



Investment Pitfall #3: Chasing Performance and Trying to Outsmart the Market

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Keith: Welcome to episode five of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode. In today's episode, we'll continue to look at investment mistakes and, in particular, look at two: trying to time the market and chasing performance. We'll review why investors find these actions so appealing. We'll also review why the outcomes of these actions often lead to disappointing returns for investors. Marcelo, let's start with what's an investment mistake?

Marcelo: That's a great question, and I think it's also a great way to start the show, Keith. An investing mistake is a deliberate action which turns into a misstep that can sabotage your financial portfolio and potentially jeopardize your long-term financial security.

Keith: All right, so we definitely don't want to be making these mistakes then.

Marcelo: Absolutely not.

Keith: Okay, so which investment mistakes have we reviewed so far in the show?

Marcelo: Yeah, in the last few episodes, we have reviewed not having an investment philosophy. Then we moved on to building portfolios based on predictions. Now, we will cover trying to time the market and chasing performance, and we'll finish up our series with lack of proper diversification.

Keith: All right. We've been discussing these mistakes, and we have a series of things that we have been covering. Why is understanding these obstacles, pitfalls, and mistakes so critical in our journey to becoming an empowered investor?

Keith: I think when I think back over time and try to see how investors, clients, and individuals we know invest money over time, what becomes clear is individuals can get caught in traps. And to be a successful long-term investor, you need to be playing the long game. In our world, the long game is 10-15 years plus. What ends up happening is that investors can get suckered into playing the short game. The short game comes from noise, which we've spoken about in previous episodes, but it also comes from getting trapped in these pitfalls. These pitfalls end up acting as catalysts and they throw investors off their long game. We will be talking about the long game and we will be talking about what investors should be doing. What are the right actions for the long game? But the problem and the challenge is always investors hopping off the long game and getting suckered into short game moves. That's why we're putting so much emphasis on helping investors become aware of what these issues that pop up are. That's why we're paying attention to investment mistakes.



Marcelo: It's almost like you need to know what you're looking for in order to protect yourself from these things, right?

Keith: Yeah, you need to build up almost an immunity to all of these different issues that come at you all the time.

Marcelo: Absolutely.

Keith: So we've split the show into two segments. Let's get into the first segment on timing the market. What do we mean by trying to time the market?

Marcelo: Timing the market is essentially exiting the market and then entering the market at a different stage. So think about it as an investor trying to outsmart the market. You see a bad situation happening in the market, like we're living now with the coronavirus, and it's simply an investor saying, "I'm going to exit at this point and then I will re-enter at another point." This most likely will happen in anticipation of a prediction or a market event.

Keith: This has nothing to do with an individual stock or trying to pick a winner or a loser. This has to do with what you're saying is moving out of the entire market. So selling stocks in general and moving to cash, and then taking your cash and moving completely back to stocks. That's what you mean by timing the market.

Marcelo: Yes, exactly.

Keith: Why is it so appealing? Why do investors like to do this?

Marcelo: This is a great question. I think it's appealing because it gives you the impression that you're doing something when markets are volatile, when things are happening around you. Like we discussed in the previous episode, you have all these things coming at you from friends, family, the media. People engaging in this type of market timing will always seem like they are doing the reasonable thing. They will try to rationalize their thinking. We see this sometimes with our clients and we hear it from people. Even people who will say they have an investment philosophy or are engaged in a plan, they will come up with these rationalizations about why this time is different and why they should do it.

Keith: We often hear, "Timing the market, you've got to get two trades correct." What do people mean by "You've got to get two trades correct"?

Marcelo: You have to get out at the right time and you have to get back in at the right time as well. If you get one of those two wrong, it can do a lot of harm to a person's portfolio. There are a lot of hypothetical examples. We have one here that is a long study of about 40 years. If you try to time the market—let's say exit at a point and then come back in and you miss the best days in the market—it could end up costing you up to 77 percent of the total returns. Imagine for a client whose goal is financial security. Now imagine what that means when you retire with 30-40 percent less because you engaged in something like market timing. That could have a significant impact on somebody's retirement.

