Chasing performance is a dead end

Wouldn't it be great if someone invented a foolproof pop-up warning to alert investors whenever they were about to make an investment mistake? Some of the strategies that would trigger pop-ups happen to be those that many investors just can't seem to resist, even though disappointing results often follow.

Chasing performance

The most common of these tempting investment strategies may be performance chasing — choosing investments based only on their recent results. Many investors assume that an investment that has had outstanding returns during the past month or year will continue performing well in the future. So, moving money into the investment seems like a reasonable move.

Unfortunately, investors who chase performance often buy when prices are near their peak and sell when they are at or near the bottom. And, that's directly contrary to a basic principle of successful investing: buy low and sell high.

The steep rise of tech stocks and their sharp fall is a classic example of the risk involved in chasing hot performance. The tech-heavy NASDAQ stock index returned 85.6% in 1999, then fell almost 40% in 2000 and an additional 21% in 2001.

A study by the consulting firm DALBAR examined the effect of chasing returns between 1984 and 2003. Investors in stock mutual funds who frequently traded out of funds during that period earned an average annual return of 3.51%. In contrast, the market, as measured by the S&P 500® Index, earned a 12.98% average annual return.

Trading frequently

Chasing performance has a second drawback. The transaction costs involved in frequent trading also tend to depress investor returns.

Overestimating the news

Another common mistake investors make is letting the news or other investors guide their investment decisions. Reports of high earnings, analyst recommendations and many other influences can quickly push up a stock's price. When a stock is rapidly rising, many investors want to get on board to share in the gains. But, prices can fall again when the news or buzz fades. By the time an investor reacts, most of the run up in price may be past. There's no way of telling whether the price will continue to advance.

The announcement of a stock split can make a company's stock seem more attractive. Good media coverage and the increased demand that often follows a split boost the stock. But, a stock split doesn't change a company's fundamental value. Once the split is no longer news, the value of the stock continues to reflect the company's earnings, market position, management and other factors. So, it's a mistake to base a buying decision on news of a split without carefully considering the stock's quality.

Stick to the basics

If relying on past performance and reacting to investment news aren't reliable strategies for making decisions, what is a good strategy? It's very basic. Analyze your goals, time frame and risk tolerance. Then, buy a diversified portfolio of investments that reflects your plan. Include different asset classes — stocks, bonds and cash equivalents — and

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plan to hold the investments unless there are legitimate reasons to make changes. A balanced and disciplined approach can help an investor weather inevitable short-term volatility in the markets while taking advantage of long-term performance trends.

For further information on financial planning

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