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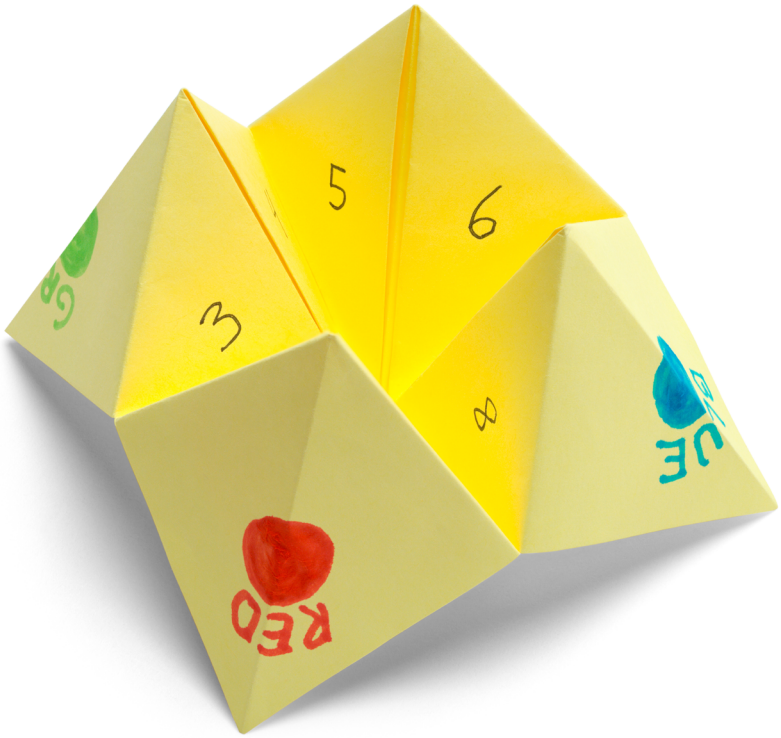
Past performance is no guarantee of future results.

Helping you make informed investing decisions



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It happens in sports, it happens in entertainment, and it happens in the markets. How many times has a star player or team had a marvellous run of success only to choke in a crucial game? Even a top-rated movie producer or actor has a dud in their resume.

Investing is much the same. Past performance is no guarantee of future results.

There's a reason this "warning label" is included in every document that discusses the performance of a particular fund, asset class or strategy. That's because when it comes to financial markets, circumstances can change—sometimes quickly and unexpectedly. Anyone who lived through the dot.com bust of the early 2000s, or the subprime mortgage crisis in 2007/08 or the COVID-19 pandemic is well aware of this possibility.

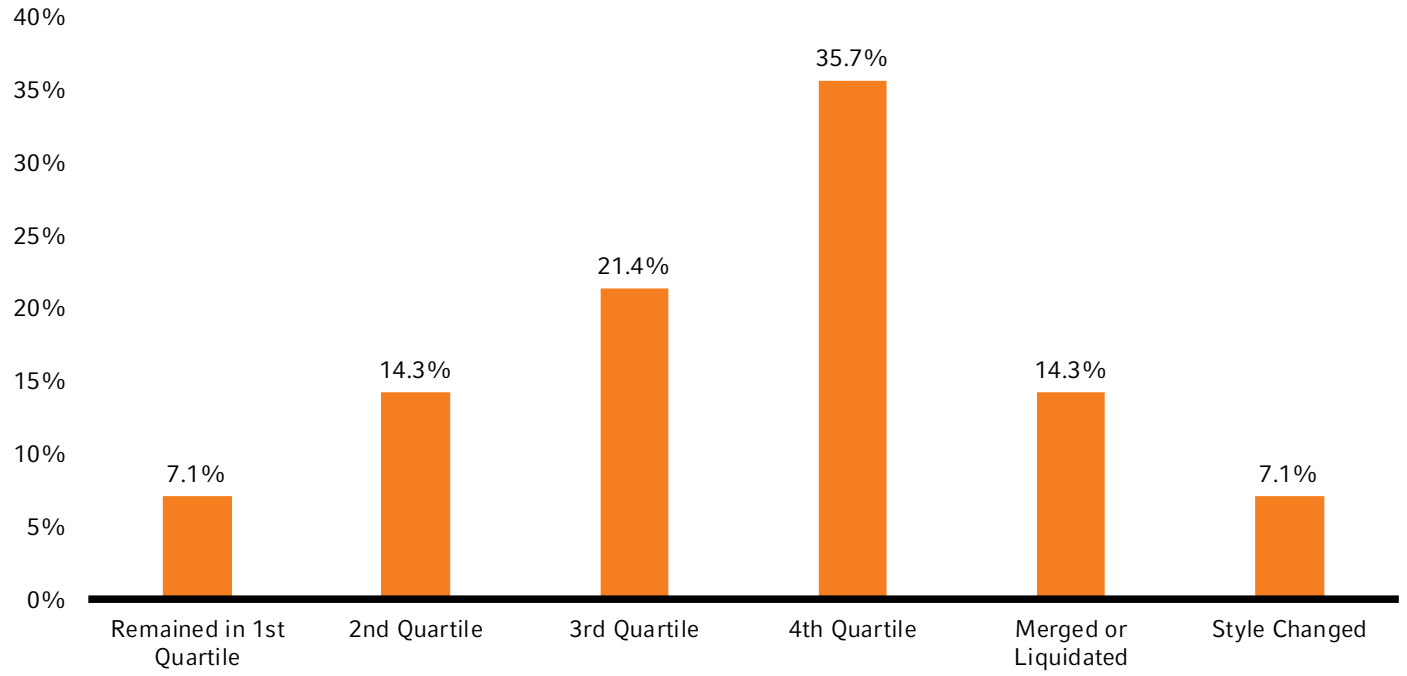
The facts bear this out.

