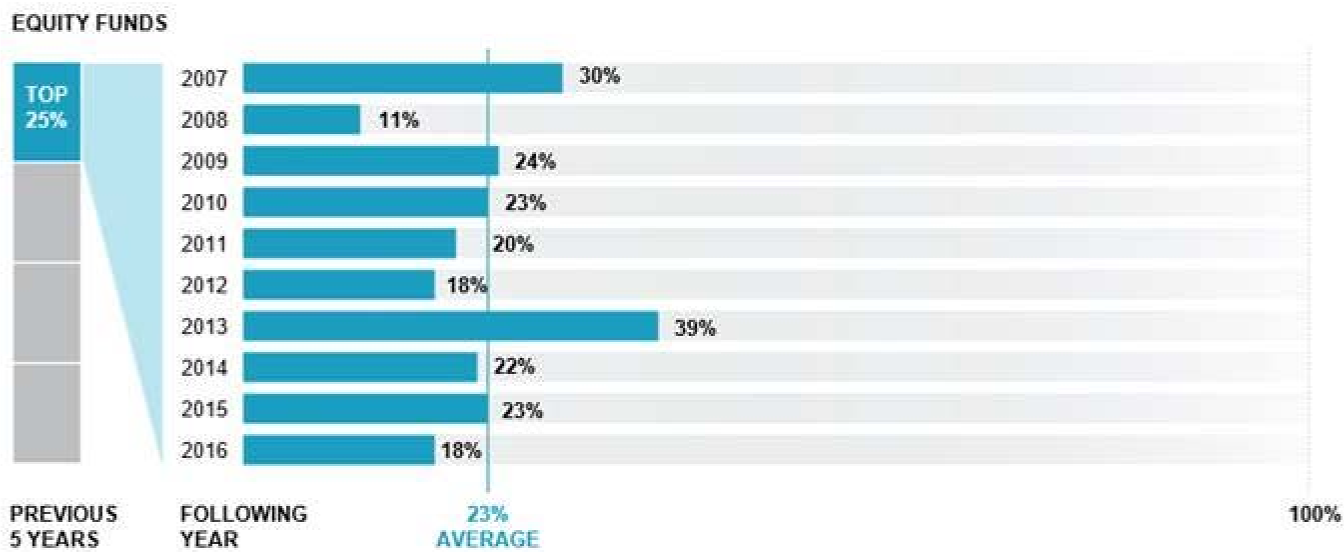
When it comes to investing, we are bombarded with information that makes it hard to focus beyond what is immediately in front of us and to think longer term. While it is far better to focus on factors you can control and not get caught up in the "noise," short-term thinking and acting on emotion can lead to the derailing of a solid financial plan. Following the crowd and looking only at recent history are two common missteps. The graphic below shows that year after year, the best recent equity fund performers tend to underperform in the next year:

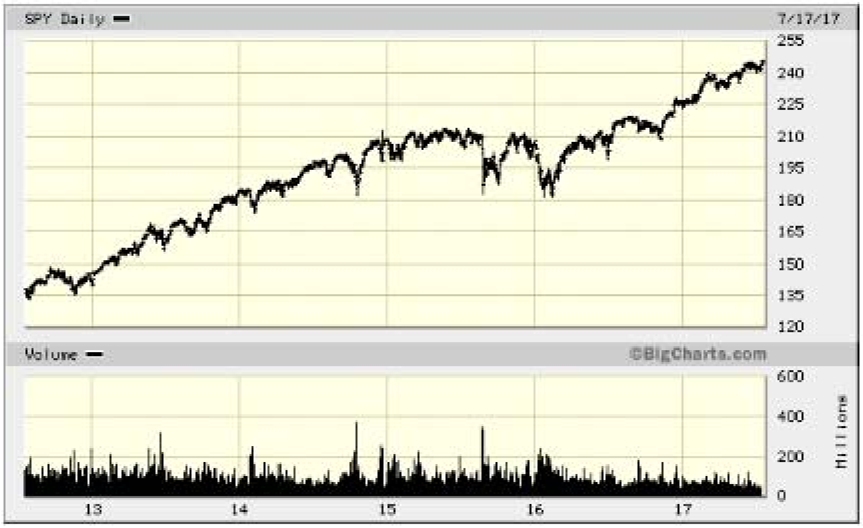
Percentage of top five-year performers that also ranked in the top quartile of annual performance in the following year



