WEALTH MANAGEMENT

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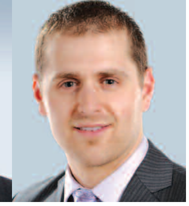

Deconstructing Investing

Why past performance affects future behaviour

When it comes to investing, past performance is no guarantee of future performance. But it does appear to guarantee future behaviour. Despite explicit warnings, investors find it difficult to resist the urge to chase trends, fads and yesterday's returns. Unfortunately this behaviour has been, and continues to be, very costly for investors.

Investors ignore industry warnings. Let's consider a very common piece of financial "legalese." Here's a real-life mutual fund disclaimer:

Mutual funds are not guaranteed, and past performance may not be repeated.

As mandated by the regulatory bodies in our industry, disclaimers such as these can be found on most sales and marketing materials related to mutual funds and other investment products. Yet despite these unambiguous warnings, investors continue to flock to funds with the highest recent returns.

Countless studies show no statistical evidence that would support the persistence of performance. Warning labels on all sales materials and prospectus documents reflect this fact, and the MFDA and IIROC require that such warnings be placed on virtually all fund literature. These industry-mandated warnings, however, are ineffective. Investors continue to chase returns despite the warnings.

This classic investing *faux pas* is often referred to as "rear-view mirror" investing. The prevailing wisdom is that history — recent history, in particular — will repeat itself. Of course this is seldom the case, and following this investment strategy can prove quite costly.

The damage caused by rear-view mirror investing is massive. Just exactly how much does this return-chasing behaviour cost investors? Dalbar's Qualitative Analysis of Investor Behaviour (QAIB) demonstrates that investors often suffer the greatest losses after a market decline. Time and time again, investors sell after a market decline and re-enter the markets *after* they have recovered. This is devastating as investors invariably end up participating in market declines rather than market rallies.

THE TAKE-AWAY

Time and time again, investors sell after a market decline and re-enter the markets after they have recovered.

As investment advisors we often hear this philosophy echoed in client statements such as, "I'm going to wait until this thing straightens itself out." In the long run, the investment experience becomes a series of buying at tops and selling at bottoms. This "buy high, sell low" strategy virtually assures failure.

If you're looking for someone to blame for this situation, well, look no further than the industry, and investors themselves. Look at the industry: performance-based advertising is everywhere. Mutual fund awards, ratings, rankings and its "number of stars" are regularly advertised in newspapers, magazines and other financial media. As if playing to a script, mutual fund companies promote the funds with the strongest returns. Of course, coupled with this message is the disclaimer that the performance touted in the advertisement isn't guaranteed to persist. But as we've discussed, those warnings do very little to temper investors' focus on past returns and expectations of future returns.

As for investors, it helps to remember that we're only human. We have a natural tendency to assume that patterns we've observed in the recent past will continue. This is known as *recency bias.* While recency bias is not specific to investing, it certainly helps explain our behaviour in many investment decision-making scenarios, where our natural tendency is to pour money into something that has recently performed very well, and withdraw money from something that has recently performed poorly.

And let's not forget about plain old impatience. Many investors perform their due diligence in order to select investments with great track records and solid management teams. All too soon there is a compelling feeling to switch investments — that the product selected is no longer working, or that some other product is performing better than the one chosen and it's time to move. This is nothing more than impatience. Even the best managers and the best strategies will be out of favour from time to time, and it's absurd to believe that a particular fund or fund manager will always be number one.

Perhaps one of the greatest callings of our profession is keeping clients on track. Acting as something of a behavioural coach, we advisors can help clients resist the urge to react to performance advertising, or to grab onto the latest hot trend or fund. In doing so we can help ensure our clients' investment portfolios remain aligned with their long-term goals and plans. Of course, staying on course and resisting the temptation to adjust based on recent performance is easier said than done. As Warren Buffett once famously said, "Investing is simple, but not easy." And that is what *we* are here for — to make investing a little less of a mystery for our clients. F

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