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Mutual Fund Hot Hands: Go with the Winners

March 1996

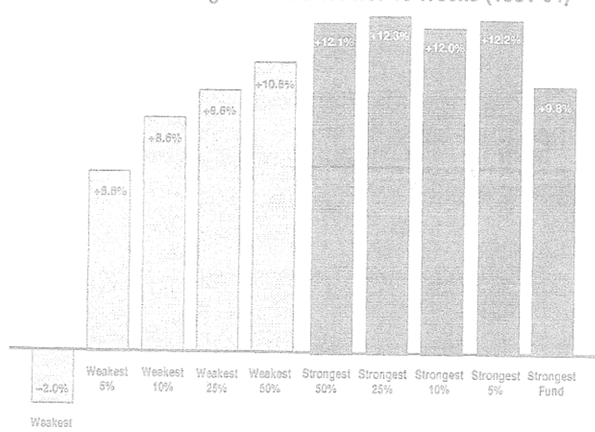
Are the top-performing stock funds in the past the best performers in the future? Every year, investors commit billions of dollars to that premise, using past performance as a fundamental, and sometimes sole, selection criterion. To answer the question definitively, we have scanned our mutual fund database, which encompasses all equity funds, back to January 1, 1981.

We first present the future performance results of diversified domestic funds selected by their performance over the most recent 13, 26, and 52 weeks. Because these relatively short past-performance periods are, at best, useful for estimating future performance only over the following several months or a year, we excluded load funds from this study. Thus, the results are based on all stock funds with 1% or lower combined front and back-end loads.

Chart 1 shows the annualized future 13-week returns of the strongest and weakest funds based on their performance in the 13 prior weeks. In other words, we initially examined performance of all funds in the first quarter of 1981, and classified them into the various weak or strong groups. Then, we computed the average performance of each of these funds in the following quarter. An identical classification was made for second-quarter performance to measure subsequent returns in the third quarter, and so on, quarter by quarter, through the end of 1994.

As shown in the chart, on average, the weakest fund in any given quarter declined 2% (annualized) in the following quarter across the entire 14-year period. In contrast, the strongest fund in a quarter recorded an average gain of approximately 10% annualized in the following 13 weeks. However, simply selecting the strongest fund was not a particularly effective strategy. You would have been better

1. Annualized Returns In Next 13 Weeks of Weakest and Strongest Funds In Prior 13 Weeks (1981-94)

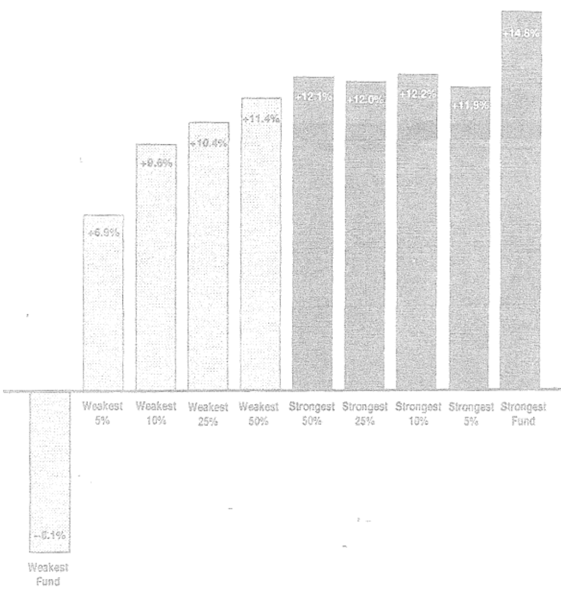


off with a random sampling of the 5% strongest funds. They subsequently returned slightly more than 12% annualized in the following 13 weeks. Or, if you had made your selections from among the 10%, 25%, or 50% strongest funds, your average return would have also have been about 12% annualized.

