The Peril of Chasing Trends

Investors are challenged to maintain a long-term perspective amid persistent market trends. While attractive, these trends can often lead investors astray. Historical patterns reveal that trends eventually reverse, highlighting the importance of a disciplined approach to asset allocation.

Most institutional investors claim to have a long-term investment horizon. They recognize the advantages of diversification and resist the urge to chase performance. However, it can be very difficult to put those beliefs into practice when a persistent trend tempts the very same investors to stray from those principles.

This Viewpoint illustrates that while long-lasting trends are "normal", chasing them is fraught with peril. For investors that are tempted to chase these trends, it is important to remember that, historically, trends eventually reverse. While some trends may last only a couple of years, others can extend for over a decade.

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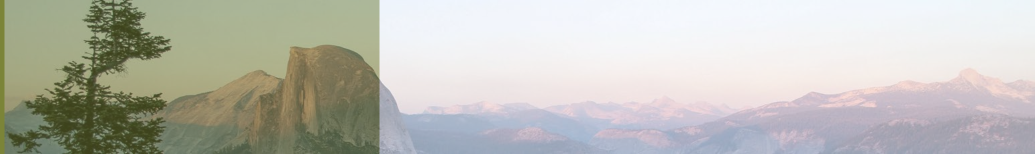
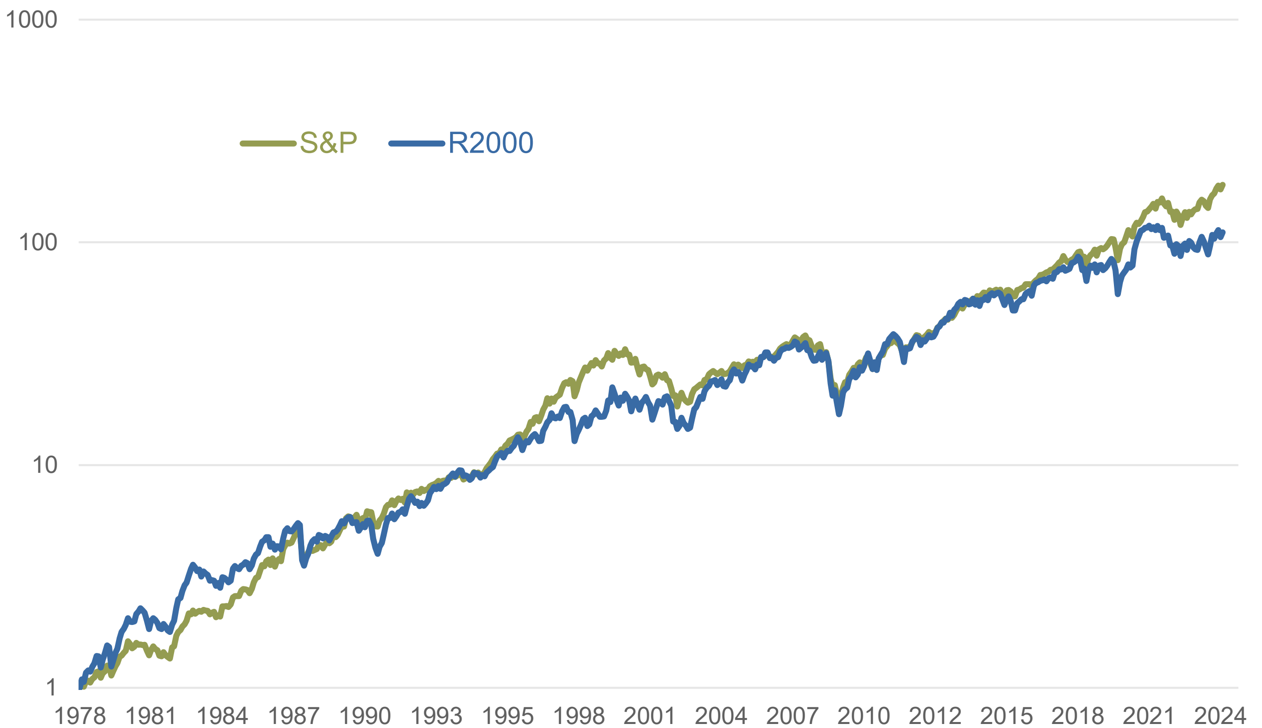


This Viewpoint uses five commonly compared pairs of investments to illustrate the issues. They are:

