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Warren Buffett states, “In the business world, the rearview mirror is always clearer than the windshield.” And even though investors are constantly bombarded with the standard compliance warning that past performance is no guarantee of future performance, it should come as no surprise that many can’t help but chase the hottest asset class, sector or stock, often to their financial detriment.

And, illustrating the propensity to zig when zag would have been better, the same goes in the mutual fund realm as billions of dollars poured into the fund managed by Ken Heebner after he was dubbed *America’s Hottest Investor* by *Fortune Magazine* in May 2008 and into the fund Bruce Berkowitz manages after he was named Morningstar’s *Fund Manager of the Decade* in early 2010. After all, both managers had top-rated (5 Stars) funds by Morningstar, given that each had enjoyed phenomenal performance. Alas, the key word is *had* as returns in the years since they were the toast of Wall Street have been very disappointing, to say the least, so much so that Morningstar now rates Heebner’s fund as 1 Star and Berkowitz’s fund as 2 Stars.

#### A 5-STAR CONTRARIAN INDICATOR

To be sure, not all top performers so quickly and dramatically lose their touch, but our study of Star ratings and subsequent performance since 1994 shows that on average investors are actually better off using Morningstar ratings as a contrarian indicator, particularly over the longer time horizons. In Figure 1, we chart the growth of \$100 invested by Star rating. The 5-Star average actually outperforms the others for the full study period, but the outperformance is entirely attributable to the Tech Bubble. Were we to start the chart in 2000, the growth of \$100 at the end of 2020 for 5-Star funds would be \$398, while 1-Star funds would have grown to \$530.

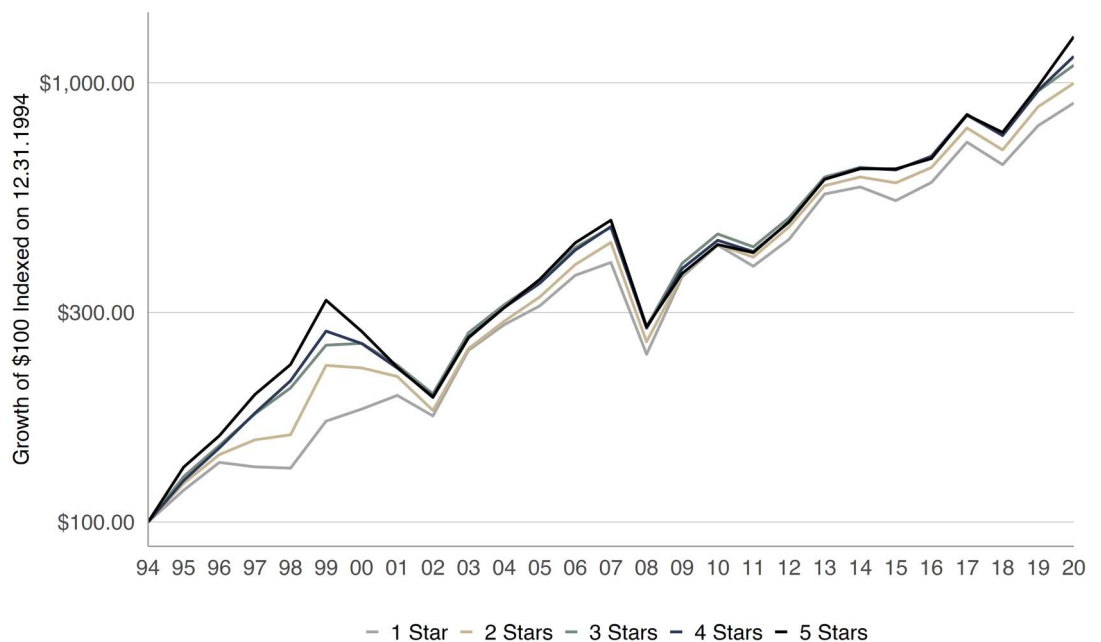


Figure 1: The Tech Buble Explains a Lot

From 12.31.1994 through 12.31.2020. Logarithmic scale. The annual returns are calculated by finding the mean of subsequent one-year returns for each respective group on December 31 of the preceding year. Funds without data, including returns or ratings are excluded. SOURCE: Kovitz using data from Morningstar and Bloomberg Finance L.P.