Weaker funds produced distinctly inferior subsequent performances, and the weaker the past performance, the poorer the future results. The weakest 50% of funds produced an average subsequent gain of only 10.6% versus an average of 12.1% annualized for the strongest 50%. Meanwhile, the 25% weakest funds produced a smaller annualized future return than the 50% weakest funds; the 10% weakest funds returned still less; the 5% weakest funds even less; and the single weakest fund actually recorded a loss.

Chart 2 also shows subsequent annualized 13-week returns, but for funds selected on the basis of their prior *26-week* performance. The results are remarkably similar to the first set among nearly all of the weakest and strongest groups. The only meaningful differences are that the very weakest fund produced an even worse return (6.1% annualized), while the single strongest fund earned a nearly 15% annualized return over the following 13 weeks.

2. Annualized Returns in Next 13 Weeks of Weakest and Strongest Funds in Prior 26 Weeks (1981-94)



3. Annualized Returns in Next 26 Weeks of Weakest and Strongest Funds in Prior 26 Weeks (1981-94)

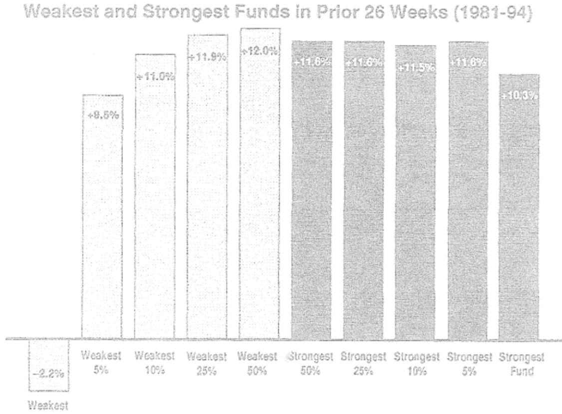
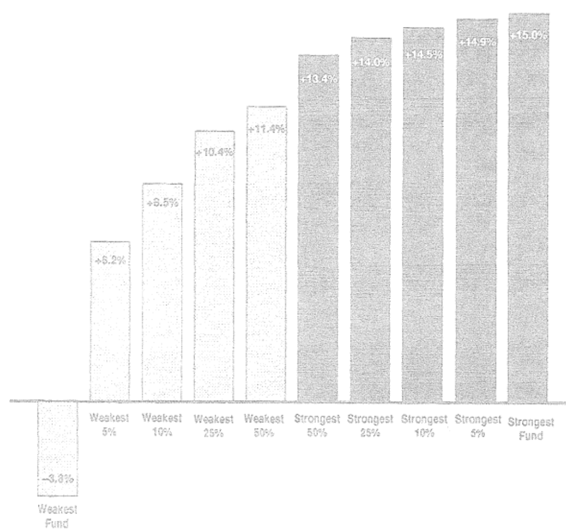


Chart 3 measures the same population of funds as in Chart 2 – i.e., funds are first classified by their weakness or strength in a 26-week period – but in this case the annualized returns are presented for a 26-week future holding instead of merely 13 weeks. Interestingly, with the exception of the single weakest fund, which still turned in an average subsequent loss, the returns across all the various weak and strong groups are much more uniform. True, there is a slight propensity for stronger funds in the past to have slightly higher returns than the weaker funds. But that is a marginal difference. This suggests that if you are using 26-week performance to select funds, you should not count on holding those funds for another 26 weeks.

Rather, their relative strength or weakness dissolves sometime after the first 13 weeks of future holding.

Charts 4, 5, and 6 all show future returns – over the following 13, 26, and 52 weeks, respectively – of funds that were initially grouped by their relative weakness or strength over the prior 52 weeks. These results show a much stronger propensity towards strength following strength than our shorter-term analyses.