Keith: I got it. I totally agree. In reviewing cycles, what typically happens with many investors is markets have these cycles. In a bear market, they go down for a certain number of months, they hit



the bottom, and then they come back up. What investors tend to do is they tend to sell halfway down or, worst case scenario, all the way down. They feel that if they push sell, they relieve the pain of seeing their portfolio go down. They will then say, "I will wait until I see better things in the economy, until I feel better." But the problem is, because markets look so far in advance, that recoveries occur at times where things don't look good, they don't feel good, and there's absolutely nothing positive in the newspapers.

Marcelo: Absolutely. You look at the best days in the market—they happen during the most violent swings, if you want to call them that. They happen when things are really bad, right?

Keith: They happen at market lows, and that's why those research reports show that when you miss the best days, those best days are typically in the middle of recessions as markets are trying to figure out and rebound. You get some big pops in that first month or two. We've already seen a pretty significant upswing in the last month. That's not to say that it will continue. I think we're in for a choppy, long ride here. Marcelo...

Marcelo: Okay, so chasing performance—how is this different? What does that mean? How is this different from market timing?

Keith: So market timing, I guess, is trying to make these massive moves, getting in and out of equities. Chasing performance, I think, is a bit different because you can describe performance of anything—an individual company, an individual sector, an industrial sector, a style. And what it essentially means is looking at an investment that has gone up significantly in value, liking what you see, and then saying, "I want some of that. I want some of those great returns," and then hopping on at a time where you are hoping to get the next upswing. But what ends up happening all too often is you hop on, and then subsequently a year, two, three, five later, it's come back down a lot. It's like that game where you've got the person on the side of the river and they've got to jump over the logs to get across. You've got to get all these hops, and hopping from one investment to another is a very dangerous strategy.

Marcelo: So Keith, you've been an advisor for a long time. I'm not calling you old, by the way. So we know the stories are so captivating. They captivate the collective imagination, and people have this idea. So it captivates us, right? Can you go over some examples of the stories that you've seen through the years?

Keith: Sure. Let's do this together, though, Marcello. We're going to go through some of the investment fads and some of the... I'm not going to say bubbles, but let's say tremendous rallies in specific investments. We'll start with the 1990s and come right to today, right? And it's amazing to see the difference that changes if you haven't held diversified portfolios. If you've tried to jump from one of these investment ideas to another and you misstep, your portfolio can take a serious beating. So, the 1990s—the early 90s were filled with oil and gas companies and big booms in that sector. I recall as a young bond trader, Altamira Equity was the top fund that everybody wanted to buy. It was run by Frank Mersch, who was considered a superstar. It had a heavy concentration in oil and gas. So most Canadians had this fund. Most Canadians had an opportunity—they heard about it, they saw it. Altamira back then actually had branches, literally retail stores that you could walk into and invest on your own and buy their strategies. But because the performance was so strong in oil and gas, that was the area that was on fire. So people are running into that. Obviously, that's not what's hot right now, but we'll show you some different peaks. In the mid-90s, it was a time for U.S. consumer companies. So back then, mid-95, 96, people were talking about Procter & Gamble,



Johnson & Johnson, Walmart. The granddaddy of all was General Electric. You look at General Electric where it is today, but it was a superstar and it was considered the bellwether stock that every portfolio had to have a piece of. And from 1990 till the year 2000, General Electric went up 800 percent.

Marcelo: It's almost like what Tesla is today, with the effect Elon Musk has. Jack Welch had that same effect with GE. You have this messianic complex of a CEO and the aura around a company, right?

Keith: Oh, books were written, strategies were drawn up. Now fast forward to today—GE has lost 90 percent of its value, unfortunately. Back then, pharmaceuticals were a huge place in the mid-to-late 90s. Everybody said you've got to own a ton of pharmaceuticals. Pharmaceuticals from 2000 to 2008 subsequently lost something like 60 or 70 percent of their value. They gained four or 500 percent and then they lose most of it after seven or eight years. These are big fads, big trends that people are trying to chase at that point. And we saw a lot of chasing. Then, of course, the late 90s were filled with technology stocks and technology plays. We're not just talking .coms that really didn't have much business substance; we're talking about some pretty major players. Intel was the big company, Dell Computers, Lucent. Canada even had Northern Telecom in the picture. Microsoft—these were massive companies that did extremely well. And then we saw the dot-com or the technology bust. I lived through this period. And then all of a sudden from 2002 to 2007, we're back to oil. We're back to this strategy that was working a decade or two before and now is resurfacing as the top performing asset class.

