# *Never invest solely because of superior past mutual fund and ETF performance*

**Category : Financial Decision Rules**

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*Summary: A previous article, “The Solution - ONLY follow financial strategies that are scientific, passive, diversified, savings focused, risk controlled, low cost, and tax efficient,” suggested that individuals are much better off with a well-considered financial viewpoint. A stable set of financial beliefs can help you to keep focused and on track throughout your life. This follow-up article discusses why you should not invest solely because of superior past performance.* Superior past fund performance does NOT predict superior future performance. Only very poor past performance tends to be a slight predictor of more poor performance in the future, and excessive investment costs are the likely culprit. Many individual investors rush around buying securities and funds that did better than average in the past. This practice demonstrates a naïve hope that such investments will deliver better returns in the future.The investment industry understands that people naively buy funds because of superior historical performance records. Therefore, they market only their successful funds, and they conveniently leave their laggard funds out of their promotions. The securities industry feeds this frenzy by selectively advertising funds that did better than average in the past. (See: How Morningstar Ratings for mutual funds are used as a marketing tool)In particular, many investors buy funds based on four star and five star Morningstar Ratings hoping to achieve superior future performance. Unfortunately, there is no reason to believe that these star ratings indicate superior future performance. At best, superior past performance is only a mirage. At worst, chasing it will waste your time and can entice you to pay excessive fees for future gross performance that is likely just to be mediocre, before your investment costs, taxes, and time are taken into account. Higher fees usually tend to lead to lower net performance. (See: Do mutual fund Morningstar Ratings changes influence individual investors?, Do Morningstar Ratings predict risk-adjusted equity mutual fund performance?, and What might be wrong with buying a mutual fund with a 4 or 5 star Morningstar Rating?)Very low cost index mutual and exchange-traded funds track the broad markets and tend to deliver better performance after costs and taxes are taken into account. Market index funds will not have “superior” performance, because their objective is to track the market return. Investors need to overcome the false idea that superior past performance is a viable method to select investments. Instead, they need to understand that "mediocre" index mutual funds and ETFs more reliably achieve close to a market return with much less volatility and much lower costs. Therefore, the pursuit of "mediocrity" is a superior strategy, because those who pursue superiority are more likely to end up with inferior net performance -- below the mediocrity of the market return. (See: Scientific mutual fund and ETF screening criteria -- a summary)Everyone naturally avoids inferior performance, which in its worst form can be a very slight indicator of inferior future performance. Again, excessive costs are the likely culprit, when highly inferior historical performance persists. (See: Evaluate historical investment performance, but only after using other investment screening criteria)Finally, beware of any recently discovered alternative “asset class” that is being promoted to you. These include the 31+ flavors of hedge funds, precious metals, managed commodities futures, and other “new asset classes.” Typically, with past hot streak value appreciation as bait, investors are encouraged to allocate a portion of their portfolio to these supposedly new asset classes to earn higher returns with presumably lower overall portfolio risk. The high cost of investing in this new asset class will often be a tip off to problems ahead. Furthermore, when you look closely at the data, past superior performance data often may be highly suspect, and the true risks may be understated substantially.

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