Disclosures: At the end of each year, funds are sorted within their category based on their five-year total return. The tables show the percentage of funds in the top quartile (25%) of five-year performance that ranked in the top quartile of one-year performance in the following year. US-domiciled open-end mutual fund data is from Morningstar and Center for Research in Security Prices (CRSP) from the University of Chicago. Past performance is no guarantee of future results. US-domiciled open-end mutual fund data is from Morningstar and Center for Research in Security Prices (CRSP) from the University of Chicago.

For example, of those funds that ranked in the top 25% of equity funds from 2002-2006, only 30% maintained a top-quartile ranking for 2007. Only 11% of the best performers from 2003-2007 did as well in 2008, and so on up through 2016. On average, only about one in four funds that performed comparatively well over a five-year period did so again in the next year. This pattern exists across equity and fixed income funds. The conclusion: investing based on recent performance has not been a recipe for success.

Here's another example. The U.S equity markets, as measured by the S&P 500 index, have been on an upward trajectory for several years. It is typical of performance chasers to be tempted to add to an appreciating asset class.



However, it's important to remember that past performance is no indication of future performance. Looking at another time period can provide some clarity on the implications of this type of investor behavior.

Historical Performance (Ranked by Highest to Lowest Return)

10 year performance ending 12/31/2007: annualized
Emerging Markets: 14.53%
Real Estate: 12.52%
International Developed: 9.04%
Commodities: 8.97%
Small Cap: 7.08%
Investment Grade: 5.97%
Large Cap: 5.91%
High Yield: 5.51%

Let's go back to 2007 and determine what the best-performing major asset class was for the prior 10-year period. Was it U.S. equities? No. In fact, the leader was emerging markets, followed by real estate. U.S. large cap stocks (measured by the S&P 500) actually came in second to last for the ten years ending 2007. The simple example above illustrates what can happen when investing based on recent performance.

12/31/07- 12/31/2016 annualized returns
High Yield: 8.09%
Small Cap: 8.07%
Large Cap: 7.11%
Real Estate: 5.08%
Investment Grade: 4.06%
International Developed: 0.13%
Emerging Markets: -1.32%
Commodities: -7.73%

If an investor decided at the end of 2007 to invest in the winners of the last ten-year period, he would have been disappointed. As illustrated above, emerging markets and real estate (winners in 2007 for prior 10-year performance) didn't stay at the top of the pack in the following nine years.

It's worth mentioning that 2008 was a horrible year for investing in just about anything. However, we can't invest retrospectively, and, despite the volatility, U.S. stocks and high yield bonds have been the best performers since 2008, while emerging market returns have averaged flat to negative.

This exercise is illustrative for a few reasons. U.S. stocks, while they have been on a great run, are not the only asset class or "market" for investors to consider. How many investors would have put all their investments purely in emerging markets or real estate in 1997, when the tech bubble was starting to form? For those who don't recall, in 1997 the Thai baht collapsed. A year later, the hedge fund Long Term Capital Management nearly caused a worldwide financial crisis by betting on the Russian ruble before it too collapsed. Predicting emerging markets to be the best performer for the next 10 years would have been remarkable, and risky. Likewise, who would have put all her money in high yield in 2007? One can speculate about what is overvalued or undervalued, or when there will be a correction or bear market, but it is hard to know with any certainty how different types of investments will perform in any given period, short or long.

These are just a few examples. History has shown that the best performing stock, fund, or asset class in any given year could be the worst performing the next year and that past performance alone is not enough to predict future results. While diversification does not guarantee a profit or eliminate the risk of market loss, it is nevertheless a critical element in your investment portfolio. By holding a broad-based, globally diversified portfolio, one can be positioned to capitalize on returns no matter where they occur.