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Why Investment Performance Is a Distraction

Successful investing stems from process, not goals

We see the disclaimer way too often. *"Past performance is no guarantee of future results."* It is massively over-used—plastered on countless investment reports, statements and research. It's not simply meaningless; it's as if it's not even there. And that creates a huge problem, because the message itself is really true: *Past performance has no predictive value*.

Since we are looking for something that does have predictive value—all the research, experience and hard facts say: Look elsewhere.

This is not a controversial finding. There are no fringe groups of investors or scholars penning op-ed pieces in the *Wall Street Journal* shooting holes in the logic of this reality. Each year there is more data, and each year that data reconfirms that past performance is completely unreliable as an investment tool. Given all that, you would think it would be next to impossible to find any serious investors still using past performance as a guideline. Indeed, that would be a logical conclusion.

But logical conclusions are often wrong when it comes to understanding human behavior. Not only does past performance remain an important issue in the minds of investors, for the vast majority it is the *primary* issue. In a study I referred to in my August column, 80% of the hiring decisions of large and sophisticated institutional pension plans were the direct result of outstanding past performance, especially recent performance.

The reason investors and the investment industry rely on performance is because it's simple, objective and easy to measure. But more importantly, performance goals, performance reviews and performance measurement are so common in business, in sports, in education, in investing—almost everywhere—that *not* using them feels uncomfortable.

The alternative, evaluating and observing the managers and their process, is far more subjective and the results are not nearly as straightforward. But *process* is a much better predictive tool in the search for future success—and the most successful people in their fields focus on it *and only it*.

For anyone who follows college football, Nick Saban is *the man*. His teams have won four of the last 10 BCS championships, and he boasts a lifetime record of 154-55-1. His extraordinary success has generated huge interest in his coaching style. In a recent *Forbes* interview Saban emphasized that he teaches his players not to think about winning or losing, but rather to focus only on the processes that will lead to success.

Not About Results

Studies of Olympic athletes show that, with rare exception, physical ability alone is not enough to differentiate between medal contenders. The difference between winning and losing is much more a function of mental focus and technique—which are finely honed during years and years of practice. When asked what they focused on during competition, all of the medalists said their attention was on executing their process, not on the end result.

In business, focusing on the end result (performance goals) may show results over the short term, but in the long run is actually damaging and counterproductive. A recent article in the*Harvard Business Review* is titled "Consider Not Setting Goals in 2013." The point of the article and others like it is that too much focus on performance goals is not a healthy business practice. But performance goals are easy to set, easy to measure, easy to reward— and hard to give up.

In health care, performance goals have gradually crept into an environment where we expect objective science to set the rules. For instance, total cholesterol has been known as an inaccurate predictor of heart disease for decades—as many people with low cholesterol develop coronary heart disease as those with high cholesterol. Yet drugs that lower total cholesterol are effective, easy to measure and the source of billions of dollars of profit for large pharmaceutical firms. The result creates an incentive structure more appropriate to short-term profits than producing the best science or health.
In education, performance measurement by the top two standardized tests (SAT & ACT) is still the primary tool for discriminating among potential college students. But a growing body of evidence demonstrates that non-cognitive traits such as determination, motivation, perseverance, good study habits and time-management skills are far more predictive of success in college than SAT scores. Children who work to internalize these traits end up with a process of learning that leads to success not just in college but in life itself.

We live in a world where we expect a *number*, a score—a simple yet definitive measure that tells us the difference between the winners and the losers. Testing for grit, determination or perseverance doesn't easily lend itself to quantification. The concreteness of a *bottom line* number has led us to favor convenience over comprehensiveness, quantity over quality and simplicity over usefulness.

The reason Nick Saban, our best athletes, leading scientists, creative educators, and successful investors focus on *process* is because it anchors them in reality and helps them make sensible choices—especially in challenging times. Without that anchor any investor observing the investment world today would be intimidated by its complexity, uncomfortable with its volatility and (after the meltdown in 2008) visibly fearful of its fragility. Of course we all want good returns—but those who use a healthy process realize that performance is not a *goal*; performance is a *result*. This is such an obvious truth—but the investment world doesn't care about *obvious*, it cares about performance.

Opportunity Pockets
In my August column I referred to David Tuckett's astonishing research, which detailed the extent that obsession over performance has infected and perverted the investment activity of a large portion of even the largest and most successful investment management firms. Yet there are still two notable pockets of opportunity where we can find funds and fund managers that focus exclusively on process—one relatively small and the other very large.

There is a small universe of talented and successful investor/managers who run funds that do not stray from their (human and evolving) investment process, irrelevant to market direction, investor sentiment or headlines.

Most of these managers invest heavily in their own funds and could care less about benchmarks, sectors or asset classes. They are just buying businesses—one at a time—and holding them, sometimes for decades. They keep to their knitting, learn from their mistakes and don't sweat over the things they can't control.

It might surprise you to learn that the single most popular investment choice today are specialized funds driven purely by process; but I doubt investors are thinking in those terms when they decide to buy *index funds*. Even though the process of an index fund is mechanical and unvarying, index funds still outperform most managed funds. And thanks to Dr. Tuckett we know why: In an obsessive but fruitless drive for performance too many fund managers compromise the single most important weapon in their arsenal: their investment process.

Now we can see the flaw in the argument that an investor's basic choice is *active or passive.* An investor indeed has two choices: whether to be *goal* oriented or *process* oriented. In reframing the investment challenge that way, the answer is self-evident and the only decision is whether to favor a mechanical process or a human one. We cast our time and money far and wide in search of any possible edge. How ironic it is that the biggest edge is right in front of our noses and our unseeing eyes—free for the taking: *"Past performance is no guarantee of future results."*