

Chapter 6

Chasing the Hot Dot

Fortune turns round like a millwheel, and he who was yesterday at the top, lies today at the bottom.

Miguel De Cervantes

Investing in the financial markets require you to make a number of decisions. First, you must decide which market to invest in, such as the US stock market or corporate bond market. Second, you need to decide how much to put into each market. Third, you must decide if you should buy individual stocks and bonds, or purchase mutual funds? Fourth, and most important, you must decide which stocks, bonds, or mutual funds to invest in.

The largest portion of the performance gap between investor returns and market returns can be traced to the security selection process. “Chasing the hot dot” is a phrase used to describe the behavior of most people when choosing investments. This selection process is based almost entirely on a review of recent performance. Though few people will admit that they rely solely on performance when choosing investments, that is how a vast majority of investments are selected.

Chasing the hot dot can be a costly mistake. Studies conclude that investors who base their decisions firmly on recent performance typically experience below average returns in their portfolios. Despite this fact, each year billions of dollars flow into mutual funds with the best short-term performance.

While an investment in these funds seems astute at the time, the out-performance is more of a signal that poor performance is around the corner, rather than a signal that superior performance will continue. Styles go in and out of favor, and a strategy of buying the top performing mutual funds or stocks eventually leads to increased volatility and below average results. The negative results of chasing may not be evident in the short-term, especially if the style stays in favor for a year or so, but over a lifetime of investing, moving from one investment to another based on recent past performance will significantly increase the performance gap.

An Example of Chasing the Hot Dot

PBHG Growth Fund was a very popular mutual fund in the mid-1990s. For three years ending in 1995, PBHG Growth was up over 100%, placing it on top of the mutual fund rankings. Several leading newspapers and magazines interviewed fund manager Gary Pilgrim and crowned him a bona fide stock-picking guru. Investment advisors and newsletter writers across the country were quick to add his fund to

their “Buy” list of funds. The attention helped triple assets in the fund during the latter part of 1995, triple again in 1996, and triple a third time in 1997.

Table 1-6
PBHG Growth Fund Comparison

Calendar Year	Assets in Millions at the Beginning of the Year	Performance Relative to the S&P 500
1993	3	36.7%
1994	184	3.4%
1995	746	12.8%
1996	2,028	(13.1%)
1997	5,931	(36.7%)
1998	5,464	(28.0%)

Source: Morningstar, Inc.

From its inception in 1985 through year-end 1992, PBHG Growth fund had mediocre performance. As a result, few people had ever heard of Gary Pilgrim. In 1993, there was only \$3 million in the fund. Fortunes changed overnight, and during the next three years Pilgrim had one of the hottest hands in the fund business. As a result of the superior return, money gushed into the fund. By the year-end 1995, PBHG Growth Fund accumulated over two billion dollars in assets, most of it from new investors. Then the tide began to turn. The fund under-performed the S&P 500 by 13% in 1996.

Despite the lackluster performance, the long-term results still placed PBHG Growth on top of the mutual fund performance rankings. Money continued to flow in at an unprecedented pace. By January 1997, PBHG Growth had close to \$6 billion in assets. Then the storm struck. During the first quarter of 1997, the fund dropped nearly 20% in value, losing shareholders nearly \$1.2 billion in real money. For the entire year in 1997, the fund registered a return almost 37% below the S&P 500. The poor performance continued into 1998. The fund under-achieved the market by another 28%.

As a general rule, the greatest amount of money flows into the hottest mutual funds at the peak, thus the gains for most investors are dismal at best. For ten years ending 1998, PBHG had a cumulative track record inline with the S&P 500. Unfortunately, the best years occurred when there was little money in the fund. The bad years came only after billions in new money was invested. Most PBHG investors lost significantly amount of money from 1996 to 1998, and they also missed three fabulous years in the stock market. This PBHG example shows how chasing the hot dot can cause a wide performance gap between market returns and investor returns. It is common to find similar circumstances in other funds and fund categories.

PBHG Was Not Alone

In 1994, Morningstar conducted a cash flow study of all US growth funds. They included 219 funds in the study and covered a five-year period between 1989 and 1994. The purpose was to compare the published

return of the growth fund category with the actual profits made by investors in those funds. The study used cash flow to look at movements of money into and out of the funds. These cash flows into and out of US growth funds were calculated in a manner similar to the DALBAR study in Chapter 3.

