Accounting & Tax | October 18, 2013 | CFO.com | US

Past Performance Is No Guarantee

The past tells us nothing about whether we will fail or succeed in the future. Executives should be mindful of this when considering their future goals.

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We humans are creatures of momentum. We expect things that have gone well to continue to go well and things that have gone poorly to continue to go poorly.

This is true in many ways. One of the easiest places to observe is in the stock markets. Many of us tend to look at stock that has gone up a lot and we expect it to keep going up. We know cases where this is true.

ANALYSIS

For example, over the five years ending in 2007, Apple was the second-best stock among the members of the S&P 500 with a total shareholder return (TSR) of 2,665 percent. Over the subsequent five years through 2012, Apple was still a great stock, with a TSR in the 95th percentile.

We of course know stocks that were bad year after year, like E*TRADE. During the raging five-year bull market through 2007, E*TRADE managed a TSR of -27 percent, which was worse than 98% of the S&P 500. Their encore over the next five years through 2012 was a TSR of -75 percent, which was worse than 99 percent of the S&P 500.

TSR captures the total return realized through changes in the share price plus dividends over a period. These benchmarks are against the current members of the S&P 500, of which 441 of them have data for the full period.

If you invested $1,000 in Apple at the start of this 10-year run it would have been worth almost $75,000 and a similar investment in E*TRADE would be worth $184. The difference is staggering and these spectacular successes and failures tend to attract our attention.

The only problem is Apple and E*TRADE are anomalies and the reality for most stocks and the companies they represent is quite different.

We studied the TSR of all current members of the S&P 500 during the five years through 2007 and the following five years through 2012. How strong or weak a stock is in the first five year period tells us practically nothing about the next five years.

The strong-performing stocks during the first period were pretty well distributed across the top, middle and bottom performers over the next five years. It was the same for the bottom performers during the first period. If anything,

there was a slight bias toward the top companies being a bit below average the next five years, and vice versa, but this varies a bit if you examine prior data through 2011 or 2010.

The formal name for the phenomena is reversion to the mean. We see it in financial advertisements that show exciting historical performance and then tell us past performance is no guarantee of future returns.

Most of us are not professional stock pickers, so this reversion to the mean may seem of little relevance. But for CFOs and other senior executives there are two important implications for strategy development and goal setting.

The first important implication from this analysis is that companies that have had strong stock-price performance in recent years cannot even think of resting on their laurels expecting the next few years will be more of the same. Going forward, they are just as likely to be a top performer as a bottom performer.

From the analysis of the S&P 500, this of course is a statistical reality but it is also an important cultural point. Just when strong- performing organizations become impressed by their own success, the problems seem to start. The CFO should make sure the management team realizes success is frail and to be successful the team must remain humble and hungry.

In fairness, it can be difficult to keep positive momentum when managers become satisfied with their success. But one proven technique to keep improvements rolling when a company leads an industry is to stop benchmarking against others and begin benchmarking against your own company.

If you are the best, beat yourself. It's about continuous improvement. You must never be content. That's how great athletes become better. They aim to beat themselves.

The second important implication from this analysis concerns business unit portfolio management. Don't assume the successful business units over the last few years will necessarily be the best sources of value creation going forward. They may or they may not.

Many management teams make the mistake of over-investing in what has been successful rather than what will be successful. This can be treacherous.

To be sure, to have a vision for the future you must first understand the past. Where have you been successful and why? Where have you delivered strong growth while realizing high returns on capital? How sustainable are these drivers of this success?

To assess the sustainability of success into the future requires a thorough assessment of sources of differentiation and their durability. When you are successful you attract competition, so a rigorous assessment of sustainability must include an in-depth assessment of each competitor and its ability to catch up and pass us by. Are there industry changes that will affect the ability to perform? Will your company lead these changes?

Similarly, where you have been less successful, are there reasons to believe the future may be brighter? This is perhaps the slipperiest of slopes. When we know a business well and the people running it, we often want to believe they can turn it around but often they cannot.

It is difficult to be objective but every effort is required to be as objective as possible when predicting a turnaround of a poor-performing business. Remember, the business is just as likely to continue to lag as it is to improve.

The science of economics and the theory of modern corporate finance, for example, were both established on a foundation of rational human behavior, but cognitive biases keep most of us from being as rational as we should be.

Cycles have been happening since the beginning of recorded time, yet we continue to act like good times and bad times will both endure. The smart CFO understands this and looks for the signs of sustainability before expecting past performance to be any sort of guarantee of the future.

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