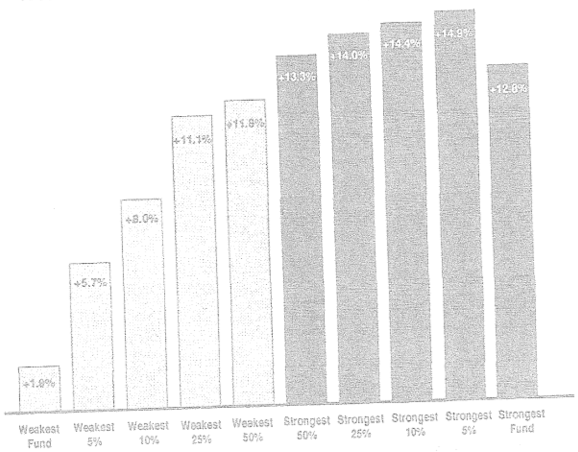
4. Annualized Returns in Next 13 Weeks of Weakest and Strongest Funds in Prior 52 Weeks (1981-94)



For example, annualized future 13-week returns based on funds classified by their relative strength in the preceding 52 weeks (chart 4) show a consistent uptrending path. The very weakest fund produced the worst subsequent 13-week return, the weakest 5% of funds earned the next worst return, and so on up to the single strongest fund, which earned the very best return. Nearly identical patterns are shown in charts 5 and 6 (next page) for annualized future 26-week and 52-week returns; the single exception is that the very strongest fund did not record as high a future annualized 26-week return as expected.

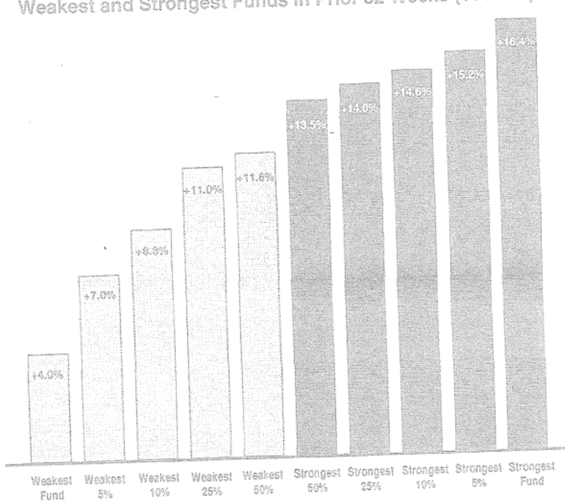
Clearly, past 52-week performance is a more reliable standard upon which to select funds for purchase, or continued holding, than past 13-week or past 26-week perfor-

5. Annualized Returns in Next 26 Weeks of Weakest and Strongest Funds in Prior 52 Weeks (1981-94)



mance. Overall, you can improve your returns over the following 13 to 52 weeks by at least two percentage points merely by making sure you own funds that are among the 50% strongest rather than among the 50% weakest. And by demanding even better past performance, the odds are you will increase your returns even more. Finally, the modest single step of removing, or excluding, from your portfolio the very weakest funds will immediately give you an edge up on the average fund investor.

6. Annualized Returns in Next 52 Weeks of Weakest and Strongest Funds in Prior 52 Weeks (1981-94)

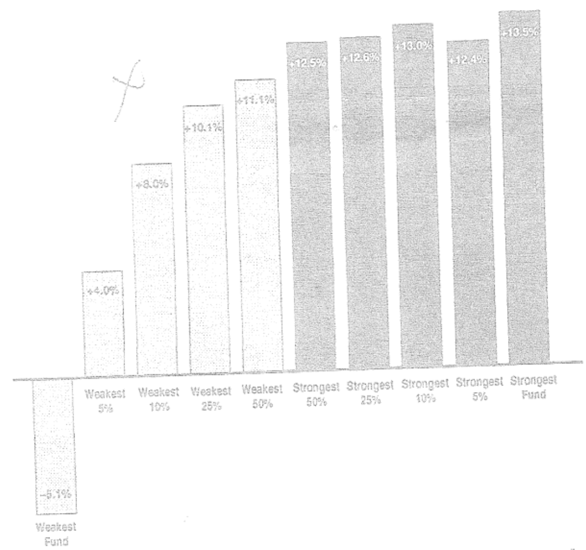


We now extend our analysis to longer time periods. We observe the extent to which two-year and five-year prior returns can be used to forecast one-year and two-year future performance for diversified domestic stock funds. All of the performances, as presented in charts 7 through 10, are expressed as annual rates of future return.

