Upside, downside

A guide to risk for savers and investors

Section 4

Investing for the long term

Expecting past performance to continue

In most facets of life, you expect whoever or whatever did well in the past – the star athlete, the fastest car, the bestselling author – to continue to perform well.

But with investments, it's often not the case. And that's true whether you're comparing shares vs property vs bonds vs emus, or whether you're comparing one share with another, or one property with another, and so on.

Note that we're not talking here about long-term trends. While our graph on the next page shows that shares and property are more volatile than bonds, over the long haul they have performed better. We expect that to continue.

Investors who switch from shares to property or vice versa, or from one share or share fund to another, because the new one performed well recently, are frequently disappointed with the future performance.

Let's say that, in 2006, you had $10,000 and a choice of the following assets to invest in: cash, New Zealand bonds, overseas bonds, commercial property, New Zealand shares and overseas shares. If you had great foresight and, at the start of each year, you moved your money into the asset that was going to perform best that year, you would have $59,600 by the end of 2016.

But, of course, you don't have such foresight. So, instead, you move your money into the asset that performed best in the previous year. By the end of 2016, you would have just $28,500.

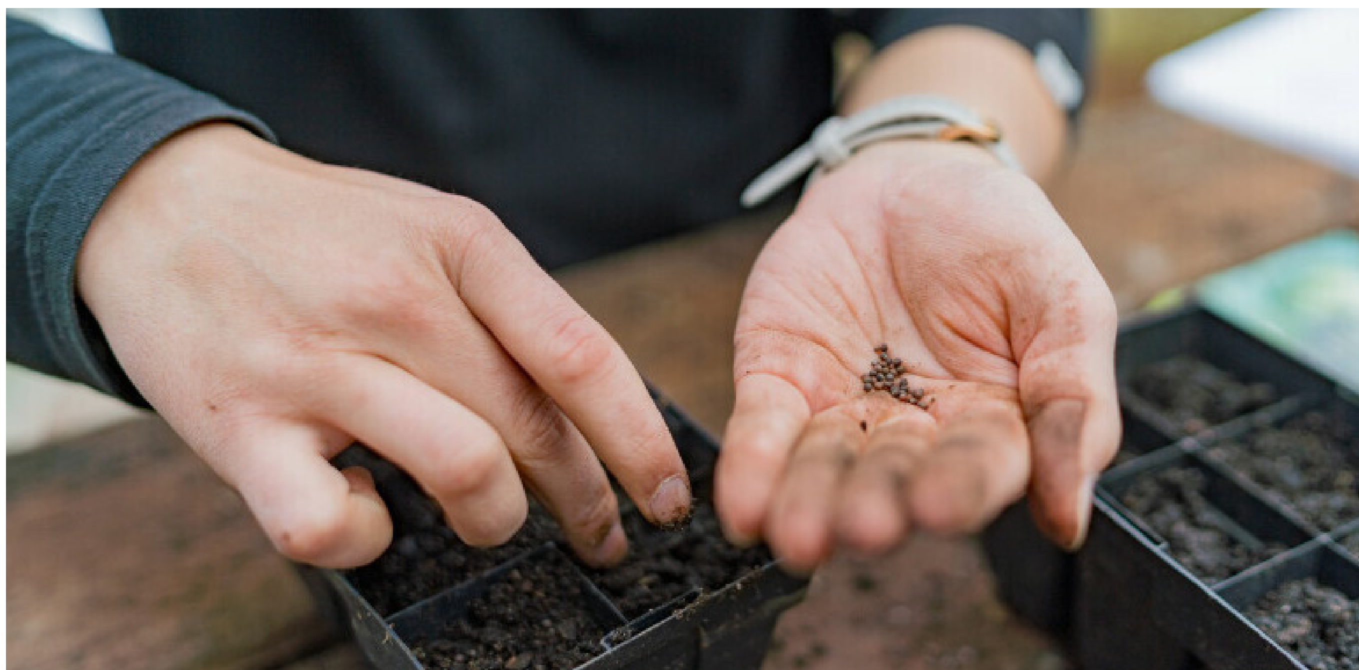
High performers often don't stay high performers. If anything, there's sometimes a tendency for last year's investment winner to do worse than average this year, and last year's loser to do well this year.

When you think about it, this is not surprising. The top performer last year might have been at the peak of a cycle and so it falls this year. And the worst performer may have been in a trough, with values unusually low and about to start rising.

