Investor Insights & Outlook

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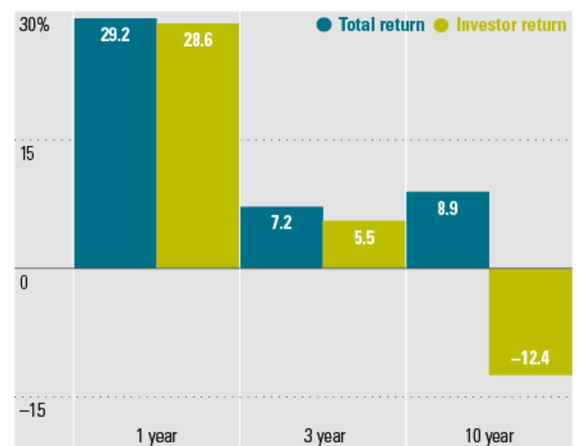
Chasing Performance

Investors often endure poor timing and planning as many chase past performance. They buy into funds that are performing well and initiate a selling spree following a decline. This becomes evident when evaluating a fund's total return compared with the investor return. Overall, the investor return translates to the average investor's experience as measured by the timing decisions of all investors in the fund.

The image illustrates the investor return relative to the total return for a given fund. Over the short term, both the total and investor returns were positive and relatively similar. Over a 10-year period, however, total return greatly exceeded investor return. Investors who attempted to time the market ran the risk of missing periods of exceptional returns.

Comparison of a Fund's Return Performance Over Time



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Returns and principal invested in stocks are not guaranteed. Morningstar investor returns measure how the typical investor in that fund fared over time, incorporating the impact of cash inflows and outflows from purchases and sales. It is not one specific investor's experience, but rather a measure of the return earned collectively by all the investors in the fund. Total return measures the percentage change in price for a fund, assuming the investor buys and holds the fund over the time period, reinvests distributions, and does not make any additional purchases or sales. Investor returns are not a substitute for total returns, but can be used in combination with them. Data as of December 2013.

Source: The fund illustrated in this example was selected from Morningstar's open-end database.

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He holds a Bachelor of Science Degree in Economics from Northern Michigan University, and earned his Master of Science in Financial Services (MSFS) degree from the Richard D. Irwin Graduate School at The American College in Bryn Mawr, Pennsylvania. This commitment to higher education and professionalism puts Jason in a select group who has reached this level of academic achievement in financial services, and puts him in a position to address a broad range of issues when working with clients.
Jason worked as an independent financial advisor for Ameriprise Financial for 9 years. He was a member of their Advanced Advisor Group until 2007 when he became a founding partner at Kerntke Otto McGlone Wealth Management Group.

Fund Flows and Asset Class Performance

Over the last 20 years, markets have experienced many shocks and recessions, including the Asian currency crisis, the Russian debt default, the dot-com crash of the early 2000s, and the recent global financial crisis. When these events occur, investors frequently attempt to reduce (or increase) investments to certain asset classes in order to lower exposure to (or take advantage of) the situation.

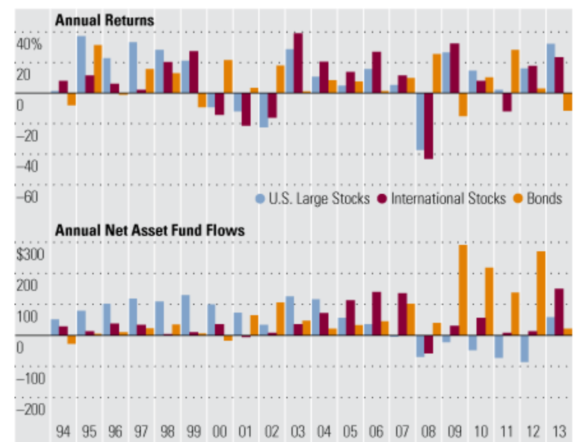
In 2008, the global financial crisis caused U.S. large stocks and international stocks to perform poorly, with losses of 37.0% and 43.1%, respectively, while bonds rose by 25.9%. In the wake of the recession, bonds performed very well in 2011, returning 28.2% as concerns about a possible double-dip recession grew. In the same year, international stocks fell 11.7%, most likely the result of events such as the sovereign debt crisis that rippled throughout the global landscape.

For all asset classes, demand and supply determine the market price of an investment. Understanding this trend may help investors ascertain how an asset class fits into their portfolio. Starting in 2007, annual net asset fund flows into U.S. stock funds became negative and stayed that way through 2012. Flows into bond funds, on the contrary, reached a peak in 2009 and remained high in 2010, 2011, and 2012 as investors flocked to relatively safer assets. As bond returns grew unusually high over the last few years, flows into bond funds may have increased as investors chased bond performance. Interestingly, outflows from U.S. stock funds continued despite U.S. large stocks showing positive returns since 2009. Was chasing bond performance the right thing for investors to do, or did investors just miss out on the returns of U.S. large stocks over the last couple of years?