Marcelo: It's a rollercoaster.

Keith: Absolutely. Income trusts were massive, and income trusts were predicated on giving income back to investors. And most Canadians back then, when oil was approaching 150, when the Canadian dollar was above the U.S. dollar, when oil and gas had done so well, and when Americans were in the middle of their lost decade—the lost decade based on that 2000 bubble—Canadians thought, "My God, the only thing to invest in is anything Canadian and anything resource."

Marcelo: Did you ever watch BNN, Marcelo?

Marcelo: Yes, I know what it is.

Keith: It's a show that's been around for a while, but I remember in 2006, 2007, watching BNN just to understand what's going on with these types of shows. And the only thing they were talking about was oil and gas. Every question was about oil and gas. Every commentator was discussing oil and gas. You couldn't have one single story on technology. Now you tell somebody in today's market that, guess what? In 2007, nobody cared about technology. Microsoft at that point had actually lost 70 percent of its value from the double-O period. Triple-Q, which was that Nasdaq exchange-traded fund, had lost 70 percent of its value. And the world was talking about commodities. It's amazing how these cycles come and go, and this performance is so remarkable at that given point in time—so enticing—and people so want to be a part of it. And then four or five years later, they realize, "My goodness, it hasn't done what I thought it would do," because they bought at the high.

Marcelo: Yeah. I remember when I first got to Canada, it was like 2007, and I was all excited to be subscribing to The Economist and I was reading all these publications. And I remember the two



things in Canada that people talked about the most in terms of investing were oil and Research In Motion. That was a big thing back then.

Keith: Yeah, so Research In Motion went from a 10-dollar stock to a 137-dollar stock during that period. You're up in the 4000 percent return range. How do you not get attracted by that kind of rocket ship going up?

Marcelo: Of course.

Keith: Unfortunately, as a Canadian, I would have loved to see that as a true Canadian success story, but the iPhone was invented, and then it was done.

Marcelo: And again, it's so hard, right? Because these things come out of the blue and you can't pretty much predict what's going to happen.

Keith: Yeah, so I actually think it's harder for Canadians because Canadians have access to all of the global companies. So we have access to all of the U.S. companies, all the technology companies, but we're also heavily influenced by resources. A little less so today, but definitely in the last two, three years, you can see how this has influenced sort of the investor psychology. It puts all these massive waves that you're trying to hop onto in the forefront, and that's a very dangerous thing to try to get onto. That's why we call chasing performance so dangerous.

Marcelo: Yeah.

Keith: Marcelo, what have you seen since 2010 till today? Let's wrap up this history of movement. What have you seen in the last 10 years?

Marcelo: Yeah, let's wrap the rollercoaster here. So, I think the three biggest things I've seen—really like stocks shooting up and then some of them coming down really hard—were Valiant back in 2015. This was the zeitgeist company back then. Everybody was talking about it, and it didn't help also that Bill Ackman, this high-profile hedge fund manager, was involved in it. The peak was 335. I remember at one point it became the largest company in Canada by market cap. So it became larger than RBC and it became the largest stock in the TSX, which is crazy. Then you look at where it is today and it's a 25-dollar stock. Of course, there was fraudulent activity and everybody knows about that, but it's easy to see how somebody can get caught up. Then we have the weed companies. Canopy Growth at the peak was 51 back in 2018. Now it's a 16-dollar stock. So that's a pretty steep decline. You can see the same pattern. It starts very low and then it just shoots up. Shopify—now Shopify is our darling stock right now. It was 53 back in 2016. Now it's 882. So the psychology of the market captivates your imagination, and it's hard for people not to get sucked in.