Perhaps, then, it would pay to do the opposite, and transfer to last year's loser. There are two problems with this, though:

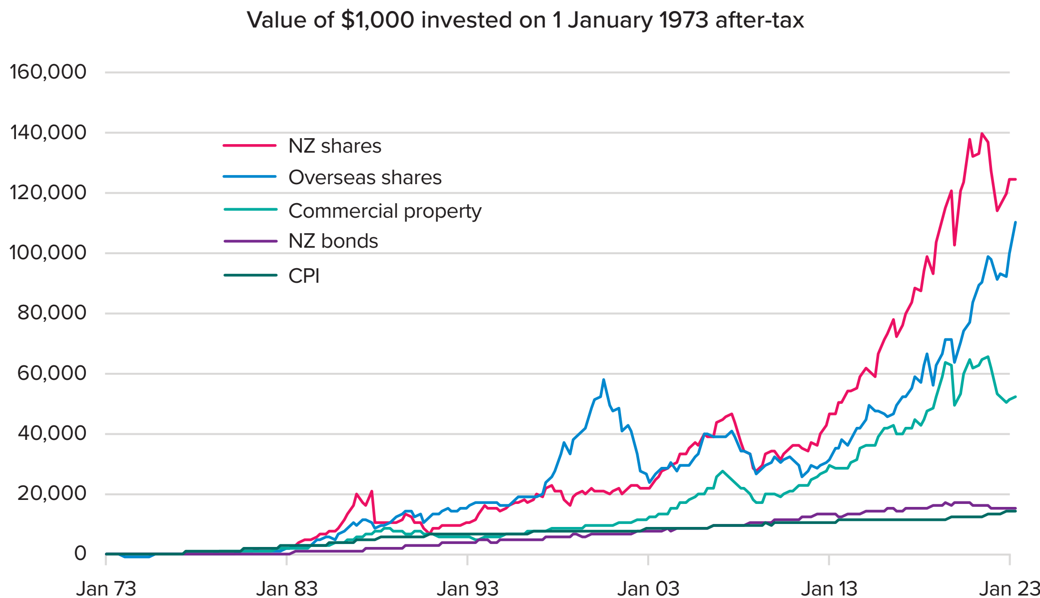
- The expense and hassle of trading. In New Zealand, this includes the possibility of having to pay tax on your capital gains if you trade frequently.
- Psychologically, many people would find it difficult to move from recently successful investments to recently unsuccessful ones.

As long as you have selected your long-term investments wisely, you're better off sticking with them than trying to chase winners.



Graph 3

Different assets and inflation - value of $1,000 invested net of tax on 1 January 1973



Sources: Equity returns: MSCI World gross return index (23 developed and emerging markets indices, expressed in $NZ), and the NZX50 gross return Index. Pre-2001 NZ data supplied by Russell Investment Group Ltd. RBNZ (bonds), Statistics NZ (CPI); Property IQ (house prices) . Note:5-year bond and 6-month deposit rates compound quarterly.

Shares usually produce the highest returns over the long term, although you get a bumpy ride, especially compared to bonds. Property is usually in between when it comes to returns and bumpiness. All the investments have grown considerably more than inflation over the years.

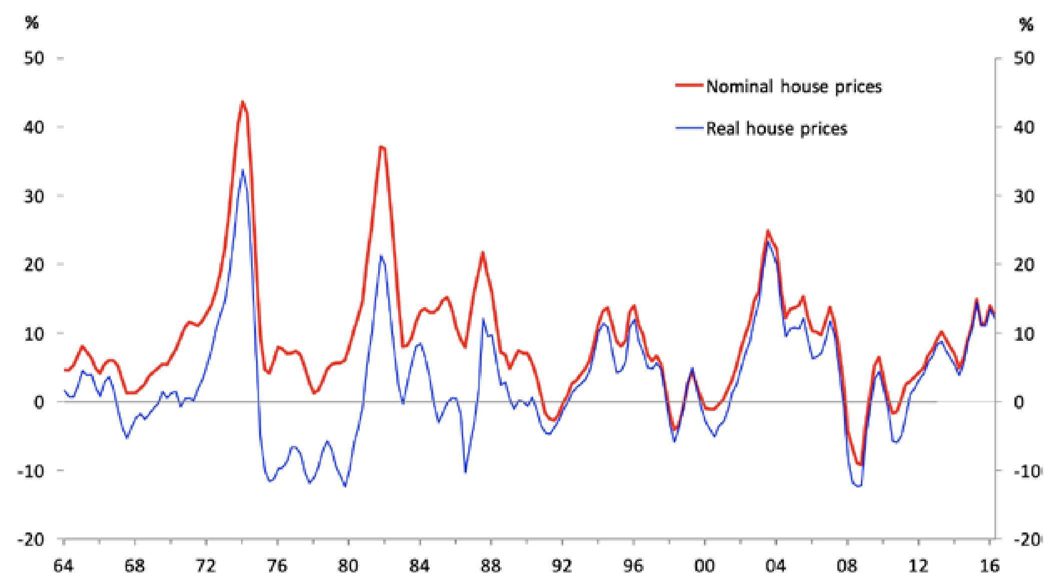
Note that the house price line shows just capital gains. If net rental returns were included, the total return would be higher, but there is no good rental returns data available over this period.

