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What Investors Should Know About Yearly Performance Rankings

The most-important lesson: The funds that rank at the top one year aren't likely to be there the next

By Mark Hulbert

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The annual performance rankings of funds or investment newsletters that appear every January are a siren song, tempting us with the prospect of mouthwatering gains but often leading us to financial pain.

Consider how you would have fared if, one year ago, you had invested in the U.S.-stock fund at the top of the ranking for performance in the previous calendar year. That fund would have been the trend-betting, Nasdaq-100-tied Quantified STF Fund (QSTFX), according to Morningstar—with an alluring calendar-2017 return of 68.9%, more than triple the S&P 500's 21.8%. In 2018, in contrast, a funny thing happened on the way to the bank: The fund lost 6.9%, versus a 4.4% loss for the S&P 500.
There isn't always such a stark reversal of fortunes for a given year's top performer. But there is far more often than not.

That is the clear message of the S&P Persistence Scorecard, a report that S&P Dow Jones Indices has been publishing periodically since 2002 that measures the likelihood that top-performing mutual funds will continue to be top-ranked. Those odds are even worse than you'd expect from flipping a coin, says Aye Soe, managing director at S&P Dow Jones Indices for Global Research & Design.

Consider the stock mutual funds that in a given year rank in the top 25% for performance. On the assumption of pure randomness, you would expect that 25% of them in the second year would also be ranked in the top quartile. In fact, the actual percentage is rarely higher than 20%, Ms. Soe says.

The perils of chasing one-year returns are also illustrated by the performance of top-rated investment newsletters. Consider a hypothetical portfolio that each year follows the newsletter model portfolio at the top of the Hulbert Financial Digest's performance scoreboard for the previous calendar year. Over the last decade, this strategy produced an annualized loss of 7.4%. (See chart.)

All the luck

What accounts for these reversals? Perhaps the biggest, according to Ms. Soe: Luck plays the dominant role in one-year returns. So when you pick the previous year's top performer you're following someone who was, for the most part, just lucky. The reversals in year-to-year rankings are therefore a reflection of little more than how rare it is to be lucky two years in a row.

A less-appreciated consequence of luck's large role in short-term performance: A given year's top performer is likely to be riskier than average, so managers who are unlucky in the second year will likely end up performing poorly. That isn't because conservative managers are less reliant on luck; it is just that they make smaller and less-risky bets. So they will rarely be ranked at either the top or the bottom.

An analogy is baseball players who always try to hit a home run but most of the time strike out. The odds are good, therefore, that even the player who has just hit a homer will strike out the next time at bat.

Another factor accounting for these year-to-year reversals in performance: There is a good chance that many of the securities owned by a year's top performer are overvalued. Consider a study conducted by Research Affiliates that focused on the stocks that, at the beginning of each calendar year between 1952 and 2011, had the largest market caps among each of the S&P 500's industry sectors. These are the companies that are both big enough and have performed well enough to propel mutual funds that hold them to the top of the performance rankings.

The firm found that, over the subsequent year, these largest stocks on average lagged behind the other stocks in their sectors by 4.2%.

Momentum’s role

Clearly, it isn’t a great idea to chase the previous calendar year’s top performers.

Some investors might wonder how to square this discussion with the so-called momentum effect. This is the widely known and documented pattern whereby the average stock that has performed the best over the trailing 12 months proceeds to outperform the average stock at the bottom of the ranking for trailing 12-month performance. You would think that this effect would mean that one year’s top performers enjoy a tailwind going into the next.

One reason it doesn’t is that one year’s momentum usually persists for only a few more months and then begins to decay. How long? Corey Hoffstein, co-founder and chief investment officer of Newfound Research, says that his research, both in the U.S. back to 1926 and in 22 non-U.S. markets back to 1969, found that a given year’s momentum typically lasts for just two to six more months. After that, the previous year’s best performers “tend to revert toward the mean and then do no better than random.”

The January factor

Another factor to keep in mind during January in particular: The first month of the year usually experiences just the opposite of momentum, with the previous year’s worst performers tending to outperform the previous year’s best. The implication, according to Kent Daniel, a finance professor at Columbia University and a former co-chief investment officer at Goldman Sachs: If you wanted to pick a mutual fund each year based on trailing 12-month returns, January would be the worst month in which to switch.

Nevertheless, Prof. Daniel adds, you shouldn’t in any case be picking a fund based on its performance over the recent past. “Even outside of January, the relation between the past and future performance of mutual funds is close to zero. Almost always, your best bet is putting your money into a low-cost index fund.”