S&P has bad news

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S&P has bad news for this year's top-performing funds

By Jason Kephart | *December 17, 2013 - 8:48 am EST*

S&P Dow Jones Indexes are playing the Grinch for this year's top-performing mutual funds. In its newly released Persistence Scorecard, the index company reports that the odds of the top-performing funds repeating that success are low at best and only get worse the longer the time frame. The bottom line: If you were thinking about buying new funds that have done well lately, you may want to think again.

Only 7% of the 692 domestic mutual funds that ranked in the top quartile of returns in September 2011 managed to continue to rank in the top quartile through September 2013, according to the report. Only 21.24% managed to stay in the top quartile over two straight years.

Large-cap funds fared the worst, with only 5.28% maintaining top-quartile performance over the three-years of rankings. Mid-cap funds had the highest chance of success over the same time period, with 10.31% maintaining their top quartile performance over the three years.

Over five years, the odds drop considerably, even if the standards are lowered to just staying in the top half of all funds in a respective category. Only 6.47% of the 1,421 domestic mutual funds that ranked in the top half of performers in September 2009 stayed in the top half for the next five years without slipping.

In a bit of a reversal, midcap funds fared the worst over the five-year period with less than 1% staying in the top half of best-performing funds. Small-caps fared the best with 9.9% staying consistent.

S&P's findings reinforce the idea that short-term performance chasing in mutual funds is likely to end badly for advisers, but for long-term investors, the lack of persistence doesn't necessarily mean a bad outcome, provided you can stomach the volatility.

For example, the MFS Equity Opportunities Fund (SRFAX), this year's top-performing large-cap blend fund, has returned 37% this year through Dec. 15, more than 10.81 percentage points better than its category average, according to Morningstar Inc. It ranks in the top 10th percentile over the trailing five years too, with an annualized return of 19.6%, two percentage points better than the S&P 500 over that span.

The fund's journey to five years of outperformance wasn't smooth though. In 2009 it ranked in the bottom 10th percentile of large-cap blend funds and in 2011 it ranked in the bottom half of its category.

The fund's rocky road is far from unusual.

The Vanguard Group Inc., which is best known for its index funds but also oversees more than $650 billion in actively managed equity funds, looked at the equity funds that outperformed over the 15-year period ending in 2012 and found that 65% of the funds that outperformed over that time period suffered at least three consecutive years of underperformance.

So if you can handle a fund that dips every now and again, without a big change to the investment process or management, the lack of persistence shouldn't matter over the long run. But, if you're the type who's going to jump ship at the first sign of performance anxiety, you're probably better off sticking with index funds.

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