Chart 7 tells us that over the last 14 years, the single weakest fund in any two-year period produced an average annual loss of 5.1% over the following year. In contrast, the strongest fund over any two-year period earned an average of 13.5% over the next year. In general, the weaker a fund's prior performance, the worse its subsequent returns, and the stronger the prior performance, the better the future returns.

Put another way, if you avoided purchase of a fund because it was the single weakest fund in the market over the last two years, or among the weakest 5% of all funds, or because it was among the weakest 10%, 25%, or 50% of all funds, you would probably have saved yourself from underperforming the market. In contrast, if you had made your purchase selections from among the 50% strongest funds, or even better, from the top 25%, 10%, or 5% strongest funds, you would probably have done better than average on balance.

7. Annualized Returns Next 1 Year of Weakest and Strongest Funds in Preceding 2 Years (1981-1994)



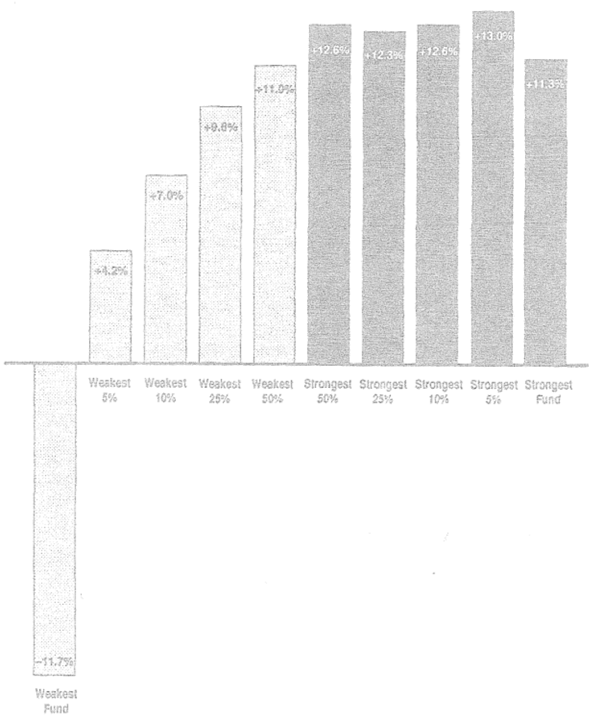
Of course, not every historically weak fund subsequently underperformed the market, and not every strong fund subsequently beat it. But these results show that you place the odds in your favor by merely avoiding weak performers and focusing your buying attention on stronger funds.

Chart 8 (next page) measures annual returns over the following *two* years, based on the same categorization of weak funds and strong funds over the prior two years. The pattern of returns, ranging from the previously weakest 5% of funds to the previously strongest 5%, is very similar to those in chart 7. However, in this case, the very weakest fund subsequently performed even worse, while the very strongest fund actually performed somewhat below the first evaluation, albeit still above average.

Overall, it appears that funds selected on the basis of two-year superior past performance earn superior returns in both the next one year and two years.