- Large cap versus small cap stocks – S&P 500 versus Russell 2000
- Growth versus value stocks – S&P 500 Growth versus S&P 500 Value
- US versus international stocks – MSCI USA versus MSCI ACWI xUS
- Emerging versus developed international market stocks – MSCI EM versus MSCI EAFE
- US dollar versus a trade weighted basket of foreign currencies – DXY Index

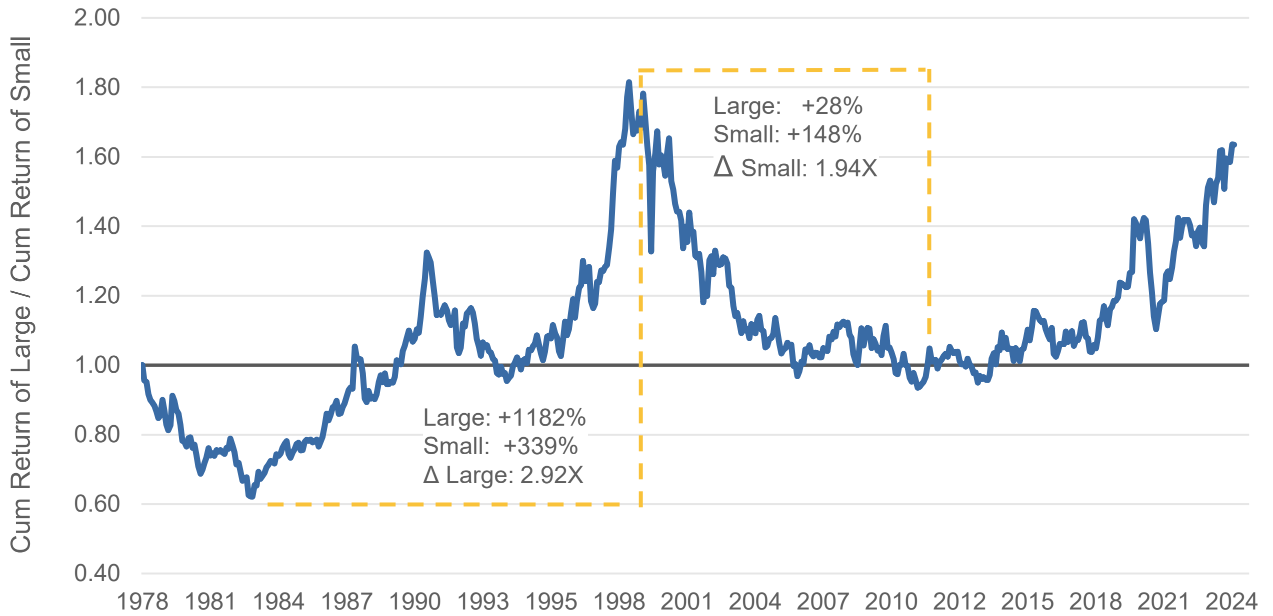
Understanding Historical Perspective

Chart 1 shows a long-term cumulative returns history of the S&P 500 and the Russell 2000. Because both indices had positive returns, and are highly correlated, it is difficult to see the patterns of relative returns.



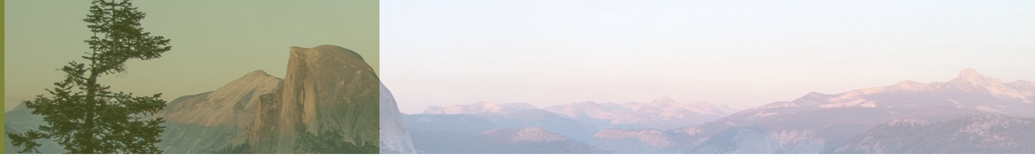
Data Sources: Bloomberg L.P.

It is more informative to look at Chart 2 which shows the cumulative relative return. It is the cumulative return of the S&P 500 divided by the cumulative return of the Russell 2000. When the line in this chart is rising, the S&P had higher returns than the Russell 2000, and when it was falling, the Russell 2000 had higher returns.

