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Should you invest in hot mutual funds? Absolutely not

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Lists of top-performing mutual funds are hard to ignore when you're looking to invest. Reports of soaring returns, impressive gains by managers and the hottest sectors and asset classes entice the most stalwart investors and advisers.

Despite the fine-print warning in most fund literature that "past performance is not an indicator of future outcomes," new money flows to funds atop the charts, studies show.

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But does it make sense to invest in today's winners? Absolutely not, say experts and analysts, and the numbers more than back them up, showing that few high-flying funds consistently stay on top. The reasons range from the cyclical nature and volatility of the market to the negative effect that a sudden inflow of extra capital can have on the top movers.

"If you're just going to go for the flavour of the year, you could be behind big time," says Carien Jutting, a certified financial planner and president of Fiscal Wellness Inc. in Stratford, Ont., noting that people who invest in today's winners are "buying backward."

Investors "shouldn't just blankly follow a list," says Saurin Patel, an assistant professor of finance at the Richard Ivey School of Business at the University of Western Ontario who specializes in mutual funds.

Nevertheless, studies show that consumers of equity funds disproportionately flock to high-performing ones, he says, with some 40 per cent of new money going to this year's winners. Fund managers and fund families thus "work extra hard to be at the top of the list."

Experts offer good reasons to avoid the funds sitting at the top of the performance charts:

Change happens

There are nine asset classes of investments, and their performance typically changes from year to year, Ms. Jutting says. Pick this year's winner and there's a good chance it might not do as well next year.

"These are all different animals, you can't compare one to the other," she says.

A recent study by Aye M. Soe, director of index research and design at S&P Dow Jones Indices, found that out of the 687 funds that were in the top quartile on the S&P Persistence Scorecard in March of 2012, only 3.78 per cent remained there at the end of March, 2014. Indeed, just 1.9 per cent of large-cap funds were in the top quartile after two years.

Sector investments can be volatile

Many of the winning funds in any given year are sector investments, and their success tends to be short-lived, Ms. Jutting says. Investments in gold, energy, India or health sciences, for example, can "run hot," she notes, but they usually don't have enough diversification to ride out trouble.

"They can shoot out the lights one year and be a loser the next," she says.

Dr. Patel says that some sectors such as oil and gas in Canada are able to outperform the overall economic benchmarks. "But will it last forever? The answer is no."

Beware the flash in the pan

The portfolio manager is the key to a fund's success, which can be linked to the manager's investment style or his or her focus on a particularly strong sector.

“We have found very little evidence that a mutual fund manager can repeat his performance,” Dr. Patel says.

Managers can experience trouble after they’ve been on top, he explains, especially as money floods in and they “can’t come up with new strategies overnight.” They tend to hold a fair bit of the additional funds in cash, or they invest in positions they already hold, driving up prices.

A study published in 2010 in the Journal of Finance showed that it’s impossible to tell whether actively managed funds that beat the market do so out of luck or skill. The study’s authors, Eugene Fama and Kenneth French, said it’s hard to determine how big of an element chance plays in good performance.

Dr. Patel says it’s difficult for managers to be lucky two years in a row, thus consistent results imply that they are skilled.

Look to the past

Newly created funds can suddenly make big gains, but they have no track record to demonstrate their sustainability or their ability to withstand volatility. Ms. Jutting says it’s preferable to review at least five years of performance and compare the fund to the index it represents, as well as its peers. “Look at how it does in bad times.”

Dr. Patel says that while longer track records can bring greater certainty, newer managers can be harder-working and more innovative, looking to establish themselves in the industry.

Numbers are tricky

Top mutual funds might look good on paper, but the data can give the wrong impression or be based on questionable statistics, Ms. Jutting says. Do your homework by reviewing more than one source of information, she advises. “Anything that looks like an aberration probably is.”

Charts can be subjective, Dr. Patel says. “Be careful what list you’re looking at to see that it matches your needs.”

Fees can rise

Success often prompts mutual fund companies to hike their fees, Dr. Patel says, which can cut into future returns. Low management expense ratios (MERs) at the beginning can rise over time.

“Fees do count,” Ms. Jutting agrees, albeit funds that cost a little more might be worth it if they outperform the market, and some fees can even go down.

Building a portfolio that meets your objectives and risk tolerance is not easy. “Consistency is important,” she says, with planning based on common sense, discipline and time.

“Everyone would like to make a consistent 10 per cent, however in today’s investing environment it’s not a realistic goal,” she points out, suggesting that a good return is about 6 per cent, which comes with solid, long-term investments. “Do you buy the winner from the last year? I don’t think so.”

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