Virtus University

The Myth of Consistency

Winning over time doesn't mean winning all the time

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So much effort in investing goes toward identifying "winners." In the world of actively managed mutual funds, we search for managers who can outpace their peers and beat the market. We know how difficult this is, but we also know it's important: a better showing over the long-term makes it more likely we can meet our financial objectives. There's a catch, however.

Research we've conducted at Virtus Investment Partners suggests that a fund's path to the winner's circle is almost never a straight line. In other words, in our quest to make "better" investments, we should accept that even those which are winners in the long run will *all* endure bouts of underperformance, sometimes for uncomfortably long periods of time. Responding effectively to those inevitable ebbs and flows is a behavioral challenge that sits at the center of being smart with your money.

To clarify this dynamic, we looked at thousands of funds in the Morningstar database and asked: *How frequently* are funds with top quartile returns in their peer group over the past ten years actually ranked in the top quartile at any particular time?

The answer is clear: Not very frequently.

Here's how we cut the data. First, we screened across 13 major equity fund categories: the nine U.S. equity categories (small-, mid-, and large-cap; value, blend, and growth), foreign large value, foreign large blend, foreign large growth, and emerging markets. Across those categories, there are 325 funds that have a track record of at least a decade.

We then looked at performance for the long-term winners over shorter *rolling time windows*. Rolling windows are a series of fixed time periods: January through March would constitute one 3-month window; February through April would be the next; and so forth. While almost no one claims to be a short-term investor, it's also true that many of us reasonably ask: How has my fund done lately?

Table 1: Funds in the Top Quartile of their Morningstar Peer Group over 10 Years

	Percentage of time in			
	Top Quartile	**Top Half**	**Bottom Half**	**Bottom Quartile**
Rolling 3 Months	31%	60%	40%	17%
Rolling 1 Year	39%	68%	32%	13%
Rolling 3 Years	52%	80%	20%	6%

As of 3/31/18. Source: Morningstar Direct. **Past performance is no guarantee of future results.**

For investors, dissonance occurs when a fund with great long-term results doesn't look competitive at any particular moment. The problem is: the data show that happens *most of the time!*

In Table 1, for example, we see that top quartile performers over the past decade overall were only in the top quartile in 31% of all 3-month windows and 39% of rolling 1-year windows. And they were in the *bottom half* of their categories *more than* 30% of the time over both time frames. In other words, winning over time doesn't mean winning all of the time.

Even over 3-year periods, which often serve as the standard time period over which performance is evaluated, long-term winners sit in the top quartile only 52% of the time.

We've just shown aggregate numbers across a large universe. So let's also get more granular by going category-by-category to identify trends for particular styles of investing. In Table 2, we evidence that there are not extreme differences in patterns of outperformance. Mid-Cap Blend funds appear less consistent than, say, Foreign Large Blend funds, but the differences across the categories are not very large; there are no standout categories where a winner's path is much more consistent than others.

Table 2: Funds in the Top Quartile over 10 Years by Category

	Percentage of time in			
	Top Quartile	Top Half	Bottom Half	Bottom Quartile
All Funds	**31%**	**60%**	**40%**	**17%**
Diversified Emerging Markets	32%	61%	39%	18%
Foreign Large Blend	38%	60%	40%	22%
Foreign Large Value	32%	60%	40%	17%
Foreign Large Growth	30%	58%	42%	21%
Large Growth	34%	60%	40%	18%
Large Blend	30%	63%	37%	13%
Large Value	33%	58%	42%	20%
Mid-Cap Growth	30%	60%	40%	16%
Mid-Cap Blend	23%	62%	38%	9%
Mid-Cap Value	32%	58%	42%	19%
Small Growth	33%	60%	40%	18%
Small Blend	27%	58%	42%	15%
Small Value	30%	59%	41%	18%

Rolling 3-month periods, as of 3/31/18. Source: Morningstar Direct. **Past performance is no guarantee of future results.**

Why does this pattern occur? Style is the main reason no long-term outperformers consistently top the charts in the short term. Within investment categories, there are material differences among funds in terms of their style profiles, such as tilts in market cap, valuation, and quality. Table 3 simply illustrates the erratic pattern of relative performance between large-cap and small-cap stocks, and between growth and value stocks. As there's no way to predict which style comes in and out of favor, there's also no way to predict which funds are going to be facing headwinds or tailwinds.

What can be somewhat predictable, however, is a manager's style profile. Savvy manager research can identify a fund's style and its consistency over time. Ironically, discipline can drive underperformance. Fund managers with a clearly defined process, and who do not chase short-term trends, will sometimes (though we don't know when) trail the pack precisely because they stick to their knitting.

Table 3: Style "Ping-Pong"

	Large Cap	Small Cap	Large Cap Growth	Large Cap Value
2006		✔		✔
2007	✔		✔	
2008		✔		✔
2009	✔		✔	
2010		✔	✔	
2011	✔		✔	
2012	✔			✔
2013		✔	✔	
2014	✔			✔
2015	✔		✔	
2016		✔		✔
2017	✔		✔	

Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. As of 3/31/18. Source: Morningstar Direct. Large Cap represented by the Russell 1000® Index. Small Cap represented by the Russell 2000® Index. Growth represented by the Russell 1000® Growth Index. Value represented by the Russell 1000® Value Index. Please see page 4 for definitions.

Here are our major takeaways:

Winning over the long run doesn't mean you win all the time.

Recognizing this takes the burden off of focusing on short-term performance and allows us to avoid overreacting.

Performance chasing doesn't work.

We already knew that, but here's even more evidence. Even the best funds jump in and out of the near-term winners circle. Trying to game that is both dizzying and futile: tactically allocating to which we might predict will be the best managers is a losing strategy.

Understanding the reasons for under- and outperformance is a must for investment success.

All funds have a particular style which goes beyond just their Morningstar category. If a fund is underperforming *for the right reasons*—generally, maintaining the integrity of its investment process—then it's actually reason to sit tight and resist the urge to find something better.

Buying winners in a temporary lag can be a smart strategy.

Topping up an investment that appears to be "struggling" (even when it's really not!) can feel emotionally uncomfortable. Nonetheless, success stems not from picking today's winners but finding managers who have achieved long-term success based on a sound, repeatable process, and knowing how they complement a diversified portfolio.

Take these lessons into account to help drive better client outcomes. Learn more about building a diversified portfolio by speaking with your financial advisor, contacting Virtus at 1-800-243-4361, or visiting Virtus.com.

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Before assuming her current role in 2011, Ms. Alvarez started at Virtus as a regional sales consultant in 2006, representing retail mutual funds and separately managed accounts. Prior to joining Virtus, she was an asset management associate at Advest, Inc.

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Mr. Portnoy is the author of The Investor's Paradox: The Power of Simplicity in a World of Overwhelming Choice, published in 2014. Through the lens of behavioral finance, the book provides a practical road map for navigating the complex landscape of countless traditional and alternative investment strategies. He is a regular contributor to Forbes.com and Yahoo! Finance, has spoken to audiences globally about investing and decision-making, and has lectured on the history and future of hedge funds at the U.S. Securities and Exchange Commission as part of its Leading Authors series.

Mr. Portnoy pursued his research and teaching interests in political economy at the University of Chicago, where he earned his doctorate. He earned a B.A. from the University of Michigan. Mr. Portnoy is a Chartered Financial Analyst® (CFA) charterholder and a member of the Economic Club of Chicago.

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