Past Performance Does Not Predict…

Evaluating Mutual Funds Involves More Than Just Looking at Past Performance

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At the bottom of every investment performance summary is a required disclosure that indicates "Past performance does not predict future returns". The challenge for investors though is that past performance is the primary data available in determining a fund's historical success or failure. So what is an investor to do?

IRA Group views fund evaluation as a multi-level process which attempts to answer the following three basic questions:

1. Did the fund achieve certain performance & risk metrics?
2. How did the fund do it?
3. Does it appear to be repeatable?

Did the fund achieve certain performance & risk metrics?

The first step to answering this question is to assign specific performance and risk benchmarks. For passively-managed index funds, the comparative metric should be the variability of returns and risk around the target index that the fund is attempting to track. For actively-managed funds, the metric can be index-relative or peer-relative. Peer relative refers to a fund's comparative performance versus other funds investing in a similar manner. IRA Group prefers to utilize a peer-relative evaluation protocol for actively-managed funds.

The next step is to assign an evaluation period for which performance will be analyzed. Because short-term results can be influenced by unpredictable events, economic cycles or certain market nuances, the IRA Group analytical process emphasizes longer-term results. Specifically, we begin by evaluating a fund's 3-, 5-, and 10-year performance. Our target is for a fund's performance to rank in the top 50% over 3 years, top 35% over 5 years, and top 25% over 10 years versus its peer group (notice the higher performance ranking target over longer periods). The application of this filtering process on all 25,221 mutual funds available as of 06/30/20 results in an overall 12% passing rate. Those funds that pass are then elevated to the next level of evaluation.

How did the fund do it?

The analytical process gets a bit more complicated at this level. While a fund may pass all three of the 3-, 5- and 10-year performance ranking criteria, it is important to determine how the results were achieved. Was it the result of one really good performance year and nine bad ones? Was overall performance attributable to a few select positions in the portfolio or did the fund receive performance contribution from a broad variety of positions? Did the fund manager employ a market timing or sector concentration strategy? Did the performance justify the risk assumed? Answering these types of questions sheds light on the process by which the fund achieved the results and whether it is a disciplined approach or not.

Does it appear to be repeatable?

Without an analysis of repeatability, the investor is relying on a historical track record which may not be achieved in the future. Hence, the common disclosure "past performance does not predict future returns". Understanding the fund's underlying investment process and matching risk characteristics to historical performance dynamics is critical in assessing repeatability. IRA Group establishes a 70% repeatability threshold which means that a fund's historical performance must rank above the median performance of its peers in 70% of the measurement periods including favorable and unfavorable market cycles. Additionally, risk characteristics should align with actual performance. If the fund's objective is to demonstrate lower risk levels than the overall market, it should be expected to outperform in down markets, and vice versa. Finally, an assessment of the fund management team is important. Are they experienced. How are they supported by research analysts? Does their tenure align with the performance evaluation periods being analyzed? Consideration of these variables will go a long way in assessing repeatability.

There are other considerations in assessing a mutual fund including expenses, fund size, style consistency, portfolio diversification/concentration, and parent company scale and resources. However, an analytical process that attempts to answer these three basic questions is a good starting point in assessing a fund's potential to consistently produce favorable results in the future.