# COSTS OF PERFORMANCE CHASING

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In this edition of the Wealth Council Insights Education Series, we will focus on performance chasing and how this phenomenon can negatively affect your portfolio. We will also address approaches to mitigate this behavior.

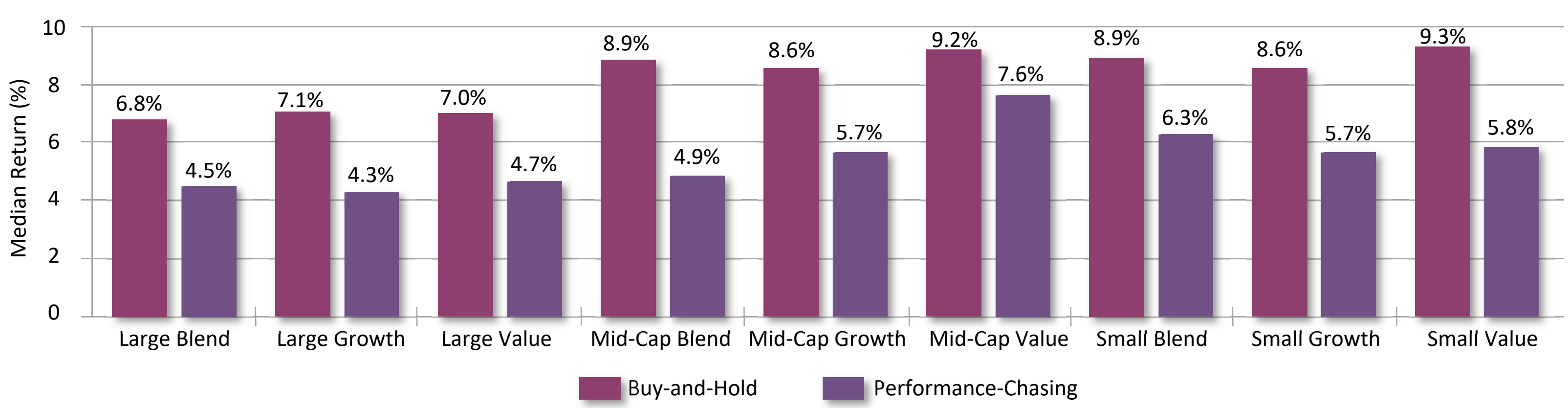
## WHAT IS PERFORMANCE CHASING?

Performance chasing is the process of making investment decisions based on the recent performance of an asset. This practice may provide investors satisfaction of holding a trendy, high-performing asset and the comfort of eliminating a performance laggard from their portfolio. While temporary satisfaction and comfort feel nice at the time, performance chasing often comes with a long-term cost.

## THE COSTS OF PERFORMANCE CHASING

As seen in the illustration below, a buy-and-hold strategy often produces superior results in the long term. This outperformance of the buy-and-hold strategy is largely driven by the tendency of performance chasers to sell under-appreciated assets in order to purchase overvalued assets along with higher trading costs associated with a performance chasing strategy. Funds are also subject to higher implicit costs as better performance often attracts more assets from investors due to their track record of delivering above-average returns. As a result, these funds experience an increase in assets under management (AUM). A larger asset base presents challenges to managers that can lead them to generate less alpha than they would have with their smaller asset base.

### BUY AND HOLD VS. PERFORMANCE CHASING (2004-2013)




*Source: Vanguard*

# COSTS OF PERFORMANCE CHASING *(continued)*

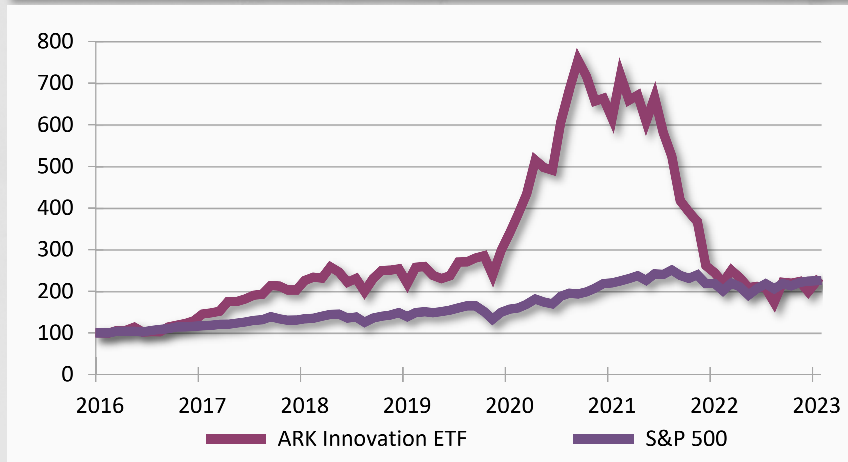
This challenge to generate alpha with a larger asset base is oftentimes driven by difficulties in identifying new investment opportunities that can provide significant outperformance. Larger funds may encounter limitations in their ability to enter or exit positions efficiently without impacting the market. Additionally, managing a larger portfolio requires more effort, time and resources, potentially diluting the manager's focus and expertise. Consequently, the pursuit of alpha becomes increasingly challenging as the scale of assets grows, making it harder for funds with stellar past performance to replicate their success and sustain their competitive edge.

