

Perhaps the most prevalent behavior exhibited by investors is to chase performance. People buy the stock, the fund, the commodity, or the asset class they wish they had bought last year. Many researchers have documented this. Brad Barber, Lu Zheng, and I did a study in which we found that 39% of the new money flowing into mutual funds went into the funds in the top 10% for performance last year, and over half the new money went into funds in the top 20%. Studies show that good mutual fund performance isn't generally more persistent than chance.

To illustrate this point, Brad Barber and I took a look at about 3,000 mutual funds that had been operating over a 10-year period. This was a sample of better performing funds, simply because many of the worst performing funds don't end up operating for 10 years. Often, poorly performing funds are merged into funds with better track records. Brad and I calculated in how many of the 10 years each fund in our sample beat the market. Then we calculated how many funds would one expect to have beaten the market for 0, 1, 2, 3, 4, 5, 6, 7, 8, 9, or 10 years if every year, each fund had a 50-50 chance of doing so. As you can see in this chart, the funds did worse than chance. By chance, we would have expected more than 500 funds to beat the market in 7, 8, 9, or 10 of the years. But only 361 did so. So why do investors continue to chase mutual fund performance despite evidence that good performance isn't persistent? To try to understand this behavior, I'm going to tell you a hypothetical story about the time my neighbor Matt and I went on an expedition in the Amazon rain forest.

You know, Matt and I were a bit too adventurous. We got separated from our group. They had gone up the river, and we had this radio, and the group leader said that he would pick us up the next morning on the way as he came back down the river. We were fine. We weren't hurt. We had water filters. But we didn't have anything to eat, and we were hungry. We looked around ourselves and saw a lot of plants that I, at least, didn't recognize. I ate one of these plants over here. Matt chose a different plant. Maybe Matt knows more about botany than me, or maybe he's just lucky, but I got sick, and he felt fine. The next morning, I woke up. I'd recovered my hunger. What did I eat? Or more importantly, what didn't I eat? I didn't eat the plant that made me sick the day before.

All right, a couple weeks later, Matt and I were back in the States. We'd had a lot of fun. We wanted to celebrate, and we went to Las Vegas. We headed to the roulette table. I put my money on the black. Matt put his money on the red. The little ball stopped on the red. I lost. He won. The next time I bet, did it matter if I bet on the black or the red? No. So what's going on here? We've got two situations where Matt made one decision, and I made another decision. His turned out well. Mine turned out poorly. Yet in one case, the outcome affected my future decision and my future behavior. In the other case, it didn't. And that's because I'm learning. And I'm learning by induction, by observation. But I'm also learning by deduction. And what I'm deducing is whether I'm dealing with a deterministic event or a random event. You know, if you eat something, and it makes you sick once, it's very likely to make you sick again. And if you can't figure that out with your head, your whole body knows. But where the little ball lands on the roulette wheel doesn't tell you anything about where it's going to land next time.

So a question that faces investors is where on this continuum from completely deterministic to completely random does the market lie. And, you know, I don't think the market is completely random. But it's more random than a lot of investors realize. And because of that, they look for patterns, and they expect these patterns to repeat themselves. In general, this is something that human beings simply do. We see patterns, some real, some not. I'd like to tell a story why I think we are that way. Evolutionary psychologists tell us that a lot of our psychological development came during hunter-gatherer times, though undoubtedly a great deal of it preceded hunter-gatherer times. But I'm going to set my story in hunter-gatherer times.

One day, two hunters go out hunting. They're about to go around a boulder, and they hear a roar. One of the hunters goes around the boulder, and he's killed by a tiger. The other hunter runs away. A couple of weeks later, our surviving hunter, the hero of this story, goes out hunting alone. He's about to go around another boulder, and he hears a roar. And he thinks to himself, roar, tiger. And he turns and runs. Now, the statisticians out there are probably thinking, come on, everyone knows a sample of one is not statistically significant. He should've tested the hypothesis. But he turned around and ran and lived to tell his tale. All right, a couple of weeks later, our hunter snares a rabbit. He and some friends eat most of the rabbit. All that's left is the rabbit's leg. The next day, he goes hunting, and he puts the rabbit's leg in his lunch box, and he has a great day hunting. He kills an antelope. He drags it back into camp. He's proud. Everyone's going to eat tonight. All that's left of the rabbit's leg is the rabbit's foot. And he says to himself, this is my lucky rabbit's foot. He puts it on a leather thong, hangs it around his neck. Now, we're thinking, come on. This is a spurious correlation. This is superstition. The rabbit's foot doesn't help you hunt. But what's the downside? What's the downside of this? The rabbit's foot weighs a couple of grams. He burns off the odd calorie wearing it. It's moderately attractive. It might help him find a mate. The point is that in the environment in which we developed as a species, it was much costlier to miss real patterns than to see a few patterns that weren't real. In the modern markets, it can be very costly for investors to see patterns that aren't real and to trade on those patterns.