Incidentally, we attribute the volatility of future returns for the very weakest and very strongest fund to the small sample size. The categories of weakest and strongest 5% and 10% performers include dozens of funds, but the single weakest and the single strongest funds measured over the 14-year period are relatively few in number, so one or two extreme performances can dramatically influence the

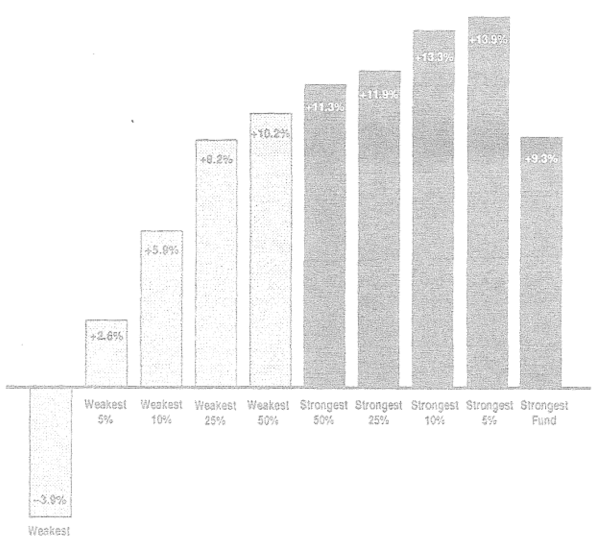
Weakest and Strongest Funds in Preceding 2 Years (1981-1994)



results. For this reason, we believe it is best to focus on the middle eight bars of the chart rather than the two extreme performing funds.

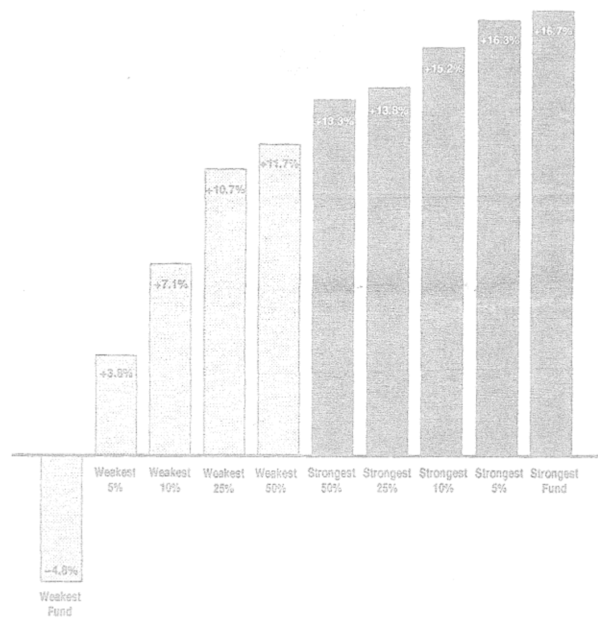
Charts 9 and 10 measure future one-year and two-year returns, after categorizing funds by their relative performance over the previous *five* years. In general, we observe the same ascending pattern of returns, with the poorest future performances recorded by the previously weakest funds, and the best future performances turned in by the previously strongest funds. Again, there is a break in the pattern for the very strongest fund, which recorded a below-average future one-year return.

9. Annualized Returns Next 1 Year of
Weakest and Strongest Funds in Preceding 5 Years (1981-1994)



The most significant results of all are exhibited in Chart 10. This shows the results of categorizing funds by five-year prior performance and then measuring their future two-year performance. The bars slope steeply upward. Over this entire 14-year period, the average fund returned about 12%. But selecting the 5% or 10% strongest funds from a given five-year period produced average annual returns over the following two years (an impressively long holding period) of 3% to 4% per year greater than average.

10. Annualized Returns Next 2 Years of
Weakest and Strongest Funds in Preceding 5 Years (1981-1994)



The results in the first two pages of this report demonstrate that there *is* value in using the short-term performances reported after each quarter and at the end of the year to select funds for purchase or sale. However, mutual fund investors are well advised to focus instead on longer-term prior performance, such as two years, or even better, five years, and then to consider holding funds selected on that basis for at least two years. Relative long-term returns zero in on a portfolio manager's true ability, as well as the efficacy of a fund's portfolio strategy. By demanding even better past performance, the odds will move increasingly into your favor for securing superior future returns. Just as important, casting a skeptical eye on weak long-term performing funds should save you lots of money.