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The Trouble with Trailing Returns

Is there a better way to explain portfolio performance?

Morningstar Investment Services Commentary

Trailing returns are the go-to yardstick for investors interested in assessing performance. But do they tell the complete story? In this commentary, we'll describe their limitations and discuss additional measures investors can use to better understand the entire performance picture.

Overused, Misunderstood

Trailing returns are annualized returns over specific trailing periods. Since they can span both the very near term (one-year or less) and also longer stretches like five and 10 years, they often serve as a one-stop shop for investors interested in analyzing a strategy's performance over a range of time periods.

Unfortunately, investors who rely solely on trailing returns for their performance analysis are getting an incomplete picture at best. For one, trailing returns are highly market-environment dependent. While that may come as no surprise over shorter stretches, it's often also the case over longer periods as well.

Take the trailing five years, a favorite time horizon for investors interested in assessing "long-term" performance. In some market environments a five-year period can represent a full market cycle, but occasionally directional markets can last longer than many expect, making a trailing five-year period representative of only a market upswing or downswing.

That's the case for the trailing five years ending May 31, 2015. Over this stretch, the S&P 500 Index is up an annualized 17%, and its gains haven't come at the cost of any corrections large enough to represent a bear market. With a five-year period that captures only the upswing of a complete market cycle, it's no surprise riskier strategies, for

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example, those that prefer speculative growth stories to a margin of safety, have tended to outperform their more conservative counterparts.

Another strike against trailing returns is their susceptibility to major market swings. As periods of significant loss or significant gain roll on and off a particular trailing period, the trailing return can change dramatically. Consider the table below, which collects the trailing five-year returns for major equity markets that end immediately before the financial crisis, those that include the 2008 bloodbath, and the trailing five years that begin in 2009. The start and end dates vary only modestly, but the range in five-year returns is extreme. In the case of emerging-markets stocks, returns span nearly 30 percentage points when we move the five-year end date from 2007 to 2008.

Asset Class	Index				Return
		1/2003 –12/2007	1/2004 –12/2008	01/2008 –12/2012	01/2009 –12/2013
U.S. Large-Cap Stocks	S&P 500 Index	12.83	–2.19	1.66	17.94
U.S. Small-Cap Stocks	Russell 2000 Index	16.25	–0.93	3.56	20.08
Non-U.S. Developed Stocks	MSCI EAFE Index	21.59	1.66	–3.69	12.44
Emerging-Markets Stocks	MSCI Emerging Markets Stocks	37.02	7.66	–0.92	14.79

Source: Morningstar Direct.

Of course, the 2008 and 2009 period is unusual; nevertheless, it underscores the volatility inflection points can create for even longer-term trailing periods, thereby impairing their ability to guide return expectations.

One final sticking point: Trailing returns tell only part of the story. Since they measure only the return quotient, they offer no insight into the risk that the strategy undertook to achieve its gains (or losses). That's an important consideration, since Morningstar, Inc. research shows that investors have a hard time hanging onto volatile funds, even when the final outcome is a good one.

To demonstrate as much, we took a look at the U.S. large-blend fund category over the trailing 10 years ending May 31, 2015. To assess the average investor's experience, we compared total returns with Investor Returns, which weight trailing returns by asset flows to proxy the typical investor's return. While the data show that investors have had a hard time collecting all the gains available to them over the trailing 10 years in general, we found they had a particularly hard time with the more volatile funds: The return gap between trailing returns and Investor Returns widened from negative 1.24% to 2.24% when we zeroed in on funds with above average volatility.

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Comparison Between Investor Returns and Trailing Returns in the U.S. Large-Blend Category, Trailing 10 Years

	Total Category	Funds with Above-Avg Vol
10-Yr Trailing Return	7.66%	7.40%
10-Yr Investor Return	6.42%	5.16%
Gap	1.24%	2.24%

Source: Morningstar Direct.

A More Complete Picture

Of course, trailing returns are one of the primary gauges of security performance. So, how can investors make use of them without falling victim to their limitations?