Keith: Yeah. Investors want a piece of all these stories. In the last 30 years, they've all run after these stories. The challenge is most of the investors would admit that they never bought at the low. They tend to buy either halfway up or all the way up, and then a year, two, five, 10 later, they might be disappointed. This speaks to why we're always talking about maintaining high levels of diversification. In the last, I would say, four years now, we all know that the FAANG stocks and the technology stocks have really become the high-priced securities. They're the high-growth companies for sure. But now, I think I saw in the Globe and Mail even this morning, they represent the highest percentage of the S&P in the last 50 years.



Marcelo: It's crazy.

Keith: Five stocks have done that. And then, of course, we've got a little bit of discussion around digital stocks or social distancing stocks. So that's a heck of a rollercoaster ride from the early 1990s till today—all these incredible ups and downs. This is what we're talking about. Even styles have seen that. So value companies versus growth companies—these different styles have gone up and down. Value was huge in the mid-90s, then growth in the late 90s, then value from 2000 to 2010, then growth from 2010 till today. Who knows what the next 10 years will be, but you definitely need to maintain consistency and protect yourself from trying to hop onto these massive price appreciations because you just don't know what will happen. Or at least maintain high levels of diversification. There's nothing wrong with owning these companies, but make sure they don't own too much of a portfolio or get caught up in these fads. Why do you think investors chase?

Marcelo: I think it boils down to one thing, and we've heard this term before: FOMO. It's fear of missing out. You get this urge of wanting to do something, and you have this feeling that if you sit this one out, you will really regret it. We know from history, Keith, that even the smartest people are prone to falling for these stories. We talked about Sir Isaac Newton with the South Sea Company bubble. He got sucked in and then he ended up losing everything. Nobody's exempt. We can all fall for it.

Keith: Yeah, that was the story you brought up a couple of shows ago where you essentially said, I think it was his friends that were making money and he felt envious, or maybe his friends had convinced him to buy. But somehow there was a social influence in there. For even somebody as astute and brilliant as he was, he still got caught in chasing performance. That's a great story. What does the evidence show? Let's switch gears a little bit here and now talk about money managers because individuals can chase money manager performance too. We just walked through individual companies, sectors, styles. Now let's talk about managers.

Marcelo: I think this is a good topic to talk about because most Canadians will probably invest through a portfolio manager or a mutual fund company. The SPIVA report, which is done by Standard & Poor's—I love this report, Keith, because it's statistically significant, meaning they have a methodology that's very sound in the way they measure things. What the study wanted to know is if you look at the managers that outperformed their benchmark, how many of them keep winning after one, two, and three years? Again, it boils down to do the winners keep winning, right? So if we look at, and we'll be posting this study in the notes, but if you look at the largest area of the market that people are most familiar with—the S&P 500, which is the 500 largest companies in the United States—they analyzed 938 funds that benchmarked themselves against this area of the market. Of those 938 funds, 10.5 percent outperformed the benchmark. So they did better than the benchmark. Now, if you look at that percentage after one year, 58.5 percent kept winning, so they kept outperforming the benchmark. If you fast forward to two years, 50.5 percent kept outperforming. So you see how it's going down, but here's where it gets interesting. At the third year, of the 10.5 percent, zero outperformed the benchmark.

Keith: Wow. So you're talking about the S&P 500, and let's be clear, as we go down this report, there are 18 asset classes within the U.S. They have large-cap, they have value, growth. They have mid-cap, value, growth. They have small-cap, value, growth. So we're not just talking about this phenomenon that most managers can't match the S&P 500 because of the FAANG stocks that are pushing it forward. What's happening in this whole series of data is that 75 percent of these



categories have almost downward declines. In other words, the winners do not win again. Why are we looking at this? Why is this important? Is it because people try to pick winners? Why do we care?

Marcelo: We have to care because most Canadians will say, "Yeah, I have an investment advisor who picks winners. He selects mutual fund managers." So what the evidence shows is that, yes, there are some that will outperform, but we know from the data that it's so hard to keep doing it. If you look at the other areas of the market that you mentioned, let's look at large-cap growth, for example, which is like the FAANG stocks. So if you look at the S&P 500 growth benchmark, which is the growth companies that compete against that benchmark, the mutual fund companies that benchmark themselves against that area—275 funds. Only 5.8 percent outperformed, right? If you fast forward to three years...

