FROM THE DESK OF

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

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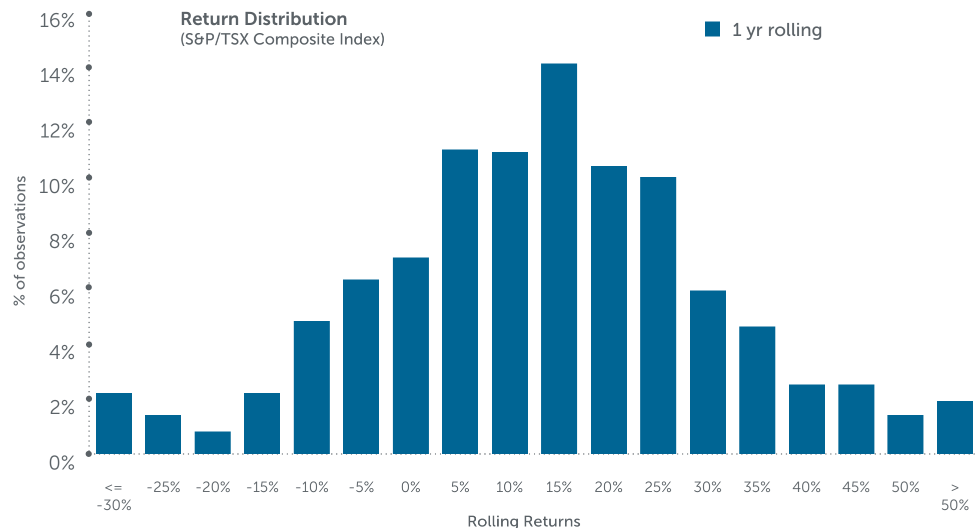
You have likely come across the following disclaimer (or something very similar) on numerous occasions – "Past performance is no guarantee of future results". It is a standard industry disclaimer used in investment marketing pieces to essentially warn investors that future performance may not be repeated. It also protects the fund company from potential liability.

There is, however, some truth to the saying. Stock market returns are subject to a high level of variability due to changing economic and business fundamentals, macroeconomic environment, and investor sentiment. Take for example the S&P/TSX Composite Index. Over the past twelve months the index returned 22.9%[1] . However, its history of twelve month rolling returns (from December 1970 to December 2019) has produced a high degree of variability, as shown by the following frequency distribution chart.



(data source: Morningstar Direct, December 1969 - December 2019; each bar reflects the percentage of returns that fall between x-5% and x%, for example, 14% of observations have returns between 10% and 15%)

Over the period, its returns have ranged from -39% to 87%. Additionally, 25% of outcomes are in negative performance territory. Therefore, if the future is anything like the past, it is very unlikely that the past year's performance will be repeated over the next year.

