The Challenge of Managing Performance Persistence: A Smarter Framework for Plan Sponsors

Plan sponsors are charged with the fiduciary responsibility to offer competitive investment options at a reasonable fee. As a result, they are faced with the ongoing challenge of deciding which active fund managers to replace and who to choose as the replacement. The big question is how to choose.

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When evaluating investment options, one of the most highly scrutinized factors is performance. Generally speaking, the evaluation of performance is not prone to some of the behavioral biases embedded in other more subjective assessments and is relatively easy to understand.

Past performance has either been better or worse than a benchmark (or a peer group). And, as the SEC and other regulatory bodies warn us, “past performance is no guarantee of future results.” Undoubtedly, investors draw comfort in strong historical returns. A rigorous investment research and due diligence process must include historical performance, which can serve as validation of an investment manager’s skill or ability to offer a differentiated way of generating outperformance.

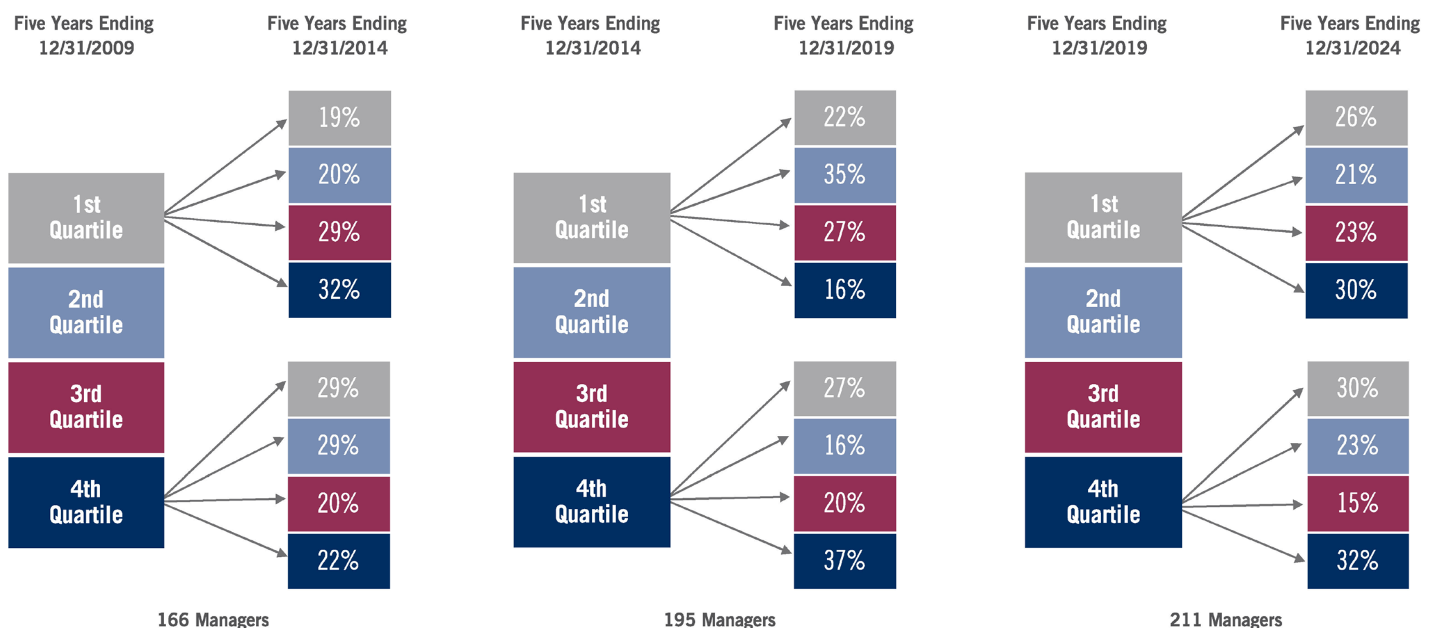
However, as RPA’s analysis confirms, performance persistence is extremely difficult to predict within actively managed mutual funds. Plan sponsors and investors should not make investment decisions solely based on past returns.