A recent example of this occurring can be found with the ARK Innovation ETF managed by Cathie Wood, which invests across five technology platforms (artificial intelligence, blockchain, DNA sequencing, energy storage and robotics) that its investment team believes will revolutionize the global economy. This approach was very successful for a period of time, especially in 2020 as a high premium was being paid for growth and disruptive technologies.

In 2020, the Ark Innovation fund was up 157% on the year with its asset base increasing nearly 900% over the same time period. At its peak, $1 billion in shares were being traded in a day, exceeding common large cap names such as Netflix and Disney.

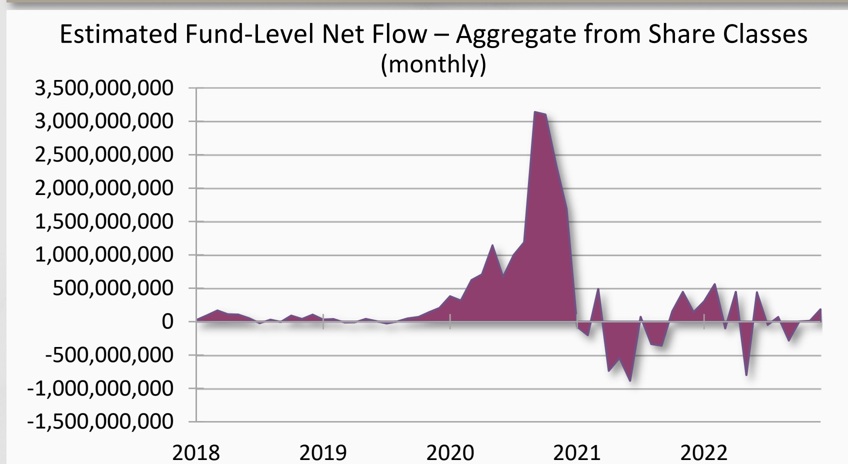
Toward the end of 2021, the fund experienced significant declines driven by its strategy falling out of favor, increased transaction sizes and forced selling as the value of the fund declined.

## ARK VS. S&P 500 CHART




*Source: Morningstar*

## ARK INNOVATION ETF




*Source: Morningstar*

## PERSISTENCE OF TOP-PERFORMING FUNDS

The table below illustrates the number of funds that remain in the top half and quartile over three consecutive 12-month periods. Of the active funds that placed in the top quartile as of June 2020, none of them across asset classes managed to remain in the top quartile over the next two 12-month periods. Similar results can be seen with a marginal percentage of funds remaining in the top half over the next two years.

## CONCLUSION

Short-term performance is not a good indicator of long-term results. The approach of chasing performance often leads investors to selling under-appreciated assets to purchase overvalued assets. Instead of relying on short-term performance to make investment decisions, investors should incorporate approaches that take into account the performance of the fund over different time periods and business cycles. It is also essential to ensure the fund manager's interests are appropriately aligned with the investors' long-term objectives, which is often achieved by a significant personal investment by the fund manager. All of these approaches should be utilized within the context of a long-term investment plan that aligns with the individual's specific financial goals and time horizon.

### PERFORMANCE PERSISTENCE OF DOMESTIC EQUITY OVER THREE CONSECUTIVE 12-MONTH PERIODS

| FUND CATEGORY | FUND COUNT AT START (December 2020) | PERCENTAGE REMAINING IN TOP QUARTILE | |
|---|---|---|---|
| | | DECEMBER 2021 | DECEMBER 2022 |
| **TOP QUARTILE** | | | |
| All Domestic Funds | 488 | 4.10 | 0.00 |
| All Large-Cap Funds | 156 | 7.05 | 0.00 |
| All Mid-Cap Funds | 63 | 0.00 | 0.00 |
| All Small-Cap Funds | 123 | 2.44 | 0.81 |
| Al Multi-Cap Funds | 121 | 9.09 | 0.00 |
| **FUND CATEGORY** | **FUND COUNT AT START (December 2020)** | **PERCENTAGE REMAINING IN TOP HALF** | |
| | | **DECEMBER 2021** | **DECEMBER 2022** |
| **TOP HALF** | | | |
| All Domestic Funds | 975 | 32.10 | 7.18 |
| All Large-Cap Funds | 318 | 39.31 | 5.03 |
| All Mid-Cap Funds | 128 | 13.28 | 2.34 |
| All Small-Cap Funds | 263 | 21.81 | 9.05 |
| Al Multi-Cap Funds | 241 | 39.83 | 9.96 |

*Source: S&P Dow Jones Indices LLC, CRSP. Data as of Dec. 31, 2022. Table is provided for illustrative purposes. Past performance is not guarantee of future results.*

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In the Wealth Council Insights Education Series, we endeavor to deconstruct some of the complexities that exist around many commonly utilized estate and financial planning concepts in order to provide you and your family with the basic knowledge needed to better understand and create a blueprint for your overall wealth enhancement needs.