Do the Top ETFs Continue to Outperform?

By Charles Rotblut, CFA

Article highlights:

- The 10 best ETFs, ranked first by three-year return and then by five-year return, were analyzed to see if they remained top performers or at least continued to beat a broad market index fund and/or their category peers.
- Some persistence in terms of outperformance did exist. Eleven ETFs appeared on the top-performers list at least twice, two as many as four times.
- Persistent outperformance did not occur as the majority of top-performing ETFs went on to lag the market benchmark and often their category peers.

Seven years ago, we started tracking the best-performing exchange-traded funds (ETFs).

We first used three-year annualized returns, before extending the look-back period to five years.

In the first article on the subject ("The Top ETFs Over Three Years Represent an Eclectic Group," September 2011), I explained that I had "compiled the list as an experiment to see what a long-term, top-performing ETF portfolio would look like." The idea for doing this came from similar articles we've written about the best-performing mutual funds over five-year periods.

One of the differences between mutual funds and ETFs is that the former are mostly actively managed, while the latter mostly follow indexes. While there are many passive mutual funds and a growing number of actively managed ETFs, both remain in the minority in terms of the absolute number of mutual funds and ETFs, respectively. Thus, while part of mutual fund performance can be attributed to the decisions made by the fund manager(s), ETF performance is usually due to a combination of index construction and what the index is designed to track (e.g., a specific asset class, a certain sector, an industry group, etc.).

Given this, the natural question is: Does it make sense to focus on the ETFs with the best three- or five-year performance? Or is a list of the 10 best performers an interesting topic, but not something to base investment decisions on? To find the answer, we looked at what appeared on the top-performers list to see how those ETFs performed over the following three to five years.

Which ETFs Were Included?

The ETFs analyzed appeared in the Top ETFs articles for the years 2011 through 2015. A cutoff date of 2015 was used in order to ensure there was at least three years of post-publication return data to analyze. (We stretched the definition of the post-publication return slightly by including the two months prior to publication—July and August of the year the Top ETFs were compiled—in the calculations.)

A fund was designated as a top ETF if its trailing three-year net asset value return (for the years of 2011, 2012, 2013 and 2014) or its trailing five-year net asset value return (for 2015) ranked among the 10 highest for ETFs included in our annual ETF Guide. Returns were ranked on an absolute basis, which allowed more than one fund from the same category to appear in the top-performers list on a given year.

The funds included in those articles appeared in our annual Individual Investor's Guide to Exchange-Traded Funds (www.aaii.com/guides/etfguide). For the original 2011 article, ETFs were required to have at least three years of return data and a minimum of $200 million in assets. The required minimum for assets was raised to $250 million in 2013 and to $400 million in 2014. In 2015, we began requiring funds to have at least five years of return data to qualify.

A three-year period was initially used out of necessity.