While we are looking at the numbers on an annual basis, and we accept that not all funds remained in business so as to have a forward return for the ensuing three and five years, the results in Figures 2 and 3 are staggering as the analyses show that the best-performing funds on a trailing basis, on average, produced among the worst returns going forward...and vice versa!

Now, that might not be so awful if investors simply stayed put in their funds, taking the good with the bad and ignoring the Star ratings, but history shows this not to be the case, despite what Don Phillips wrote in 2010. In *Star Wars, the Sequel*, the

**Figure 2:**  
Star Ratings: Trailing & Forward 3-Year Returns

From 12.31.1991 through 12.31.2020. The best performers each year are the darkest in color. Mean total returns are calculated for all mutual funds with the indicated star rating and full performance history over the indicated time horizon. Funds were excluded only for the specific time periods that they did not have sufficient performance history. SOURCE: Kovitz using data from Morningstar and Bloomberg Finance L.P.

	36 Months Before Rating					36 Months After Rating				
	1 Star	2 Stars	3 Stars	4 Stars	5 Stars	1 Star	2 Stars	3 Stars	4 Stars	5 Stars
1994	2.6	6.3	7.2	10.5	16.6	7.6	15.9	21.3	19.6	25.1
1995	9.6	11.8	14.7	16.3	20.0	2.9	12.8	16.1	17.7	20.0
1996	3.0	7.8	12.4	15.0	19.9	7.2	14.1	20.1	18.4	21.0
1997	0.6	10.5	18.8	22.3	26.5	7.0	8.3	11.4	11.5	11.9
1998	-6.0	1.5	14.8	20.3	27.0	7.5	5.6	2.9	1.6	-0.1
1999	-5.2	7.6	16.3	23.4	37.9	5.9	-5.0	-8.7	-14.3	-21.1
2000	-5.7	3.1	9.4	14.2	25.5	22.7	7.4	-0.2	-2.2	-4.7
2001	-8.0	-2.5	2.6	5.6	13.8	8.1	8.7	10.8	10.9	11.4
2002	-15.3	-14.7	-11.8	-7.6	-2.8	22.9	22.3	21.7	21.6	21.9
2003	-9.8	-1.7	0.7	2.2	8.5	14.6	15.9	16.1	16.3	16.6
2004	2.2	7.1	9.1	11.7	16.5	12.4	14.6	14.5	14.7	15.9
2005	17.0	19.4	20.7	23.8	27.6	-7.5	-8.3	-8.4	-8.2	-8.5
2006	10.2	13.8	15.4	18.0	19.7	-3.9	-3.7	-3.5	-3.3	-3.4
2007	7.3	12.0	13.8	16.6	19.9	-1.6	-2.1	-1.9	-2.0	-2.5
2008	-14.2	-11.1	-8.6	-5.9	-3.4	16.5	15.3	14.5	14.1	13.5
2009	-9.3	-6.0	-3.8	-1.4	0.6	6.5	8.2	8.2	8.0	8.8
2010	-9.1	-4.4	-2.5	-0.2	2.6	8.7	11.0	10.4	10.7	10.6
2011	9.2	12.5	14.5	15.9	19.5	13.9	15.7	14.9	15.0	14.1
2012	3.9	6.4	8.1	9.4	11.5	8.4	7.8	8.4	9.4	9.3
2013	5.5	8.8	10.2	12.2	14.1	2.1	3.0	3.4	3.6	3.3
2014	10.2	13.6	14.6	16.3	18.4	7.2	8.4	9.4	9.4	10.0
2015	3.2	6.6	8.6	9.7	12.1	5.4	5.4	6.0	6.3	6.6
2016	-1.0	1.3	2.9	4.4	5.9	10.6	11.3	12.0	12.4	11.8
2017	4.7	6.8	8.7	10.3	12.7	8.8	8.1	9.3	9.7	12.8
2018	1.3	3.9	5.7	7.4	9.5	8.1	8.4	8.7	8.4	8.5
2019	5.2	9.2	11.3	13.8	17.0					
2020	1.3	5.7	8.6	11.9	18.0					
Average	0.5	5.0	8.2	11.0	15.4	8.1	8.4	8.7	8.4	8.5