Analysis

To understand the relationship between past performance and the likelihood of it continuing in the future, we evaluated historical performance of hundreds of mutual funds across various asset classes dating back to 2000. We segmented each asset class into quartiles based on trailing five-year returns (e.g., the top-performing funds fall into the top 25th percentile for their asset class). We then evaluated how those funds within each quartile performed over the subsequent five-year periods. The funds that remained in the top quartile exhibited performance persistence over this period, and those that fell in ranking did not.

The timeframe produced 16 observable periods of trailing five-year returns evaluated against the subsequent five-year returns through the end of 2024. Our analysis produced a clear result: **Active managers have exhibited limited ability to persistently produce top-quartile results over time.** Though the level of consistency may vary, this theme is consistent across and within asset classes and through a number of different market and economic cycles and environments.

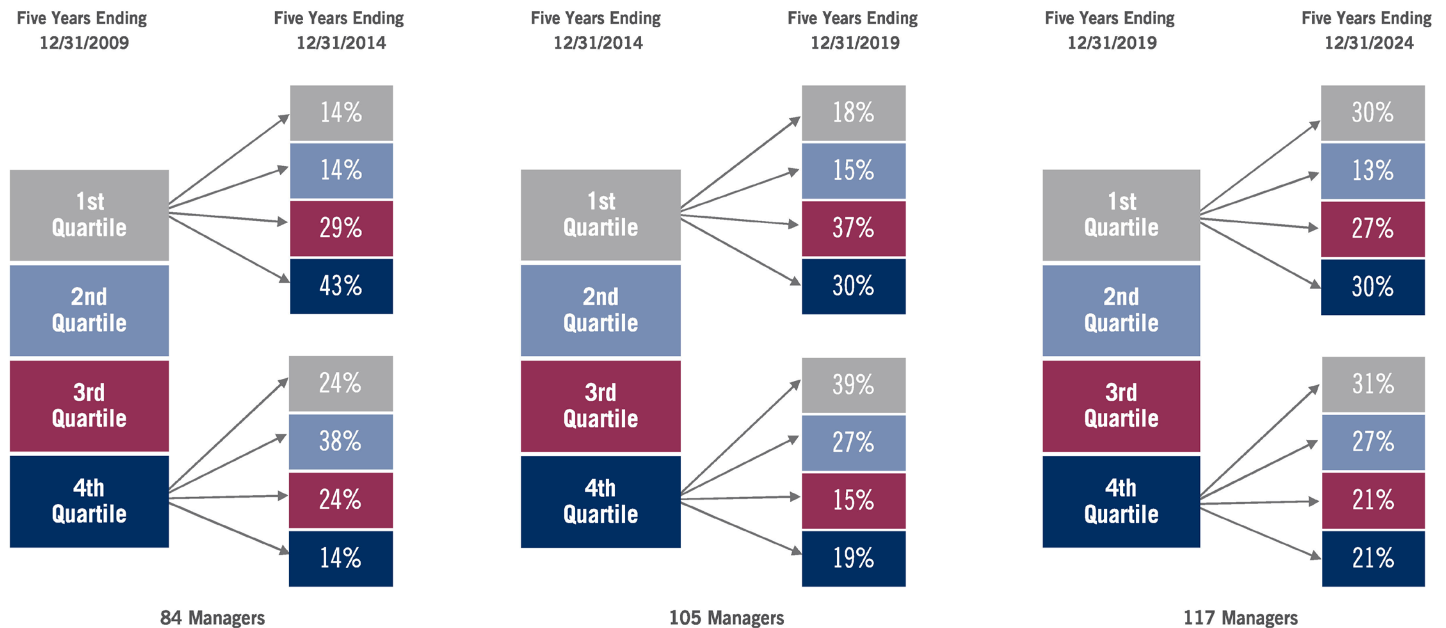
For example, we evaluated a peer universe of 211 active **U.S. Large Cap Value** funds dating back to 2000 (not all funds had a track record back to 2000). Over the course of this evaluation period, on average only 21% of funds that produced top-quartile results in a given five-year period did so again over the subsequent five-year period. In fact, there was a greater likelihood that a top-quartile fund would fall into the fourth quartile over any given subsequent five-year period. As we further evaluated the time series of our data, it became clear that major market events (e.g., the Global Financial Crisis) resulted in the largest moves between quartiles among funds. This further supports the notion that blindly following strong past performance can actually result in poorer returns in the event of a major shift in markets.



