

Don't judge a mutual fund by its past

Why track records shouldn't guide your investment choices

By Sam Mamudi, MarketWatch Jan. 24, 2010

NEW YORK (MarketWatch) -- It's perhaps the most quoted financial-services mantra: Past performance is no indication of future results. Unfortunately, human nature usually leads investors to think the exact opposite. Most investors look at a fund manager's returns before deciding to invest. The question is: Just how much can we judge a fund by its track record?

Several studies published last year suggest that picking a fund based on its past is far from a sure thing. Among other findings, the studies show that fund ratings don't help identify future performance, that it's difficult to distinguish a manager's skill from luck, and that for all but the very top funds, future performance is unlikely to meet expectations.

In other words, it's a messy and largely unpredictable business. But that doesn't stop investors from choosing their funds based purely on track record.

"When you look at the data, there's a pretty slight and often infrequent relationship between past and future performance, and yet people still put an awful lot of stock in a fund's performance," said John Rekenthaler, vice president of research at Morningstar Inc. "In their hearts, most people believe that it works."

Top dogs fall down

Advisor Perspectives, an e-newsletter for financial advisers, in December published a study which suggests that Morningstar Inc.'s star ratings, which are based on past returns, don't provide much predictive value. It also found that many five-star-rated funds were likely to underperform their peers.

Robert Huebscher, chief executive of Advisor Perspectives, randomly selected a fund with a particular rating, and then looked at how that fund performed against randomly-selected funds with lower-star ratings from the third quarter of 2006 through the third quarter of 2009. He found many cases where the lower-rated funds were more likely to outperform those with higher ratings.

Yet, despite those findings, "the public pour money into funds that get higher ratings," Huebscher said.

Part of the problem is how fund companies sell themselves, he said. "The most concrete thing a fund can sell is its historical performance, so they say, 'We did well in the past and you should think that we'll do well in the future.' "

Matthew Morey, professor of finance at Pace University's Lubin School of Business, conducted several studies on the predictive value of Morningstar ratings. He took issue with some of Huebscher's methodology, particularly the way it lumps all mutual funds into five broad categories -- U.S. stock, international stock, taxable bond, balanced and municipal bond -- and compares funds within these broad categories. That doesn't account for the variety of approaches that funds take, he said.

A better method, Morey said, would be to look at funds' relative performance within each of Morningstar's 48 categories. And, he said, Huebscher's study acknowledges that it doesn't include funds that were liquidated or merged away during the period -- a fact that likely boosts the performance of the worst funds, since it's rare for a four- or five-star fund to close.

Morningstar's Rekenhaller questioned the timeframe the study used. But while he disagreed with some of the details, he said he didn't have an issue with the notion that it's hard to use past performance to predict future results.

Luck versus skill

Morey said there's a case to be made that top managers can repeat their performance.

"I do think good managers, who've been at a fund a long time, produced consistently good performance and charge relatively low fees are a good way to go," he said.

Morey added that about 10 years ago he was a firm believer in index funds, but has recently come around to the idea that there are some good managers out there.