

# MARKET SIGHT LINES



## Beware of Recency Bias and the Allure of Strong Performance

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As an investor, setting a clear objective while considering one's risk tolerance is important. With stocks, examples of objectives include total return, dividend income, dividend growth, or diversified active management. Assessing performance, especially near-term results, while considering the objective is also important. Inevitably, when a popular index earns a much better return than others, investors may ask: Why wasn't I invested there? Should I switch to that strategy? And this allure can be intensified by recency bias, or the belief that such strong relative performance will continue.

In this week's Sight|Lines we review the strong allure of the S&P 500's total return in 2023, the risks of recency bias, and a look at history to better understand how performance ebbs and flows across different objectives.

### **THE TAKEAWAY: RETURNS IN RECENT YEARS HAVE PRESENTED CHALLENGES FOR PERFORMANCE CHASERS.**

Performance across stock indices for different objectives varied in 2023, reversing 2022's results. In summary:

- In 2023, the S&P 500 has earned a strong return, driven in good part by the performance of the larger tech-oriented companies. Other diversified indices, including those related to other objectives, fell short.
- The strong 2023 S&P 500 return has people's attention, and recency bias, or the belief these results will continue, can be problematic, as these trends often reverse themselves from year to year.
- In fact, 2023 reversed the results seen in 2022, when big tech-oriented stocks were down big and the S&P 500 fell, while indices associated with other objectives held up.
- And when we look back at history, some patterns repeat, with specific indices sometimes looking better but then reversing in the other direction. Investors often regret chasing the best performers.
- While one cannot guarantee that long-term performance will repeat itself, strategies like high dividend and dividend growth, and the equal-weighted approach have outperformed over the long term.

Investors are well served to set a clear investment objective and align their portfolio with that objective.

### **IN-DEPTH: RETURNS IN RECENT YEARS HAVE PRESENTED CHALLENGES FOR PERFORMANCE CHASERS.**

In 2023, big tech-oriented stocks have performed well, driving positive results for the S&P 500 Index. Other indices fell short, sometimes reversing the results seen for 2022. Going deeper:

- Let's review a few examples of objectives for a stock portfolio and their performance:
  - A total return objective may align with a cap-weighted index like the S&P 500, which has earned 24.8% year to date, with big tech-oriented companies comprising about 66% of this return.

- A dividend growth objective may align with an index like the S&P 500 Dividend Aristocrats Index, which is comprised of companies that have grown dividends for 25 years or more; this index has earned a 2023 year-to-date return of 7.7%.
- A high dividend objective may align with an index like the S&P 500 Low Volatility High Dividend Index, which contains the 50 least-volatile high dividend-yielding stocks in the S&P 500; this index has earned a 2023 year-to-date return of -0.3%.
- Investing on a more equal weighted basis, often done with active management, to diversify beyond larger companies that dominate market indices, may align with an index like the S&P 500 Equal Weighted Index; this index is up 13.2% year to date, well below the S&P 500.
- The strong 2023 S&P 500 return has people's attention, and some believe its dominance will continue:
  - Recency bias favors recent events more than historic events, which could be driving these views.
  - In the markets, short-term trends often reverse themselves, sometimes year to year.
- The pattern we see in 2023 is a reversal of 2022 results. Last year:
  - The S&P 500 was down 18.1%, while the S&P 500 Equal Weighted Index fell 11.4%.
  - The S&P 500 Dividend Aristocrats Index was down 6.2% last year, and the S&P 500 Low Volatility High Dividend Index was off only 0.4%.
- And when we look back at history, sometimes these patterns repeat:
  - For example, as the dot-com bubble built up in 1999, the S&P 500 outpaced its equal-weighted counterpart by 9% but underperformed in 2000 by almost 19%.
- While one cannot guarantee that long-term performance will repeat itself, each of these four indices have outperformed the S&P 500's annualized return of 7.53% since December 31, 1998 (almost 25 years):
  - The S&P 500 Low Volatility High Dividend Index earned an annualized return of 8.0%.
  - The S&P 500 Equal Weighted Index earned an annualized return of 9.51%.
  - The S&P 500 Dividend Aristocrats Index earned an annualized return of 9.54%.

Note that market figures have been updated from an earlier release given market action after the December Fed meeting.

## CONCLUSION

Investors often set investment objectives that differ from total return. These can focus on dividend income, the growth of dividend income, or a diversified active management approach that is often implemented with a more equal-weighted portfolio. When performance in a short period, like a calendar year, varies greatly, people are sometimes tempted by the best performing indices. This is happening in 2023 with the S&P 500. This allure may be intensified by recency bias leading to a belief that the trend will continue. Historically, these trends tend to reverse. So, instead of focusing on short-term performance, an investor will be well served by setting a clear investment objective, aligning their investment portfolio with that objective, and then reviewing performance with a focus on the objective over the long term.

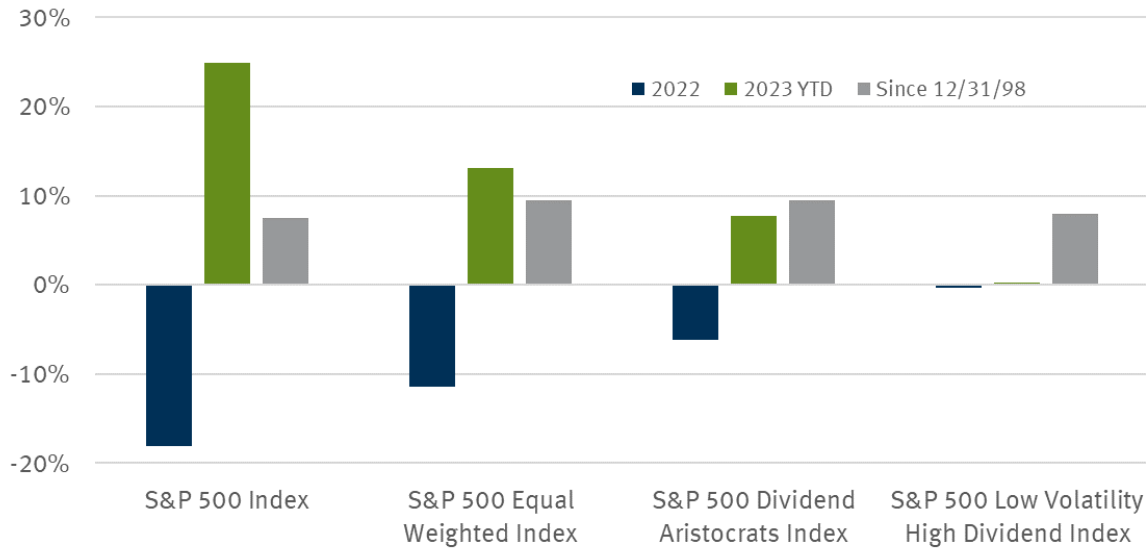
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Figure 1. Market Returns



Source: Stifel CIO Office via Bloomberg. As of December 15, 2023.

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