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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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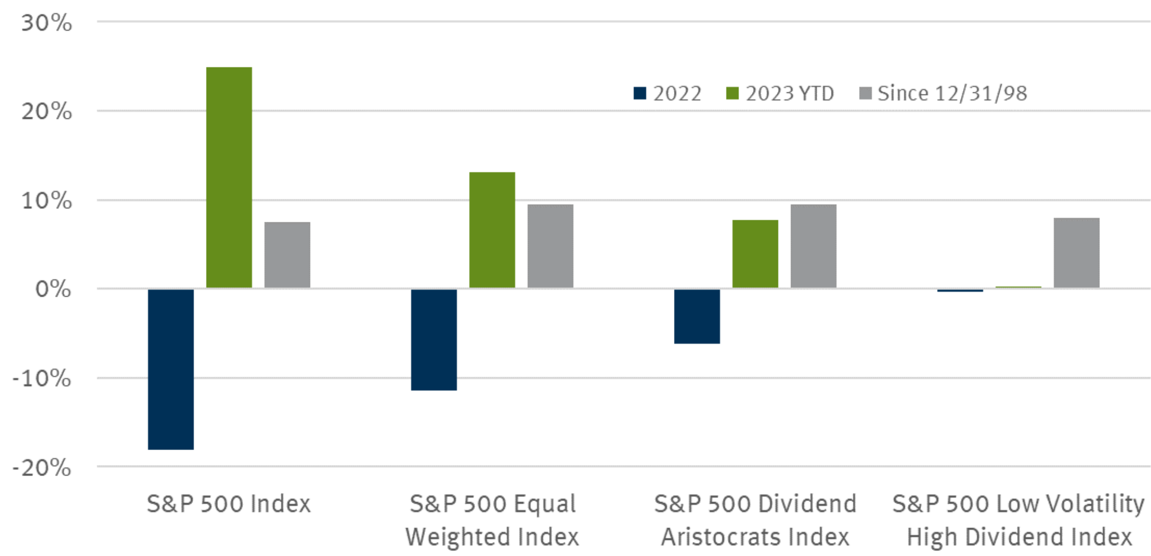
Figure 1. Market Returns



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