Managing Director of Morningstar said, "The Morningstar Rating for funds is a grade on past performance. Period. No one at Morningstar ever claimed that the Stars have predictive power or ever ran an ad telling investors to follow the Stars to riches."

That may be true, but fund companies spend a ton of advertising dollars promoting their highly ranked products, with the marketing efforts obviously bearing plenty of fruit.

**Figure 3:**  
Star Ratings: Trailing & Forward 5-Year Returns

From 12.31.1989 through 12.31.2020. The best performers each year are the darkest in color. Mean total returns are calculated for all mutual funds with the indicated star rating and full performance history over the indicated time horizon. Funds were excluded only for the specific time periods that they did not have sufficient performance history. SOURCE: Kovitz using data from Morningstar and Bloomberg Finance L.P.

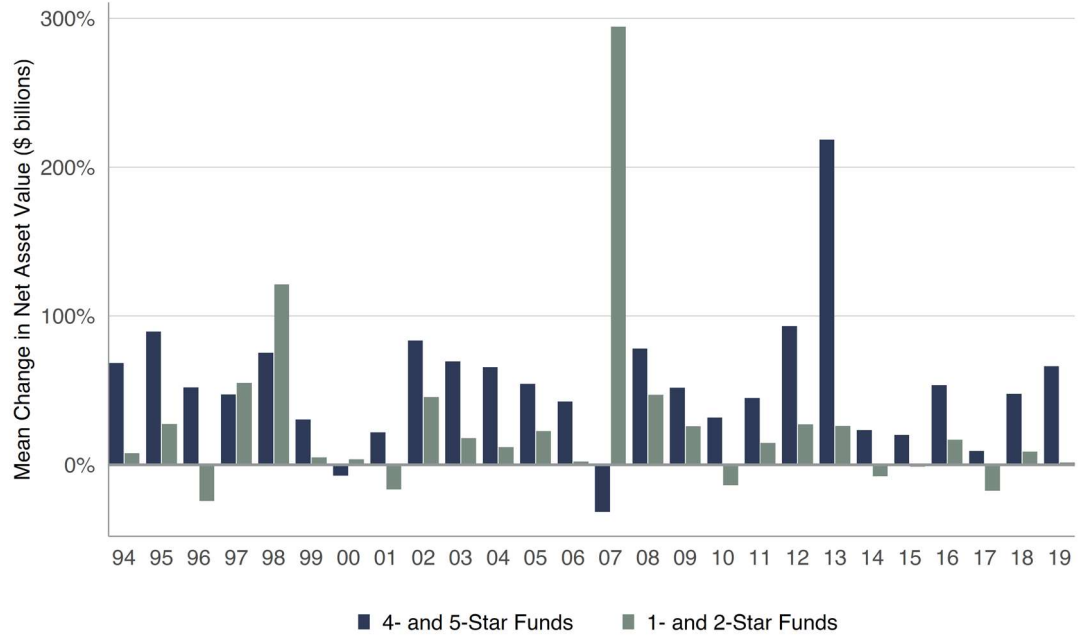
	60 Months Before Rating					60 Months After Rating				
	1 Star	2 Stars	3 Stars	4 Stars	5 Stars	1 Star	2 Stars	3 Stars	4 Stars	5 Stars
1994	1.3	5.7	8.8	9.5	16.8	9.1	14.9	19.7	20.7	24.0
1995	7.5	13.0	15.2	16.9	21.0	7.8	11.5	13.5	13.9	15.0
1996	7.3	10.0	13.0	15.0	19.3	0.7	3.6	7.3	7.8	9.8
1997	5.2	11.5	15.3	17.6	20.4	3.4	-0.3	-0.1	-0.6	1.4
1998	-1.9	3.6	13.6	17.1	22.5	13.3	9.7	4.0	2.1	0.1
1999	1.8	11.3	18.0	22.2	31.9	14.6	7.2	3.0	-1.3	-5.3
2000	-4.5	4.6	12.3	16.5	21.8	20.6	12.7	5.3	3.2	1.7
2001	-9.2	0.8	5.1	9.2	14.7	10.6	11.7	13.3	13.0	13.5
2002	-5.1	-3.3	-0.9	2.5	6.0	20.3	19.5	19.2	19.0	19.1
2003	-1.5	3.0	4.1	6.5	11.8	-0.9	0.0	0.2	0.5	0.6
2004	-5.6	-0.9	1.4	4.9	9.6	2.7	3.7	3.8	4.0	4.7
2005	-1.5	2.3	5.5	8.5	12.6	3.3	4.6	4.2	4.6	5.0
2006	5.8	9.5	12.1	14.3	17.2	-0.4	-0.6	-0.5	-0.4	-0.4
2007	11.9	16.6	18.4	21.2	24.2	0.5	0.6	0.5	0.4	-0.2