Keith: Zero continue to win. You're right. I know one of the reasons why we're bringing this up is that when investors go to advisory firms or financial institutions or even do it themselves, we have a propensity to want to hear the following: "You're being proposed a manager because they're a top performer." I don't want to see that person that's in the middle. I want to see the top performer. The problem is the top performer doesn't stay the top performer. You get shown a top performer, you go, "Wow, I really like that. Let's go ahead and invest." And then three years later, you're having a conversation with your advisor saying, "Why is this not the top performer anymore?" And that has to do with consistency. This gets back to really the way to do it is to have a proper investment approach with a proper investment philosophy and then stick to your knitting.

Marcelo: Another thing Canadians will be familiar with is the Morningstar ratings. Morningstar has a ranking system of five stars, right? So five being the best, one implying that it's not a very good fund. Vanguard had a fantastic study over a long period of time. Essentially, they looked at what happens after the funds get their rating. For example, if you're a mutual fund and you get a five-star rating, what happens after that? We have a nice graph here, and we'll put it in the show notes. Essentially, you'll see the inflows and outflows of funds after they get their rating. Most of the money goes to the five-star and the four-star funds. In the five-year period after they get their rating, the three, two, and one-star funds get negative outflows. So money is coming out of them, whereas the four and five get the most money into them. Now, this is where it gets super interesting. What happens in a 36-month period after the funds get the rating? After the five-star funds got their five-star rating, they underperformed the benchmark by about 1.3 percent.

Keith: And the numbers are shocking here relative to one-stars. It's completely counterintuitive. The best performance was the one-star.

Marcelo: Yep.

Keith: This is a great report because it's from 1992 to 2012, so 20 years. There are a couple of hard bear markets in there. There are plenty of opportunities for five-star managers to shine. First of all, they don't shine because we know that the results over long periods of time underperform. But what we're really speaking to here is cash flows and what people are doing, and they're investing in five-star managers and then getting one-star returns. This is a great example of individuals chasing what would be performance and not staying the path. This whole idea of bouncing from one investment idea—whether it be an individual stock, a sector, or a manager—trying to jump onto this wave going up gets you into trouble.



Marcelo: We talked about these two mistakes: timing the market and chasing performance. What are the consequences for investors falling for these mistakes?

Keith: We were hinting at it before, but essentially, it's falling short of your financial goals. You run the risk of not getting the returns you should be getting through a standard diversified long-term portfolio. You run the risk of getting worse returns, which means falling short on your financial goals. You run the risk of underperformance, and that's pretty straightforward. The untold issue that also comes through is you will have more stress and anxiety throughout that whole period because you're always going to be worried about, "Am I making the right decision as I move things around while I play the short game? How am I doing? When should I move?" So you end up with this, I think we've mentioned it in previous shows, double negative—bad results and not feeling great. All of this is manageable. It's manageable through a much better way of investing.

Marcelo: How do we not succumb to pitfalls in general?

Marcelo: That's a great question. I think the first thing is being aware is the most critical thing. If you don't know what you need to protect yourself against, it's hard to protect yourself against those things. So that's the first thing—it's continuing education, learning how to identify these things. Then, adopting and following an evidence-based investment philosophy, which we will be getting into, but this will set up the framework and set up a roadmap of the rules and things you should and shouldn't do. Once you have that, that's the recipe for success.

Keith: Yeah, you mentioned sort of a guideline. Part of this, the Empowered Investor, is trying to share with listeners and Canadians to help them along the way, show them what things they need to do. But in particular, the first few shows that we're doing right now, we're really talking about what things to stay away from, what to be careful of because that can have a pretty significant impact.

Marcelo: Absolutely.

Keith: What's in store for our next episode, Marcelo?

Marcelo: In our next episode, we're going to have one more investment pitfall to look at, and that will be lack of proper diversification. Everybody hears about it. Everybody will say things like, "I think I can diversify quite well. I think I am diversified," but we're going to share some stories about individuals who may have thought they were diversified and why they're not. We'll talk about some of these concepts at large. So everybody, thank you for tuning in to episode five of the Empowered Investor. Stay well, be safe, and we'll see you in two weeks for our next episode. Thank you, everybody.

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