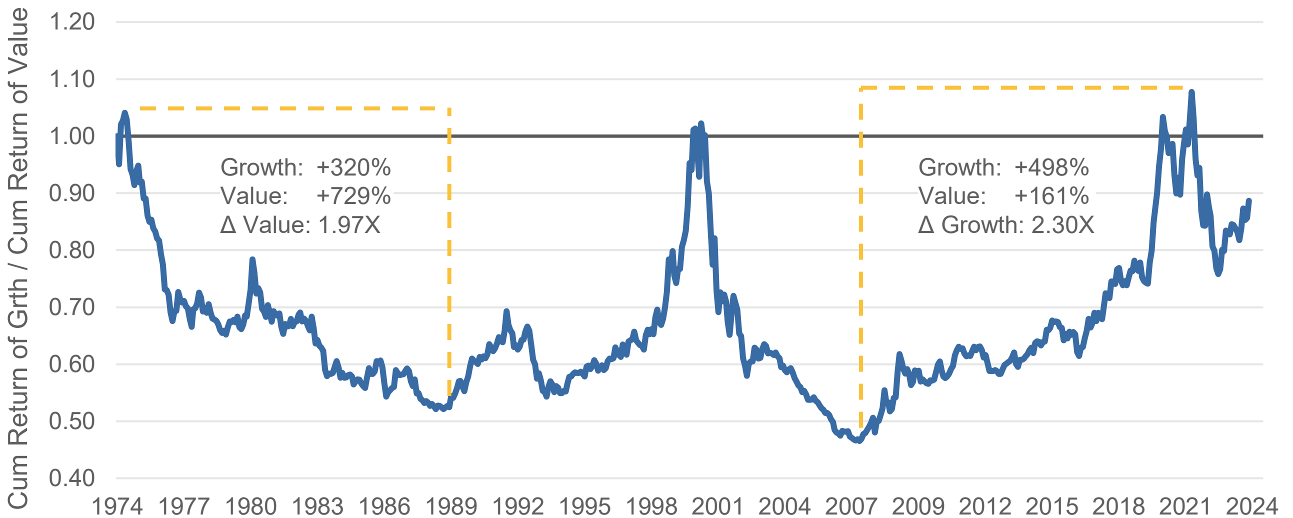


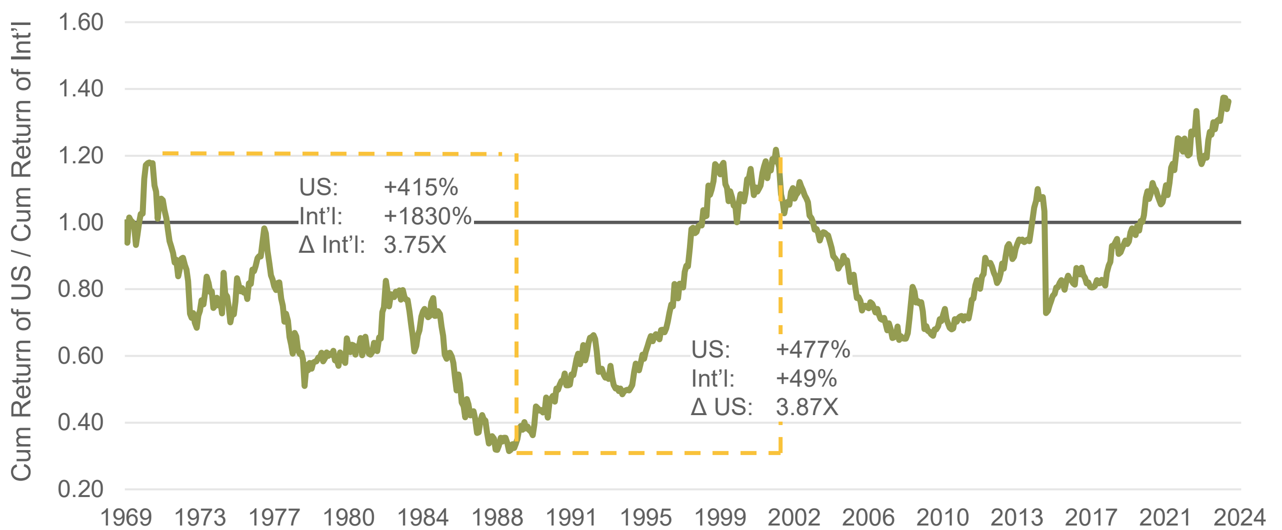
Examining Chart 2, we can see that small cap stocks outperformed large from 1978 to 1983. During that period, small caps returned 247% (31% per annum) versus only 115% (18% per annum) for large. As a result, at the end of that period, a dollar invested in small cap stocks would have been worth 1.61 times as much as a dollar invested in large (1.247/1.115 = 1.61). The next regime had large caps outperforming for 7 years. The last two periods had small caps outperforming for twelve years, followed by large outperforming for thirteen.[1]

Looking at the longer periods, large caps outperformed small from July 1983 to March 1999 (with a pull-back from December 1990 to February 1994). The callout on the chart shows that large caps returned 1182% during that period, while small caps only returned 339%. The "Δ Large" of 2.92X says that at the end of the period, a dollar invested in large-caps would have been worth 2.92 times as much as a dollar invested in small caps ($12.82 vs $4.39). Conversely, a dollar invested in small cap stocks in March of 1999, and held until March 2011 would be worth 1.94 times as much as a dollar invested in large cap stocks for the same period.