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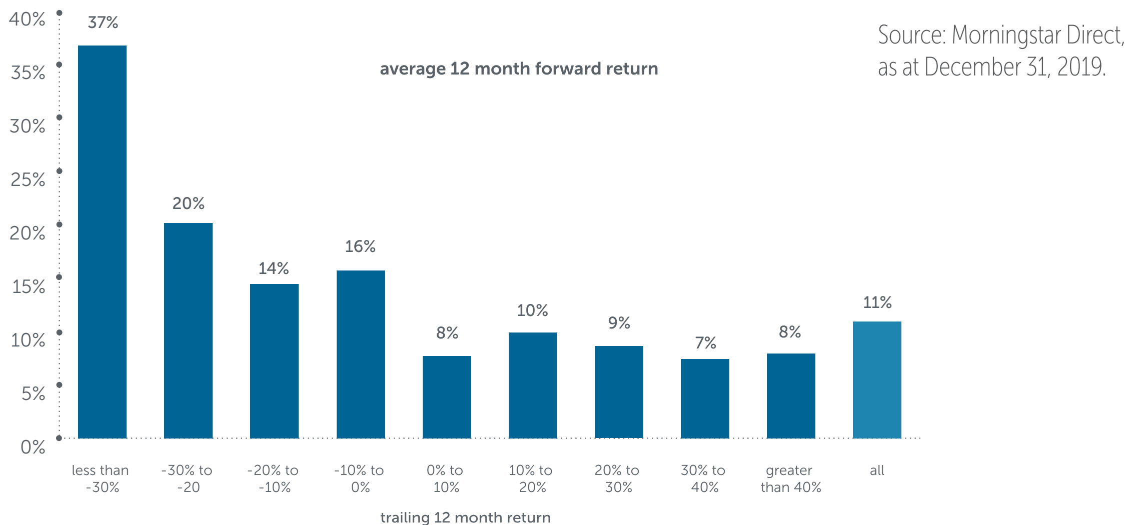
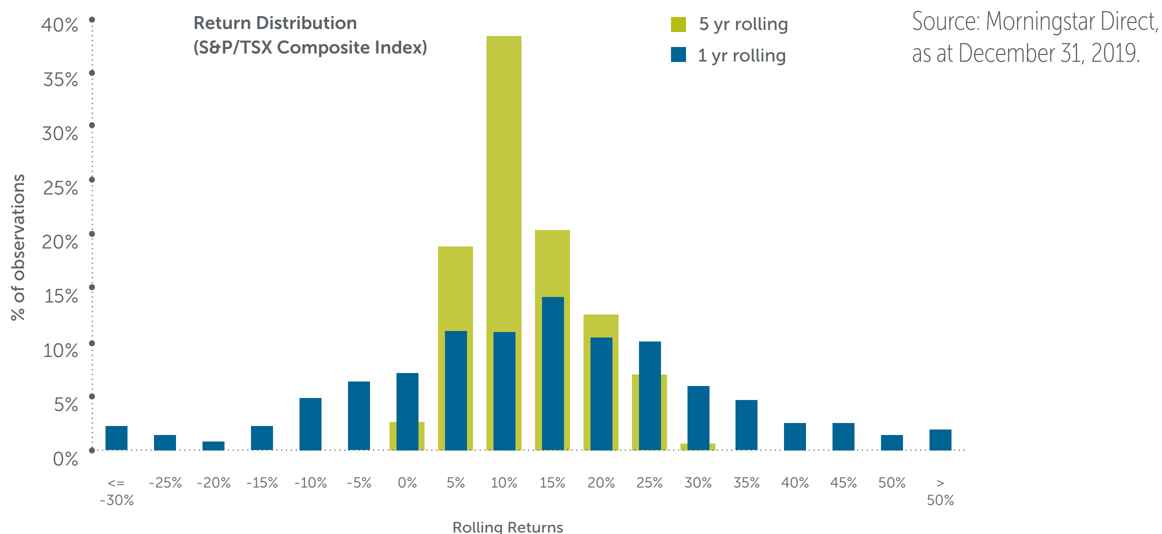
Another interesting trend is uncovered when examining these historical 1 year rolling returns; they tend to be mean-reverting, particularly when focused on the range's extremes. We asked ourselves "if performance fell within a relatively narrow range over the past twelve months, what is the average return over the next twelve months"? The results are as follows.



Source: Morningstar Direct, as at December 31, 2019.

Based on this history, the highest average returns occurred following periods of negative returns, and some of the weaker average returns occurred following periods of strong returns. Therefore, making investment decisions based on recent performance may actually be detrimental to your long-term performance.

Given the above scenarios, it is clear that the correlation between past performance and its immediate future results is weak. It can be argued that one should not choose their investments based on past performance. What can be done to combat these challenges? As illustrated, acting against your instincts might help (continuing to invest when the environment seems most bleak). Admittedly, this is easier said than done in the heat of the moment, as it requires strong conviction. Another option is to look beyond short term returns and embrace longer term results. Expanding on the earlier example of performance distribution patterns and adding five year rolling returns produces the following results.



Source: Morningstar Direct, as at December 31, 2019.

The distribution pattern of five year returns is much narrower with a range of -1.9% to 27.8%, meaning there is much less variability in observed outcomes. Additionally, only 3% of these longer term observations fall in negative return territory.

To conclude, it is true that past performance - particularly shorter term performance - is no guarantee of future results. So what should an investor do? Have an investment time horizon that is measured in years not months, continue to invest in weak markets and finally understand the investment process and philosophy of your money manager.

We thank you for your support,

Ian Hardacre
Co-authored by Henry So, Sr. Investment Product Manager

[1] Source: Morningstar Direct, as at December 31, 2019.

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