The average growth fund earned an annual return of 12.5% during the five-year period. Unfortunately, according to Morningstar, the average investor in those funds lost 2.2% during the same time period. The reported 12.5% annual return of the category had little bearing on an individual investor success. It was investor behavior within the category that had the greatest negative impact on their results. Investors shifted money into growth funds at the wrong time, and their profits never materialized. In fact, chasing growth funds in the early 1990s caused investors to lose while the entire market gained.

Tracking the Performance of Past Winners

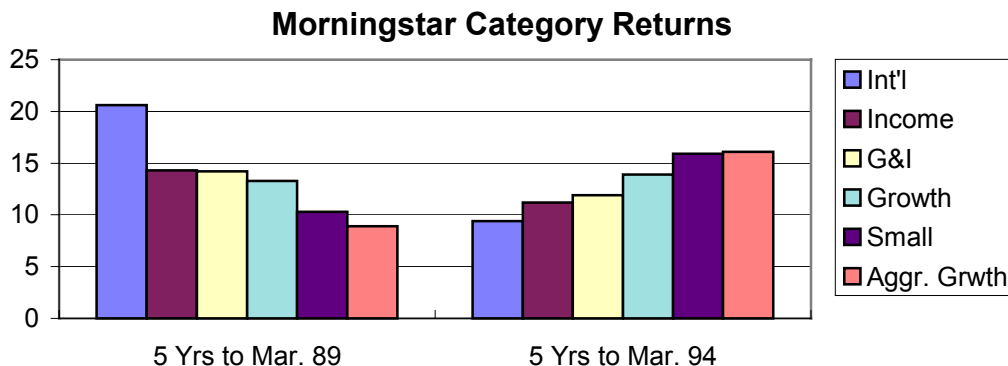
Selecting an investment based on superior performance is like selecting a line to stand in at the super market. The moment you get in one - it stops moving.

Dr. Howard Green

In 1988, CDA Technologies conducted a study of 363 mutual funds to see if past performance could be used to choose investments. They ranked mutual funds by their 5-year returns from 1977 to 1981, and compared the results to the next 5-years. Of the top twenty performing funds in the first 5-year period, not one fund made it to the top group in the second 5-year period, and only two funds made it into the top 100 group. The top twenty funds from the first period ranked 222 on average during the second period. Based on CDA data, buying a mutual fund based on prior five-year performance leads to below average results.

In 1994, Morningstar conducted a similar study. Consistent with the CDA study, the top performing categories the first period were at the bottom category the next. Performance of fund styles is not consistent. Chasing the hot dot leads to below average returns.

Figure 6-1



Mark Carhart of the University of Southern California conducted a recent landmark study of the persistence of mutual fund returns. He found there was a small tendency for the very best funds to continue their performance for a short while, but any excess return generated by holding the top funds did not last more than one year. By the third year, the top funds tended to fall into the below average category. In addition, there was more risk in buying the top funds. When a top fund falls, it does so very quickly, and many go straight to the bottom of the rankings. Carhart also concluded that fund expenses had a large impact on return, and the worst funds within a category tended to be those with the highest fees¹.

In 1996, Morningstar conducted an interesting study comparing popular fund categories against unpopular funds. A popular fund category was characterized as a style that took in the most money over the preceding 12-month period. Unpopular funds had the worst money flow during the preceding 12-months. In the following year, the unpopular funds performed much better on average than the popular ones². As a general rule, mutual fund styles regress to the mean. The performances of all investment styles tend to merge together over time³. If investors flock to styles that recently surged, they already missed most of the upside and are more likely to capture the regression backwards.

Investors Continue to Chase the Hot Dot

Although evidence against chasing the hot funds and hot styles is overwhelming, investors still prefer top performers to everything else. A survey conducted by Montgomery Asset Management in San Francisco found that 63% of investors list superior performance as the number one reason for choosing a fund⁴. Columbia University's Graduate School of Business found the investors chose past performance 2 to 1 over any other method of fund selection. As a result, over 90% of all new investment money flows into mutual funds with the top ratings by Morningstar, while those with the lowest rating lost assets⁵.