2008	-4.0	-2.1	0.0	2.0	3.8	17.9	17.6	16.5	16.3	15.4
2009	0.7	1.8	3.3	5.6	6.9	8.8	10.9	10.8	10.4	10.4
2010	0.3	2.6	4.1	6.2	7.6	4.8	7.5	6.8	7.1	6.7
2011	-6.2	-2.9	-0.5	1.4	3.8	8.6	10.0	9.7	9.8	8.9
2012	-4.5	-1.8	0.2	1.9	4.5	10.6	10.5	10.9	11.6	11.3
2013	11.9	14.9	16.2	18.5	21.1	2.9	3.4	4.2	4.7	4.8
2014	5.3	9.1	10.4	12.0	13.8	6.1	7.1	8.5	8.4	8.6
2015	1.7	5.1	6.8	8.2	10.5	10.4	10.9	12.2	11.8	13.2
2016	4.8	8.3	9.2	10.7	12.2	8.0	8.0	7.9	7.6	7.6
2017	7.0	9.2	10.7	11.7	14.5					
2018	-0.6	2.1	4.0	5.2	7.7					
2019	3.1	6.0	7.6	9.2	11.4					
2020	6.1	8.9	11.1	13.3	17.6					
Average	1.4	5.5	8.3	10.7	14.3	8.0	8.0	7.9	7.6	7.6



In Figure 4, we chart cumulative fund net asset value for all funds that had a Morningstar rating and asset data in Bloomberg, and it shows that dollars have actually flowed out of 1- and 2-Star U.S. equity funds, while funds with 4 and 5 Stars have experienced massive asset growth without the accompanying explosive performance that earned them those high ratings.

**Figure 4:**  
Fund NAV Change  
by Morningstar Rating

From 12.31.1994 through 12.31.2020. Mean fund net asset value percentage change over the subsequent year by Morningstar rating. The asset value change includes investment return and investor cash flows. SOURCE: Kovitz using data from Morningstar and Bloomberg Finance L.P.



**IF YOU DON'T CHANGE DIRECTION YOU MIGHT END UP WHERE YOU ARE HEADING**

Sadly, many lack a solid financial plan, or do not have the benefit of working with an investment professional, so the weaker longer-term performance of 4- and 5-Star funds is compounded by an inability to stick with whichever funds they hold for enough time to reap the rewards of long-term ownership. Whether Morningstar or other factors deserve the blame, investors have proved to be lousy timers with their mutual fund purchases and sales.