The annual S&P Persistence Scorecard is one way to measure whether an active fund manager at the top of their game can stay at the top. In short, does past performance predict future performance?

Invariably, the scorecard finds that regardless of asset class or style focus, few fund managers consistently outperform their peers.

According to the 2020 scorecard, fund managers are unlikely to remain at the top of the heap for more than a few years. **Of the 144 funds that ranked in the top quartile of their respective style category in 2016, just one fund remained in the top quartile annually through 2020.** In fact, over an even longer time frame, top-quartile Canadian Equity funds for 2011-2015 were more likely to revert to the bottom quartile for 2016-2020."[1]

Exhibit 1: Top-Quartile Domestic Funds for 2011-2015 were far more likely to be in Bottom Quartile for 2016-2020 than stay at the top



Source: S&P Dow Jones Indices LLC, Fundata Canada Inc. Data as of Dec. 31, 2020. Canadian Investment Funds Standards Committee (CIFSC) categorizations are used. Past performance is no guarantee of future results. Chart is taken from S&P Persistence Scorecard website, and is provided for illustrative purposes. For more information about the methodology of the scorecard click **here**.

[1] https://www.spglobal.com/spdji/en/spiva/article/canada-persistence-scorecard/

Still, it seems our human instinct to focus on positive past experiences causes us to be attracted to investments that have done well recently. We do this in other areas of our lives too. For example, you are likely to buy the same model of car or at least prefer cars from a specific country if you had a good experience with a vehicle from that manufacturer or country. But if you owned a lemon, you are more likely to avoid that car model or brand. From a psychological point of view, disregarding past outcomes when making future decisions can be difficult and counterintuitive.

A recent study titled "Persistence is futile: Chasing of past performance in repeated investment choices,"[2] found that investors are more likely to choose funds or strategies with strong past performance over any other characteristic (fees, complexity, regional bias, need for diversification, etc.).

There are a few reasons for this:

1. **We prefer small sample sizes.** The more information we have, the harder it is to decide. If you've ever had to choose a paint color for an area of your house, you will understand this concept. When it comes to investments, most investors find it's so much easier to just look at the past few years of performance than do an exhaustive investigation.
2. **We often have a recency bias.** If an environment is constantly changing, as markets do, it's tempting to disregard old information and just focus on the most recent outcomes. You may have forgotten and forgiven a long-ago poor experience with your hairdresser or mechanic if they have done great work more recently.
3. **We tend to have an overconfidence bias.** We often believe we can avoid the pitfalls that can trap others. This is why studies have shown the majority of us think we are better drivers than everyone else, even though logically half of us have to be worse.

The researchers surveyed 1,600 people in the United States, asking them to choose between two hypothetical funds. The fund profiles shown to the potential investors included disclaimers that either said "past performance does not guarantee future results" or "some people invest based on past performance, but funds with low fees have the highest future results."

Surprisingly, the researchers of this study found the investors inevitably chose the fund that came with the "no guarantee" disclaimer, ignoring the comment about fees. This happened even though the investors were provided with the monthly performance statistics and the fund with lower fees generally outperformed. The researchers determined that was because investors often think they are smarter than the next guy and believe they can get a better result.

While you should not assume an investment will continue to do well in the future simply because it's done well in the past, neither should you discount an investment simply because it's done poorly recently.

Past returns *can* be helpful when analyzing a stock or fund. But here's where a long-term perspective is key. If a stock has risen 20% this year, you don't know what its returns could be in the future. You only know how it performed over a specific period of time.

However, if a stock has shown average annual returns of 7% (or more) or 12% for an extended period—let's say 30 years (or more)—then it might be an investment worth considering. While that past performance still doesn't guarantee any future returns, it does mean that stock has performed well through several decades of market volatility, which speaks to its durability and resiliency.

But a better way to deal with your behavioral inclination to hang on to winners is by **rebalancing**—the disciplined shuffling of your investments to keep your asset allocation in line with your original goals. It ensures you sell your winning stocks and allocates those gains to securities that are trading at more attractive prices. Done properly, this can smooth out your returns and help protect you from any sudden shock in the market.

Maintaining a **diversified portfolio** is also a good way to overcome your investing biases. That can also help smooth out returns when market leadership changes. And that can also help you stick with your strategy over the long, slow journey to your financial goals.

[2] Source: Journal of Experimental Psychology: Applied
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