Another example of this particular dynamic can be found in the **U.S. Small Cap Blend** category from 2009 to 2013 (immediately following the Global Financial Crisis). Of the 80 funds in the peer universe at that time, 55% of the top-quartile funds going into that period moved into the fourth quartile during the period.

In addition, 45% of funds that entered the period in the bottom quartile moved into the top quartile. What does this mean? The funds that were taking the most risk and delivering the best returns leading into the crisis produced the worst returns during the crisis and vice versa.

U.S. Small Cap Blend Universe



Generally speaking, performance persistence has proven to be a significant challenge for active managers across asset classes. While certain areas of the markets, such as core fixed income, may exhibit greater consistency among top and bottom performing funds, our analysis supports the notion that prior period returns are not a good predictor of future returns.

As the table below shows, **top quartile managers for a given period remain in the top quartile for the subsequent period on average between 16% to 34% of the time** depending on the asset class (17% for Small Cap Blend, 34% for Core Bond).

Beginning Quartile	Subsequent Quartile	Large Cap Blend	Large Cap Value	Large Cap Growth	Mid Cap Blend	Small Cap Blend	Developed Intl Equity	Core Bond
1	1	26%	21%	30%	24%	17%	34%	34%
1	2	20%	23%	24%	17%	20%	22%	27%
1	3	26%	25%	21%	21%	26%	24%	19%
1	4	28%	31%	25%	38%	37%	20%	20%
4	1	28%	29%	21%	32%	36%	26%	19%
4	2	26%	24%	24%	26%	28%	25%	18%
4	3	19%	23%	25%	23%	22%	20%	16%
4	4	27%	24%	30%	19%	14%	29%	47%

Percentage of managers within the subsequent quartile, relative to their beginning quartile.

Conclusion

Given the lack of predicative accuracy past performance has on future results, the evaluation of past performance needs to be broadened to include consistency and volatility. Two active managers with the same, or very similar, five- and 10-year returns may have exhibited very different annual returns over those time periods. The volatility in annual returns (how much a fund's return fluctuates from year to year) has significant impacts to retirement plan investors. There is the behavioral risk of an investor selling after experiencing an outsized loss and not benefiting from the next outsized gain, undermining their actual investment result. Further, plan participants taking distributions from their accounts are subject to a sequence of return risk (withdrawing money during a period of investment losses). Funds with large return swings may exacerbate this issue.

Further, plan sponsors should give organizational stability, consistency of process, and prudent investment philosophy meaningful weighting in their overall evaluation. **Ultimately, the securities selection in any actively managed fund is done by a team of people with a particular philosophy, approach, and methodology for both buying and selling securities in their portfolio.** Understanding the approach and identifying a skilled and experienced team of decision makers is critical in identifying top-tier investment managers and funds.

As plan sponsors responsible for your retirement plan's investment offering, selecting funds solely on the strength of historical returns is not the best approach. While strong trailing three-, five-, and 10-year returns against the benchmark and peer group are very appealing, they may at times mask underlying risks or deficiencies that can have an impact on future returns. **Fund companies with a clearly articulated approach and investment discipline, *combined* with long-term track records of delivering consistent returns (even if not the top performer in the past five years!), should better serve you and your plan participants.**

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