

## **How to lie with statistics: Investment performance charts (Part 2 of 2)**

**Category : Are Your Best Interests the Same as the Financial Services Industry?**

**Published by [The Skilled Investor](#) on Jun/25/2007**

How to lie with statistics: Investment performance charts (Part 2 of 2)

**3) HARD TO INTERPRET CUMULATIVE HISTORICAL PERFORMANCE CHARTS.** For humor, [let's assume for a moment that historical ETF and mutual fund performance charts actually do have some useful information for individual investors.](#)

[\(This might not actually be very funny to many fund investors who have been lured into lousy and expensive investments because of historical performance charts. It can be hard to see humor, when the securities industry siphons away your assets through high management fees using the siren song of superior historical performance charts. The cover-your-ass small legal print in the footnote of the performance chart is actually right. Essentially, it says, "Don't count on it." And, you should not.\)](#)

[Interpreting rates of change from a cumulative performance chart is a challenge for many people.](#)

[Visually, cumulative historical ETF and mutual fund performance charts are just very difficult to interpret. Most people would only look at the most recent values to see whether the fund's cumulative performance to date is above or below the index. Well, of course, if you are being sold to or advertised to, then the most recent cumulative performance will always be above the market index benchmark, because of selectivity \(#1 above, "Selecting only "winners" to promote\). This is the easiest kind of fund to sell to naive individual investors -- you know, "good" funds with "better" performance. However, an ETF or mutual fund's performance history that would truly exhibit investment management skill \(or just a sting of good luck\) is the relative rate of change in fund versus index benchmark asset valuation. The rate of change between the investment fund's historical performance and the market index benchmark is what counts. A consistently superior ETF or mutual fund would have a cumulative performance line that increasingly and consistently diverges from the benchmark index. Visually, the wedge between the two lines should just keep widening. \(On the other hand, a widening wedge could also describe the situation of an overly easy market index benchmark comparison and mediocre ETF or mutual fund performance. \(#2 above, "Easy index benchmarking\) Rarely do you see historical ETF or mutual fund performance graphs with increasingly widening lines -- particularly since luck is a major factor and high investment management fees and high trading costs tend to drag fund performance down relative to appropriate market index benchmarks. If, for example, the lines diverged quickly ten years ago and then they maintained a relatively constant gap thereafter, that could mean that a very small and immature fund got lucky and/or it had a riskier investment portfolio profile. Then, money from performance chasing individual investors flowed in, and the fund got much larger. If the gap between the lines on the chart does not increasingly widen, then this means that subsequent performance has just been mediocre. If the lines tend to narrow that demonstrates subsequent inferior performance. Cumulative performance could still be above the index due to a selectivity bias and/or an easy index benchmark, but the fund might really have been exhibiting mediocre or inferior performance for years. 4\)](#)

**4) INDUSTRY CYNICISM ABOUT UNSOPHISTICATED INDIVIDUAL INVESTORS.** [The securities industry knows that chasing historical performance is bad for individual investors, but they encourage this behavior by publishing historical performance charts and 4 star and 5 star Morningstar Ratings, which are also largely meaningless. For the industry not to know would imply that many very smart](#)

[professional investment managers have had their heads in the sand about decades of financial research. \(Concerning Morningstar Ratings, see articles in this category on \*The Skilled Investor\* website: Ratings Services: Morningstar \(16 articles\) and "Investment astrology &ndash; should you pick investments according to the Morningstars?" \)](#)The securities industry and many of its brokers and investment advisors know that low cost index strategies are better for individual investors. However, the "active-management-beat-the-market" industry crowd will not make any money off of you, if they tell you that. They have to push the "we deliver superior performance" mantra, because that is the justification for their excessively high and performance killing fees. Since market realities make it virtually impossible for actively managed funds to consistently beat the market after their fees, they have to resort to promises, deceptions, and what Darrel Huff would call "statistical" lies. These lies include: #1 selecting only winners to promote, #2 easy index benchmarking, and #3 hard to interpret cumulative historical performance charts.

Those in the industry who do not understand this have not bothered to do their homework. And, why should they? If these superior performance hustlers learned what is good for individual investors, they might also realize that they should find another career that adds some genuine value to our society. **CONCLUSION: How one fund family solves this problem -- They refuse to play the game.**

In the same issue of the *Journal of Indexes*, which published the Israelsen article referenced above about variance among index benchmarks, there was a ["Straight Talk" interview with John Brennan, CEO of the Vanguard Group](#), who succeeded John Bogle in 1996. (Pages 24-25, 50) When asked about performance chasing, Brennan said the following: "The way(s) you mitigate against it are several. One, you never -- in our view -- never promote performance. You just never run a performance ad. I think that is endemic to our business, and I think it's a shame for our industry. When you read a performance ad, there is an assumption that the strong performance will continue. And that is not necessarily true. The second thing is ... when you call Vanguard to talk about our funds, or when you read our literature, you won't find a Morningstar Star Rating. ... The third way to mitigate is with communication. When you read our annual reports after a terrific year, you can be sure that we will tell investors, "please don't assume that this will continue." ... Finally, you also have to be willing and able to close a fund and have a cooling off period. That's bad for business, and it always inspires some nasty letters. But it's how you build a performance track record. I have never once regretted closing a fund. At the end of the day, firms that promote performance do so at their own peril." (And, *The Skilled Investor* would add -- at the peril of their clients, i.e. you!)

(Note that there is no business relationship between *The Skilled Investor Blog* or website and the Vanguard Group. *The Skilled Investor* has not received any kind of compensation for this article. Note, also, that some of *The Skilled Investor's* personal family assets have been invested in Vanguard's index funds for many years.)