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When Is It Too Late To Get Into A Hot Fund?



Ben
King

In my commute, I sometimes find myself sitting in the left lane of the highway and not moving at all. Meanwhile, the cars in the lane to my right move along steadily and the lucky people who happened to choose the correct lane pass me in droves. I change lanes only to have my new lane grind to a halt just as the left lane now begins to pick up speed and all of the people who were behind me moments ago zoom ahead of me.

Most people can probably relate to this commuter dilemma literally, but this scenario might also describe the investment strategy of more than just a few. You put your money into a mutual fund that has done well for years. It has a great Morningstar rating and millions have been made already by the people lucky enough to have invested in the fund years ago. As soon as you put your hard-earned money in, you find that the fund seems to run out of steam. It becomes average or worse. Inevitably this was the case for some emerging market investors recently. At the end of the first quarter of 2006, the emerging markets had enjoyed their largest three-year return on record, at more than 200%. In that same quarter, emerging market mutual funds saw a record level of cash flowing in, totaling more than \$13 Billion. Unfortunately for the owners of that \$13 Billion, emerging markets lost 4% in the following quarter, including a hard-to-swallow 10% loss in May. Those who had been invested in emerging markets for a year or two, could still proudly boast of gains, but the latecomers are now looking at losses.

So how can you tell if it is “too late” to begin investing in a top-performing fund or asset class? We may be tempted to attribute good timing to the lucky, especially when referring to others rather than ourselves! After all, as the disclaimers on mutual fund ads always say, “past performance is no guarantee of future returns.” But in actuality, there are some things we can learn from past performance – just not what you might think.

Contrary to the investment philosophy of many individuals, our own research, as well as studies by others, has demonstrated that those funds that have consistently outperformed their peers for the previous three years tend to *underperform* in the following years. This generally reflects the fact that all investment markets, sectors and styles are subject to “reversion to the mean.” In other words, nothing outperforms forever, but rather a period of above-trend performance in a given area will typically lead to a period of below-trend performance that brings that area back to its long-term average performance trend.

Given investors’ penchant for chasing returns, one explanation for the significance of this period is that after three years of solid returns, a fund suddenly attracts a huge inflow of assets that the manager cannot reasonably invest in the same style, and so returns suffer. Whatever the cause, it seems that three years represents something close to the average reversion to the mean cycle and it is

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fairly safe to say that when a fund outperforms for three years or more, it is probably too late for investors to still make a profit with that fund in the near term.

It is important to note, of course, that looking at return data is only one part of our process in analyzing a mutual fund, and not the most important part either – that remains talking directly with a fund’s management team to understand their investment process, skills and passion for their work. And our research does not mean that if a fund has been on a great run for two and half years that you have six months of continued success before the run is over. Nor does it mean that no fund will ever outperform for five or even ten consecutive years. For instance, there is one fund that Kobren Insight Management has been consistently (and successfully) recommending to clients for almost ten years.

What these studies do mean is that when considering investing in (or selling) a mutual fund, we view the three-year return as an important (negative) indicator among the others we utilize to make our assessment of the fund’s prospects.

So, the next time you are tempted by that “hot” fund that is getting all the press thanks to a great three-year run, your best bet is to look the other way. n

-- Ben King