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Performance Cycles Not Well Understood

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Performance cycles for most stock funds are more prolonged and swing to far greater extremes than most investors realize. The performance cycle for any fund is usually more reflective of the fund style than the fund itself. Many investors equate poor fund performance to a poorly managed fund. Most of the time this observation is far from the truth. Poor performance is usually a matter of an investment style that has gone out of favor.

Let's look at the T. Rowe Price New Horizons Fund which has one of the longest and best track records among all mutual funds. The table below shows a comparison of returns between this fund and the S&P 500 going back to 1961, so it offers a good long-term perspective on the fund and its growth investment style. As can be seen in the table, each cycle tended to be long in duration with very wide extremes. Since 1961, five of the nine cycles were characterized by a performance differential relative to the S&P 500 of 100 points or more. Its worst cycle lasted ten years in the 1980s and its best cycle is still intact since 2003.

New Horizons vs. S&P 500 Relative Performance

Period	Years	New Horizons	S&P 500	Differential
1961-64	4	-7%	+66%	-73
1965-72	8	+500	+80	+420
1973-76	4	-45	+7	-52
1977-80	4	+168	+55	+113
1980-90	10	+83	+267	-184
1991-95	4	+220	+115	+105
1996-98	3	+37	+11	-74
1999-02	4	-7	-30	+23
2003-18	16	706	196	+510

New Horizons Fund went through some very bad years and several prolonged periods of poor relative performance during its 58-year life. Investors willing to stick with that fund which regularly adhered to its investment style even in bad periods were richly rewarded over the full term as shown in the table.

Growth of $1000 during 1961-2018

	New Horizons	S&P 500
1961	$1,000	$1,000
2018	$538,791	$227,894

Many investors unknowingly will purchase an equity fund toward the end of its in-favor performance cycle and right before the out-of-favor performance cycle begins. Investors will sometimes decide to dump that fund based on disappointing short-term results even if its superior long-term track record in still intact. The most successful investors will tell you that there are only two good reasons for selling a poor performing fund and neither of these is related to performance. First, a fund should be sold if it departs from its investment style since its style was a compelling reason to buy it in the first place. Second, a fund should be sold if its manager who built the track record is no longer there. Putting trust into a new manager with no performance record is taking a giant leap of faith.

In conclusion, investors would be better served by staying put in their funds for at least 10 years and not jumping around in search of the best returns. This is borne out by a study on mutual fund investors who lost patience with their funds by jumping in and out. These investors only achieved 30% of the S&P 500 return during the 1990s according to Financial Research Corporation. Furthermore, Putnam Investments studied investors in their Growth Fund and found that the jumpers earned just 25% of the overall fund return over a ten- year period.

History demonstrates that periods with good returns are frequently followed by periods with bad returns. History also demonstrates that good performance tends to repeat itself after bad periods if the fund remains in the same style and the manager is the same. Investors having a better understanding of the intricacies in performance cycles will be able to make better investment decisions going forward. In turn, such investors will be more richly rewarded over the long term.