The next four charts provide similar comparisons for growth versus value stocks, US versus international stocks, emerging versus developed market stocks and the dollar versus foreign currencies. Each of them shows that there were long periods when one asset significantly outperformed the other, and then the roles switched. However, the lengths of the periods were not consistent, and nor were the magnitudes of the relative performance. Each investor will have to decide for themselves if they would have been able to reliably forecast the turns.





Data Sources: Bloomberg L.P.

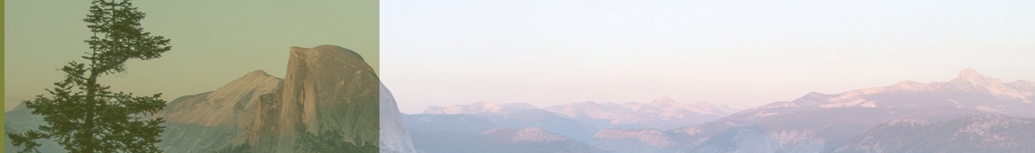


Chart 5: Emerging Markets vs Developed International Stocks

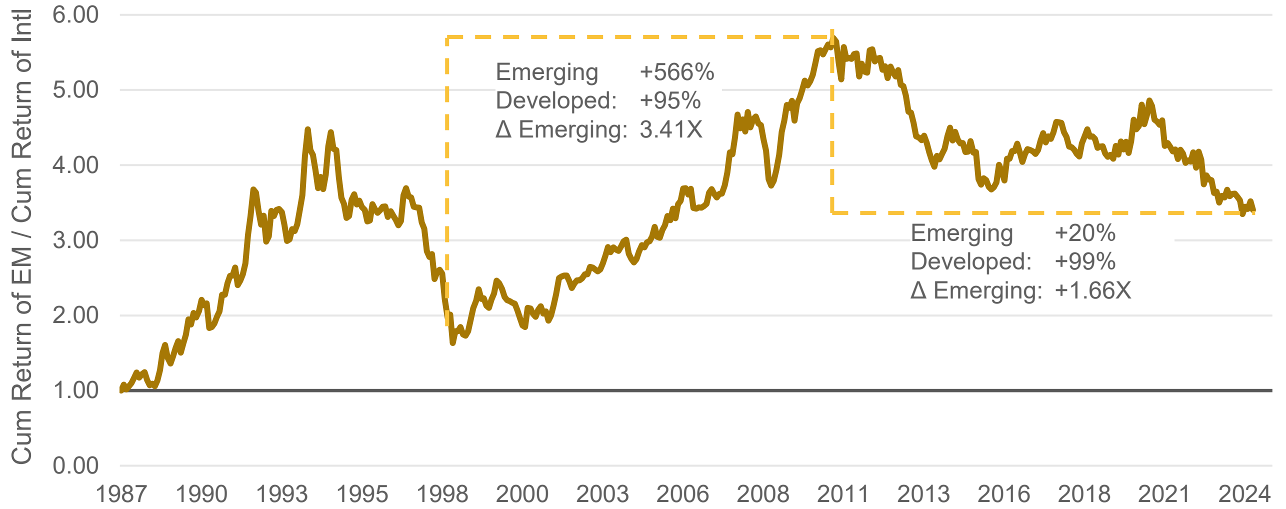
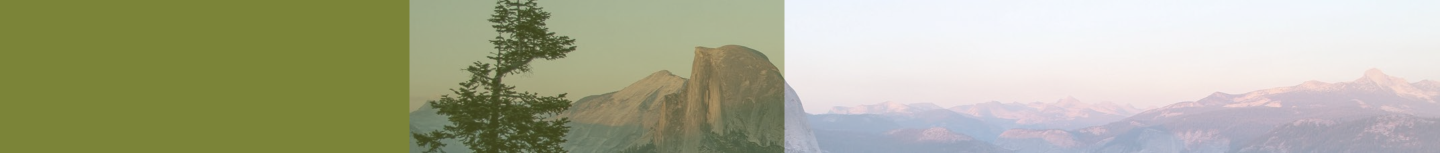


Chart 6: Dollar vs Trade Weighted Currency Basket

Data Sources: Bloomberg L.P.