Table 1. Publication Date and Post-Publication Performance of the Top ETFs

	NAV Total Return (%)						Total Assets ($ Mil)			Expense Ratio (%)		
	As of Pub Date		3 Years Later		5 Years Later							
	ETF 3-Yr Ann'lzd	ETF 5-Yr Ann'lzd	ETF 3-Yr Ann'lzd	Cat 3-Yr Ann'lzd	ETF 5-Yr Ann'lzd	Cat 5-Yr Ann'lzd	As of Pub Date	Three Years Later	Five Years Later	As of Pub Date	Three Years Later	Five Years Later
2011 Overall Three-Year Top Performers												
iShares Silver Trust (SLV)	**25.1**	**26.1**	(16.3)	(9.8)	(12.6)	(9.2)	10,734	6,736	6,122	0.50	0.50	0.50
First Trust NYSE Arca Biotech Index (FBT)	**24.8**	**16.4**	23.4	22.3	15.4	15.3	550	1,309	815	0.60	0.60	0.55
SPDR S&P Retail (XRT)	**24.0**	**8.5**	18.8	17.9	10.7	9.9	570	560	502	0.35	0.35	0.35
iShares MSCI Chile Investable Mkt Idx (ECH)	**20.0**	—	(14.0)	(1.8)	(11.8)	(5.9)	860	316	315	0.61	0.61	0.63
SPDR S&P Pharmaceuticals (XPH)	**19.4**	**11.2**	**28.9**	22.3	14.3	15.3	244	949	506	0.35	0.35	0.35
First Trust Health Care AlphaDEX (FXH)	**18.8**	—	21.4	22.3	14.7	15.3	341	2,005	1,134	0.70	0.70	0.62
PowerShares DB Precious Metals (DBP)	17.6	—	(8.0)	(9.8)	(5.9)	(9.2)	551	189	220	0.75	0.75	0.75
First Trust Dow Jones Internet Index (FDN)	**17.5**	**11.4**	**18.0**	13.4	**14.8**	10.4	725	1,864	3,068	0.60	0.60	0.54
Rydex S&P Midcap 400 Pure Growth (RFG)	**17.2**	**12.7**	12.9	15.5	7.1	9.7	678	827	578	0.35	0.35	0.35
iShares Gold Trust (IAU)	17.2	19.2	**(4.7)**	(9.8)	**(2.8)**	(9.2)	6,983	6,965	8,838	0.25	0.25	0.25
iShares Dow Jones US ETF (IYY)	3.9	3.4	16.2	16.1	11.5	11.8	612	932	915	0.20	0.20	0.20
2012 Overall Three-Year Top Performers												
iShares FTSE NAREIT Resid Plus Cp Idx (REZ)	**34.3**	**4.1**	**9.0**	8.2	10.4	10.1	204	250	430	0.48	0.48	0.48
iShares Cohen & Steers Realty Majors (ICF)	**33.9**	1.4	7.8	8.2	8.8	10.1	2,914	3,029	3,252	0.35	0.35	0.35
SPDR Dow Jones REIT (RWR)	**33.2**	1.9	8.4	8.2	8.7	10.1	1,960	2,863	3,030	0.25	0.25	0.25
Vanguard REIT Index ETF (VNQ)	33.0	**3.1**	8.6	8.2	9.3	10.1	13,219	23,802	33,954	0.10	0.12	0.12
First Trust S&P REIT Idx (FRI)	32.3	1.8	8.2	8.2	8.7	10.1	388	208	203	0.50	0.50	0.49
PowerShares Dynamic Pharmaceu'ls (PJP)	**30.3**	**12.5**	**35.4**	30.3	16.2	17.2	275	2,021	747	0.63	0.58	0.57
iShares Dow Jones US Real Estate (IYR)	30.2	0.8	7.7	8.2	8.7	10.1	4,125	4,223	4,777	0.47	0.45	0.44
SPDR S&P Retail (XRT)	**30.2**	**7.6**	20.0	18.7	7.9	12.8	558	1,110	419	0.35	0.35	0.35
iShares MSCI Thailand Invest Mkt Index (THD)	**29.8**	—	6.1	10.4	5.5	8.0	623	349	393	0.59	0.62	0.63
First Trust NYSE Arca Biotech Index (FBT)	**27.4**	**12.9**	**41.5**	30.3	**21.1**	17.2	250	3,596	1,031	0.60	0.58	0.56
iShares Dow Jones US ETF (IYY)	16.6	0.4	17.3	17.1	14.3	14.3	610	959	1,097	0.20	0.20	0.20
2013 Overall Three-Year Top Performers												