Property

Property prices go through fast-growth and slow-or-no-growth periods, and occasional declines. And despite some people's claims that property cycles are easy to predict, there's wide variability in how long and strong they are. If house prices rose fast last year, they may continue to do that this year, or they may not – as we've seen recently.

Graph 4

House prices sometimes fall



The lines on the graph go down whenever house price rises are slower than in the previous year. When the lines cross below zero, prices have fallen. From 1961 to 1990, nominal house prices – the prices that are normally quoted – never fell. That was partly because inflation was high during much of that period. However, real house prices – after adjusting for inflation – fell frequently. And since 1990, with lower inflation, even nominal prices have fallen at times, including recently.

Shares and share funds

Research shows that people who chase high returns often lose out. In one study, for example, return chasers in share funds earned 5.96 percent a year between 2000 and 2020 compared with 8.29 percent in a sharemarket index.

Why the big difference? The researcher found some people consistently moved their money into funds that had performed well in the previous period, quitting funds that were often just about to do well. They ignored the fact that particularly big gains are often followed by losses.

Share fund managers that invest in lots of high-risk shares, or perhaps shares in a particular industry, will sometimes have a run of luck, boosting their unit prices. Other times, though, the value of many of their holdings will drop fast, and so will the fund.

This explains why, when comparing different share funds, you often find the ones that do best some years are also among the ones that do worst in other years. They are the risky funds.

Even the shares in much lower-risk companies don't always perform the way you might expect.

Let's say a company in a stable industry announces that it has a huge new contract, and it expects its future sales to double. Its share price is likely to leap. Then, in the following years, sales are, indeed, twice as big. Does the share price continue to grow fast? Probably not. When the contract was first announced, analysts realised the company would be stronger in the future. Wanting to get in while the price was still low, they bought lots of shares immediately, pushing up the price straight away. Once the price reaches its new higher level – which would reflect all the expected future growth – it's unlikely to continue to grow particularly fast unless it performs even better than expected. And if its performance is okay but not as good as expected, its price is likely to fall.

So even the prices of shares in a low-risk company that is doing pretty well won't necessarily follow a steady path.

KiwiSaver

Some people tend to move their KiwiSaver money from one provider to another, switching to whichever provider has turned in a good performance recently. This is a hassle, and you probably won't benefit from doing it.

As stated in Investing in Companies that get into trouble, on page 10, if your KiwiSaver fund consistently performs worse than most other similar funds, that suggests poor management. But reserve judgement over short periods. Many funds that perform badly for a year or two later perform well.

Note the words "similar funds" in the previous paragraph. Whenever you compare the performance of KiwiSaver funds, make sure you are looking at funds with similar risk. For example, compare several conservative funds, or several high-risk funds. Also, make sure all results are presented after fees and taxes, which can make a big difference. It's good to use the Smart Investor tool on www.sorted.org.nz for fund comparisons.

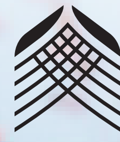
If you do want to switch provider, all you have to do is contact the provider you want to move to. They will contact your current provider and arrange to move your money, and also tell Inland Revenue that you have switched.

Take care, also, before switching within your provider's range of funds. Let's say the share markets have performed badly recently. You may be tempted to move to a lower-risk fund – perhaps just before shares are about to recover, bringing in great returns.

You should shift your risk level for one of two reasons only:

1. You realise you can't cope with the volatility of a higher-risk fund and you can't sleep from worrying about it.
2. You are getting nearer to the time you will spend the money.

In both cases, make the switch regardless of what is happening in the markets at the time. And don't move back again later.



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