Such was the conclusions reached by two studies: (i) Hsu, Jason C. and Myers, Brett W. and Whitby, Ryan J., Timing Poorly: A

**Figure 5:**  
Individual Investors Returns  
Don't Measure Up

From 12.31.1984 through 12.31.2020. SOURCE: Kovitz using data from DALBAR and Bloomberg Finance L.P.

Individual Investor Returns vs. Broad Benchmarks						
Time Period	Average Equity Investor Return	S&P 500 Return	Difference	Average Bond Investor Return	U.S. Aggregate Bond Index Return	Difference
<b>1 Year</b>	17.1%	18.4%	-1.3%	3.1%	7.5%	-4.4%
<b>3 Years</b>	10.2%	14.2%	-3.9%	1.6%	5.3%	-3.8%
<b>5 Years</b>	11.6%	15.2%	-3.5%	1.5%	4.4%	-3.0%
<b>10 Years</b>	9.4%	13.9%	-4.5%	0.8%	3.8%	-3.0%
<b>15 Years</b>	6.7%	9.9%	-3.0%	0.8%	4.5%	-3.8%
<b>20 Years</b>	5.3%	7.5%	-2.1%	0.9%	4.8%	-4.0%
<b>25 Years</b>	7.5%	9.6%	-2.0%	1.5%	5.2%	-3.7%
<b>30 Years</b>	8.7%	10.7%	-2.0%	2.4%	5.9%	-3.5%
<b>Since 1984</b>	9.4%	11.6%	-2.2%	2.9%	6.8%	-4.0%



Guide to Generating Poor Returns While Investing in Successful Strategies—Dollar Weighted Return in Equity Funds of 6.87% per year from 1991-2013, compared to a Buy & Hold Return of 8.81% per annum; (2) Morningstar—Asset Weighted Return for U.S. Equity Funds of 6.52% per annum for the 10 years ended December 2013, against an 8.18% Average Return.

And, lest folks think that getting the timing right is easier today than when the data for those studies were compiled, DALBAR Inc.'s 2021 Quantitative Analysis of Investor Behavior argues that equity fund timers have had even less success over the last 3, 5 and 10 years, with the returns gap widening as compared to longer-term time spans. What's more, if timing equity market movements is difficult, the gyrations of the bond market have led to even uglier returns for fixed income timers, given the miserable average bond investor figures. In fact, DALBAR found that bond investors panicked in March 2020, bailing from bond funds at the rate of 5% of assets during the COVID-19-fueled financial market upheaval. Incredibly, the average fixed income investor return came in at a loss of 4.51% that month, compared to a drop of 0.59% for the Bloomberg Barclays Aggregate Bond index.

## CONCLUSION

The above in mind, we think the best advice is to have professional guidance rather than going it alone. We offer our clients a wide portfolio of investment options paired with an experienced team of Financial Advisors, which allows allocation decisions to be tailored for individual situations, taking into account factors like time horizon, risk-taking ability and personal goals.



**For additional information about subscribing to the *The Prudent Speculator* newsletter, or details about our asset management and wealth management services, please call Phil Edwards at 800.258.7786 or email [pedwards@kovitz.com](mailto:pedwards@kovitz.com).**

## DISCLOSURES

Definition of the Firm: Kovitz Investment Group Partners, LLC (Kovitz) is an investment adviser registered with the Securities Exchange Commission under the Investment Advisers Act of 1940 that provides investment management services to individual and institutional clients. From October 1, 2003 to December 31, 2015, the Firm was defined as Kovitz Investment Group, LLC. Effective January 1, 2016, Kovitz Investment Group, LLC underwent an organizational change and all persons responsible for portfolio management became employees of Kovitz. From January 1, 1997 to September 30, 2003, all persons responsible for portfolio management comprised the Kovitz Group, an independent division of Rothschild Investment Corp (Rothschild).

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All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

In Figure 1, Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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