Using Star Ratings and other Devices to Pick Mutual Funds

As the number of mutual funds nears ten thousand, there is a huge demand for mutual fund ratings. As a result, the slicing and dicing mutual fund returns have become a huge, competitive business. There are numerous companies in the game, with the largest and most popular being Morningstar Mutual Funds in Chicago, Lipper Analytical Services in Summit, NJ, and Value Line Mutual Funds.

¹ Mark M. Carhart, "On the Persistence of Mutual Fund Performance", *Journal of Finance*, Mar. 1997, Vol. LII, No. 1, pg. 57-82.

² Susan Paluch and Jeff Kelly, *Going Against the Crowd*, Morningstar Mutual Funds, Jan. 1996, Vol. 4, Number 5.

³ John Bogle, *Bogle on Mutual Funds*, Dell Publishing, NY, 1994, pg. 92

⁴ As reported in *Dow Jones Asset Management*, May/June 1997

⁵ Karen Damato, "Morningstar Edges Toward One-Year Ratings", *The Wall Street Journal*, April 5, 1996, pg. C1.

Most private rating agencies use star ratings and other designations to rank mutual funds. However, Morningstar and Lipper are quick to point out their rankings have no predictive value, and that this was not the intent of the rating system. Morningstar editor Amy C. Arnett wrote about misuse of their rating system:

Over the years, Morningstar's star system has been frequently - and sometimes willfully - misunderstood. Many commentators insist on treating the star rating as a predictive measure or a short-term trading signal. The rating, which is clearly labeled as a historical profile, does neither⁶.

Right or wrong, the investment industry sells their products based on a favorable Morningstar rating. You see the ads in every commercial investment publication. Open any Money magazine and you will find several examples of how Morningstar and Lipper rankings are misused by mutual fund companies. In addition, brokers and other financial advisors use mutual fund rankings to imply that their ideas have merit. Generally, a highly rated fund helps make the sale easier. The salesperson's attitude is, "If the public believes a star rating or past performance data can predict the future, then let them believe it. I will use that to my advantage."

While Morningstar is first to admit their rankings should not be used to predict performance, competitor Lipper Analytical couldn't resist driving the point home. In 1994, Lipper examined Morningstar's 5-Star funds from 1990-93 and found their top ratings did not translate to top performance. Lipper found a majority of 5-Star funds performed below average after they received their rating⁷.

The Hulbert Financial Digest newsletter also tracked Morningstar 5-Star funds. The study found the funds lagged the market by a sizable margin. The average 5-Star funds rose 28.9% during the 32-month period while the Wilshire 5000 stock index rose 59.5% and the Lehman Brothers Treasury bond composite gained 36.9%. Mark Hulbert has also found the average 5-Star fund retained its' rating for only five months⁸. Arnett was correct. The star rating has no predictive value.

Owning Several Funds May Not Solve the Problem

It is common belief that holding several mutual funds in a portfolio lowers overall risk. However, diversification only works when the mutual funds are of sufficiently different styles. Many investors falsely assume their portfolio is well diversified simply because they hold several funds. The 401k plans of the Big-3 auto companies offer dozens of mutual funds, many with similar styles. During the growth stock boom in the late 1990s, it was common to find plan participants "diversifying" among 4 or 5 large-cap

⁶ Amy C. Arnett, Editor, *Beyond the Stars: The New Category Rating*, Morningstar Mutual Funds, Summary Section, Dec. 6, 1996, vol. 29, issue 2

⁷ *Selling the Future, Concerns About Misuse of Mutual Fund Ratings*, Lipper Analytical Services, Inc., Summit, NJ, May 16, 1994

⁸ Mark Hulbert, *Forbes*, December 6, 1993, pg. 275

growth stock funds, and ignoring all other fund categories. Buying different funds of the same style is not diversification.

There is a logical reason why many investors do not diversify their mutual fund holdings. Generally, people have little knowledge of investment styles. In a recent survey, Columbia University asked investors to describe what category of funds they owned. 75% of investors did not know if they were in a fixed income fund or a stock fund, and 72% did not know if they were in a US stock fund or international fund⁹. Most people simply invest in the funds that have performed the best over the last few years, regardless of style or category. In 1993, emerging country funds were hot. Some funds were up more than 80% for the year. As expected, in early 1994, more than half of all new stock mutual fund money flowed into emerging country funds. After the surge of new money, emerging country funds collapsed, and many investors sustained large losses.