Conclusion

The charts in this Viewpoint demonstrate trends in capital markets persisting for an extended periods of time. While some refer to them as cycles, the term implies a regularity that does not exist. Instead, trends in capital markets persist until the underlying conditions that cause them change. Common causes include shifts in expectations of future earnings, and changes in relative valuations. These differences in underlying macro and economic conditions can persist for long periods. However, knowing that is not particularly helpful in forecasting when investor sentiment or expectations will shift.

We believe that forecasting both the cause and timing of a trend's reversal is very challenging. History suggests that most investors do not have the skill required to reliably make such predictions. While it is difficult, our recommendation is that investors ignore trends (neither chase them, nor assume they will reverse in the near-term), and base their asset allocations on robust forecasts of longer-term expected returns that do not incorporate momentum or reversals.

Appendix

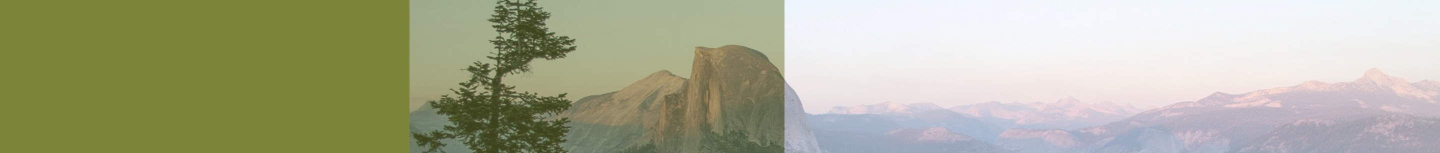
Table 1 describes the relative behavior of each pair of assets. For each, there are columns describing:

- **The length of the history** The shortest is emerging versus developed market stocks, with 36 years, 5 months of data. The longest is US versus international stocks with 54 years and 5 months of data.
- **The number of regimes, or periods with a persistent trend** (We should note that our regime identification is subjective, and based on our best judgement.) We identified the most (10) in US versus international stocks, and the fewest (5) in both emerging versus developed stocks and the dollar versus foreign currencies.
- **Regime lengths** The overall average is 7 years, 4 months. The shortest was 1 year, 2 months, and the longest was 14 years, 7 months.
- **Relative wealth ratio** is the value at the end of the regime of $1 invested in the first asset of the pair at the start of the regime, divided by the ending value of $1 invested in the second asset. For example, the 2.13X maximum for Large versus Small cap stocks is the result of the S&P 500 returning 146% between July 1983 and October 1990, while the Russell 2000 returned only 15%. As a result, at the end of the period, a dollar invested in the S&P would have been worth 2.13 times the value of a dollar invested in the Russell 2000. (2.46/1.15 = 2.13)
- **The difference in annual returns for the full history** For example, from December 1978 through May 2024, the S&P returned 12.1% per annum while the Russell 2000 returned 10.9%, resulting in a difference of 1.2%.

Table 1: Behavior of Each Asset Pair

	Length of Index Return History	Number of Regimes	*Regime Length*			*Relative Wealth at End of Regime*		Difference in Annual Return (Full History)
			Average	Shortest	Longest	Min	Max	
Large vs Small Cap	45 yrs, 5m	6	7 yrs, 7m	3 yrs, 4m	13 yrs,1m	52%	2.13x	1.2%
US vs International	54 yrs, 5m	10	5 yrs, 4m	0 yrs, 5m	8 yrs, 9m	38%	2.51x	-0.6%
Growth vs Value	49 yrs, 5m	6	8 yrs, 2m	1 yrs, 2m	14 yrs, 5m	46%	2.30x	0.3%
Emerging vs Developed Int'l	36 yrs, 5m	5	7 yrs, 3m	3 yrs, 0	12 yrs, 7m	36%	4.47x	3.6%
Dollars vs Currency Basket	51 yrs 5m	5	8 yrs,10m	6 yrs, 2m	14 yrs, 7m	49%	1.93x	-0.1%

Data Sources: Bloomberg L.P., Alan Biller and Associates.



Endnotes

1. Tables describing the performance are in the appendix.

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