About the data

U.S. Large Stocks—S&P 500® Index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. International Stocks—Morgan Stanley Capital International (MSCI) World ex-U.S. Index. Bonds—20-year U.S. government bond. Annual Net Asset Fund Flows: U.S.-domiciled open-end fund flows from Morningstar. Start date of 1994 constrained by data availability. U.S. stock: funds that primarily invest in U.S. stocks; International stock: funds that invest in specific regions or a diversified mix of international stocks with 40% or more in foreign stocks; Bond: taxable bond funds (government, corporate, international, emerging markets, high yield, multisector) that invest primarily in fixed-income securities of varying maturities.

Fund Flows and Asset Class Performance 1994–2013



Past performance is no guarantee of future results. Assumes reinvestment of all income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

ETFs Versus Actively Managed Funds

Do we have a winner? Ever since passively-managed funds like exchange-traded funds (ETFs) came into being, there has been much debate about active management versus passive management. Research published by industry professionals presents different arguments. Some studies show that only a fraction of active funds beat their respective benchmarks. Other studies show that, while active funds have failed to beat their benchmarks, they do provide added-value when a disciplined approach is adopted over longer periods.

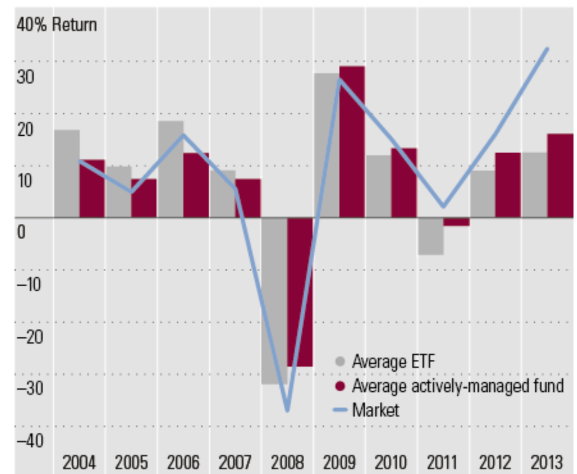
An exchange-traded fund strives to achieve a return similar to a particular market index. The ETF will invest in either all or a representative sample of the securities included in the index that it is seeking to imitate. ETFs provide passive diversification, are tax-efficient investment vehicles and have cost advantages. However, the return on an ETF is capped by the return of the index it tracks. Active managers, on the other hand, attempt to pick the best investments in the market and, if well executed, their performance is not limited by the return on an index. However, active funds are prone to style drift—the tendency of a fund to deviate from a particular investment style over time to improve performance. These modifications in investment style may be attributed to changing trends in the market environment.

Let's take a look at how the "average" ETF and "average" active fund performed over the last decade. The image compares the performance of the "average" ETF with the "average" actively managed mutual fund during the past 10 years. As evident from the image, in periods of poor market performance (2008 and 2011) when the market experienced negative or very low returns, the "average" actively managed mutual fund performed better than its passive counterpart. When the market experienced strong positive performance, ETFs fared better in some years (2004 to 2007, for example). In other years, actively-managed funds performed better (2012 and 2013).

Why is this, you may ask? One reason for this behavior is the underlying structure of active and passive funds. Passive funds like ETFs are designed to track a particular index or benchmark. This means that when the benchmark experiences poor performance, the ETF also fares badly. On the other hand, active managers may be able to quickly adjust their portfolios depending on the underlying market conditions. This may be one reason for better performance in down markets.

Making a choice between active and passive investing isn't an easy one. When deciding which style of management is better for you, it is important to take into account several factors, such as costs, style, risk, transparency of investments, manager performance, and tax implications. Consult your financial advisor to learn more about investing in ETFs and actively managed funds.

Performance Over the Past 10 Years



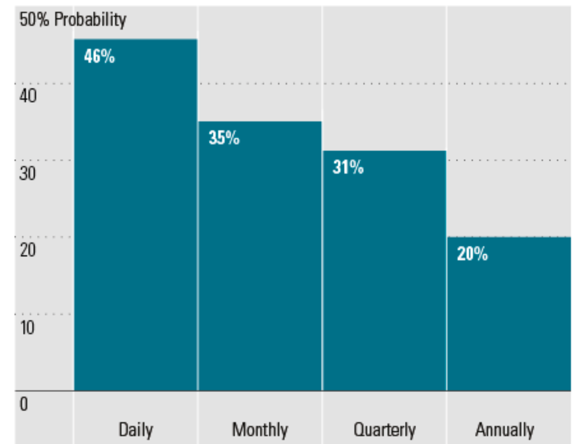
This information is for illustrative purposes only and not indicative of any investment. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Investors should read the prospectus and consider this information carefully before investing. ETFs are subject to similar investment risks as common stocks. An ETF's performance may not be exactly that of its underlying index. Past performance is not a guarantee of future results; holding a portfolio of securities for the long term does not ensure a profitable outcome. Investing in securities always involves risk of loss. An invested cannot be made directly in an index.

Source: The market is represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Average ETF and average mutual fund performance from Morningstar's open-end database.

Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1994–2013



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

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