Individual Stock Investors also Chase Returns

*Nothing captures interest faster or keeps it at a higher level than the mouth-watering thought of a profit. If the potential is large, your prospects interest focuses sharply on your next comments.*¹⁰

Leory Gross

Thus far we have addressed only mutual fund investors, but many people still take the old fashioned route, they build individual stock portfolios. What common habits do these investors exhibit? As a group, they buy and sell roughly the same stocks during the same time, with little influencing their decisions except short-term price momentum, media hype, and what friends are buying.¹¹ Several independent studies confirm these investing habits.¹²

Why do individual investors go for risky stocks and generally ignore Blue Chip companies? “Those are too big, too boring, and everyone already knows the story”, says G.M. Leob in his 1935 classic book, *The battle for Investment Survival*. He explains:

It is characteristic for the novice investor to want to run before he has learned to crawl, or walk. Tell a beginner to buy one of the best-known listed [companies] as his first equity venture and you get a look of scorn for such kindergarten ideas. Talk about the pitfalls in new, unseasoned, small, or relatively obscure stocks and get brush off for your pains. The blue-ribbon roster of America's most

⁹ Noel Capon, Gavan J. Fitzsimmons, and Russell Alan Price, *An Individual Analysis of the Mutual Fund Investment Decision*, Columbia University Graduate School of Business working paper.

¹⁰ Le Roy Gross, *Art of Selling Intangibles - How to Make Your Million\$ Investing Other Peoples Money*, New York Institute of Finance, NY, 1988, pg. 71, Gross's book was written for stockbrokers. His techniques are widely used throughout the brokerage industry. As a broker trainee in 1989, this book was required reading.

¹¹ Terrance Odean, University of California at Berkeley, as reported in *Registered Representative* magazine, July 1997, pg. 38.

¹² Robert J. Shiller, *Market Volatility*, First MIT Press, 1997, pg. 376

successful corporations might be good enough for our best institutions, but somehow fail to interest the tyro. He feels incorrectly that he must buy something “new”, something “special”, or something “exclusive” for him¹³.

There are several studies pointing to the inability for individual investors to pick stocks. In a landmark study, Terrance Odean of the University of California concluded that most investors sell winning stocks before ever seeing large gains develop. He analyzed thousands of individual accounts from an unnamed brokerage and found investors twice as likely to sell winners over losers. This reduced returns by about 5% per year.¹⁴ Jeremy Siegal of the Wharton School came to a similar conclusion. He estimated individual stock investors perform about 5% less than the market as a whole.¹⁵ Siegal assumed investor's stayed 100% in stocks, and did not time the market. Having evaluated hundreds of stock accounts over the years, my experience is that investors perform at least 5% below the market, if not more.

Summary of this Chapter and Part I

The erosion of return in a portfolio from chasing the hot dot is a gradual process. It takes several years before the irreversible effects are truly evident. Since most people hold a fund for between three and five years, they tend to forget what drew them to the fund to begin with. However, when they do decide to sell one fund and buy another, it is emotions based on recent performance that forces the change. Peter Lynch had this to say about chasing the hot dot in his second book *Beating the Street*¹⁶:

How do you choose a value fund, growth fund, or capital appreciation fund that will outdo its rivals? Most people look at past performance. They study the Lipper guide published in Barrons or any one of a number of similar sources that track fund performance. They look at the record for one, three, five years, and beyond...Thousands of hours are devoted to it [reviewing performance]. Books and articles are written about it. Yet with few exceptions, this turns out to be a waste of time.

It is not the action of the stock or bond market that leads to below average investment returns, it is the cost of investing in the markets, and the behavior of investors that affect results. Fees, commissions, market timing, and investment selection errors can significantly reduce returns over the long-term. Eliminate these mistakes, and your results will improve dramatically.

Straight talk about the antics of Wall Street will help set your portfolio straight. Part II of this book explains why the financial services industry supports ill-fated investment strategies, and why market “experts” are more of a hindrance than help.

¹³ G.M. Leob, *The Battle for Investment Survival*, Simon and Schuster, NY, 1935, pg 281

¹⁴ ebit Odean.

¹⁵ Jeremy J. Siegal, *Stocks for the Long Run*, Irwin Press, 1994, pg 292.

¹⁶ Peter Lynch, *Beating the Street*, Simon and Schuster, NY, 1993, pgs 67,68