PRUDENTIAL **INSIGHTS**

Prudential Investment Managers

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The past-performance trap

You've probably heard the message time and time again: that past performance is no guarantee of future performance. And while in your head you know that it's true… in your heart you simply can't help but look at past performance when deciding on where to invest your hard-earned money.

The big question is why? Why, despite the disclaimer and common sense, do so many investors fall into the trap of making their investment decisions based mainly – or entirely – on performance?

The reason is surprisingly simple. Given the unknowns of the future, we have an inherent need to base our decisions on something that's tangible, something that gives us a sense of security… and past returns ticks all of these boxes. What's more, it's psychologically very difficult to invest in something that has been delivering poor returns, or to purposefully avoid an investment that has historically outperformed its benchmark and peers.

As humans we also have a weakness for ascribing more importance to things that are recent. This is called "recency bias" and it means that, if the equity market has been weak lately, you tend to think of it more negatively than what you would have in the past, and incorporate that into your decisions. So you may end up making a bad investment decision by avoiding funds with poor recent returns.

Dangers in relying on past performance data are that you might not be looking at an appropriate time span, or using the correct return measure. If an investment has wobbled a bit over the past three years, but has delivered excellent returns over the past two decades, should you look at the recent results as an indication of the fund manager's ability to meet its mandate? And what about bull and bear markets ? If the market struggles , as South Africa's has over the past four years or so, is it really fair to look only at returns over this period? And if so, are you looking at the fund's absolute return, or its return relative to its benchmark or versus its peers?

The good news is that you can use an investment manager's track record to help you decide where to invest – but just be sure that it is a long time period you're looking at – i.e. 15 or 20 years or longer. This will capture the manager's performance through all the different economic and financial market cycles, and will be able to give you an indication of their consistency. At the same time, you can compare the performance of various investment managers across different cycles, to see who performs reliably. This would mean comparing each fund's performance relative to its own benchmark. Remember, the benchmark is the return you're trying to outperform over time, and if a fund consistently achieves this, then you shouldn't worry about short-term underperformance (it's the long-term picture that counts).

When you speak to your financial adviser, they'll be sure to remind you about the pitfalls of using past performance as an indication of future returns, and of choosing the hottest fund of the moment through performance-chasing . Rather, as part of a more holistic assessment, they should tell you about other measures to help you choose a fund. This would include information like how long the investment team has been together, what level of IT systems and infrastructure they have in place to safeguard your money, measure risk and comply with all of the strict regulations in place.

So in short, when choosing an investment it's important to choose a fund that is aligned to your investment goals, that is run by a fund manager that you can trust and that has a solid long-term track record. At Prudential, for example, our Equity, Dividend Maximiser and Inflation Plus Funds are all ranked in the top-quartile of their ASISA categories in terms of performance over the past 15 years*. While long-term performance is important, it shouldn't form the unique basis of your investment decision.

For more information speak to your financial adviser. Alternatively, feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.

**Source: Morningstar as at 30 June 2019*