For starters, we recommend relying on trailing periods that cover at least one complete market cycle rather than focusing on those that encapsulate predominately one-way market environments. This modest adjustment will help ensure investors aren't besotted by overly defensive funds that perform well in a year like 2008 but are poised to underperform in the ensuing recovery. Similarly, a wider lens should help investors take a critical eye to risker fare that has had a field day in the bull market we've seen since 2009, but may suffer severe losses in a less forgiving environment.

For those willing to do a bit more legwork, evaluating a strategy's trailing returns alongside its performance during particular market environments can also prove useful. In so doing, investors can deconstruct the trailing returns to approximate how much of the gains (or losses) came from bull markets and how much came from downside protection during sell-offs. For example, when we evaluate U.S. large-cap stock funds over the trailing 10 years, we also assess their defensiveness in 2008's financial crisis and the downturns during the second quarter and third quarter of 2010 and 2011, respectively. On the flip side, we take a look at their performance during the 2009 rally and the recent bull market that has continued to grind higher.

Finally, it is a potentially costly mistake to look at trailing returns without also evaluating risk statistics. Within our Performance Scorecard, which grades all funds in the mutual-fund universe relative to appropriate peer groups and indexes, we give significant weight to risk statistics such as standard deviation, maximum drawdown, up/down capture ratios, and risk-adjusted return metrics such as the Sharpe and Sortino ratios. While not foolproof, these additional metrics provide a richer context to the overall performance assessment. Time and again we've found some strong-returning strategies no longer look attractive after considering the jolts they've experienced along the way.

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To showcase how dramatically the picture can change when we consider risk statistics alongside trailing returns, we evaluate the large-blend category over the past 10 years ending May 31, 2015 below. First, we ranked the category merely by total return and noted the category's top ten funds. We then took a second pass at the category, calculating an equal-weighted ranking based upon return, standard deviation, Sharpe ratio, upside capture ratio, and downside capture ratio.

Under this more extensive analysis, half of category's top performers has turned over, and four of the remaining five have changed rankings within the top 10. Notably, the fourth-ranked fund according to return—MassMutual Select Focused Value—slipped to a ranking of 125 when we considered the additional metrics.

Top 10 Funds by Return

Rank	Fund	Return (%)
1	Columbia Contrarian Core Z	10.83
2	AMG Yacktman Focused Service	10.42
3	Parnassus Core Equity Investor	10.40
4	MassMutual Select Focused Value A	10.22
5	AMG Yacktman Service	10.11
6	PIMCO StocksPLUS® Absolute Return Instl	10.06
6	Amana Income Investor	10.05
8	BBH Core Select N	9.95
9	Sit Dividend Growth I	9.86
10	Pin Oak Equity	9.78

Top 10 Funds by Total Performance Analysis

Rank	Fund	Return (%)	Standard Deviation (%)	Sharpe Ratio	Upside Capture Ratio (%)	Downside Capture Ratio (%)
1	American Century Fundamental Equity A	9.52	14.41	0.61	101.66	94.44
2	Eaton Vance Stock A	8.97	14.08	0.58	99.66	94.66
3	Parnassus Core Equity Investor	10.40	13.15	0.72	94.42	78.91
4	Sit Dividend Growth I	9.86	13.43	0.67	96.81	85.43
5	Amana Income Investor	10.05	12.19	0.74	90.98	75.86
6	Columbia Contrarian Core Z	10.83	15.37	0.66	108.92	97.49
6	PRIMECAP Odyssey Stock	9.72	14.29	0.63	98.45	88.65
8	RS Large Cap Alpha A	9.59	14.87	0.60	103.68	96.92
9	BBH Core Select N	9.95	12.41	0.72	89.27	73.96
10	Hartford Disciplined Equity HLS IA	8.74	14.53	0.56	100.99	97.87

Source: Morningstar Direct. Risk and return metrics span the trailing 10 years ending May 31, 2015.

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Final Thoughts

Investors can't do away with trailing returns, but they don't have to be deceived by them. By noting the market environment before assessing the relevant trailing return, measuring the strategy against a range of return metrics over a variety of time horizons, and keeping one eye on risk, investors can better ensure they've taken the true measure of a strategy's performance over time.

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