PowerShares Dynamic Pharmaceu'ls (PJP)	**33.5**	21.5	**17.9**	14.4	12.0	14.3	547	1,140	541	0.63	0.56	0.56
iShares Nasdaq Biotechnology (IBB)	**31.4**	**18.0**	14.2	14.4	13.8	14.3	3,148	6,450	8,880	0.48	0.48	0.47
SPDR S&P Retail (XRT)	**30.6**	**22.9**	4.1	6.7	6.1	10.5	1,053	502	444	0.35	0.35	0.35
SPDR S&P Homebuilders (XHB)	**28.8**	**13.8**	5.0	6.3	6.7	8.4	2,472	1,244	835	0.35	0.35	0.35
PowerShares Dynamic Leisure & Entertain (PEJ)	**27.2**	**17.5**	7.0	6.7	11.4	10.5	108	121	144	0.63	0.63	0.61
Vanguard Consumer Discretionary ETF (VCR)	26.7	16.8	**11.8**	6.7	**14.8**	10.5	865	1,762	3,158	0.14	0.10	0.10
iShares Dow Jones US Home Construction (ITB)	26.7	10.4	**7.7**	6.3	**11.7**	8.4	2,423	1,496	1,226	0.47	0.43	0.44
Consumer Discret Select Sector SPDR (XLY)	26.6	16.7	**13.0**	6.7	**15.8**	10.5	5,898	9,653	13,779	0.18	0.14	0.13
SPDR S&P Biotech (XBI)	**26.4**	12.8	**16.7**	14.4	**22.9**	14.3	866	1,985	5,219	0.35	0.35	0.35
Guggenheim Spin-Off (CSD)	**26.0**	**12.8**	3.7	9.6	9.3	12.0	196	217	206	0.65	0.65	0.62
iShares Dow Jones US ETF (IYY)	18.5	7.1	11.0	11.1	13.0	13.0	728.5	915	1,165	0.20	0.20	0.20
2014 Overall Three-Year Top Performers												
iShares Nasdaq Biotechnology (IBB)	**34.3**	**29.0**	6.6	9.3	—	—	5,251	9,565	—	0.48	0.47	—
PowerShares Dynamic Pharmaceu'ls (PJP)	**32.7**	**33.0**	4.1	9.3	—	—	1,166	747	—	0.63	0.57	—
SPDR S&P Pharmaceuticals ETF (XPH)	**28.9**	**30.0**	(1.9)	9.3	—	—	949	452	—	0.35	0.35	—
SPDR S&P Biotech ETF (XBI)	**28.7**	25.1	**15.2**	9.3	—	—	1,109	3,514	—	0.35	0.35	—
iShares US Home Construction (ITB)	**25.7**	21.1	**11.5**	8.5	—	—	1,769	1,702	—	0.46	0.44	—
iShares US Pharmaceuticals (IHE)	24.5	25.7	6.1	9.3	—	—	744	698	—	0.46	0.44	—
First Trust US IPO Index (FPX)	**24.4**	**26.2**	8.2	9.1	—	—	486	841	—	0.60	0.60	—
Guggenheim Spin-Off (CSD)	**24.1**	**28.2**	2.9	7.2	—	—	702	195	—	0.65	0.65	—
First Trust NYSE Arca Biotech Index (FBT)	23.4	**31.2**	11.5	9.3	—	—	1,309	1,031	—	0.60	0.56	—
SPDR S&P Homebuilders ETF (XHB)	23.4	**24.2**	6.2	8.5	—	—	1,849	1,058	—	0.35	0.35	—
iShares Dow Jones US ETF (IYY)	16.2	19.1	9.0	14.3			932	1,097		0.20	0.20	

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2015 Overall Five-Year Top Performers												
SPDR S&P Biotech ETF (XBI)	**42.7**	**37.8**	4.6	3.6	—	—	2,713	5,219	—	0.35	0.35	—
iShares Nasdaq Biotechnology (IBB)	**41.9**	**37.0**	(3.5)	3.6	—	—	9,044	8,880	—	0.48	0.47	—
PowerShares Dynamic Pharmaceu'ls ETF (PJP)	**35.4**	**35.5**	(2.7)	3.6	—	—	2,021	541	—	0.58	0.56	—
First Trust NYSE Arca Biotech ETF (FBT)	**41.5**	**32.1**	4.1	3.6	—	—	3,596	1,618	—	0.58	0.56	—
SPDR S&P Pharmaceuticals ETF (XPH)	32.1	**29.4**	(9.2)	3.6	—	—	1,135	335	—	0.35	0.35	—
iShares US Pharmaceuticals (IHE)	28.1	27.9	(3.3)	3.6	—	—	1,161	370	—	0.45	0.44	—
PowerShares Dynamic Biotech & Genome (PBE)	**36.2**	27.8	(4.5)	3.6	—	—	560	257	—	0.59	0.58	—
First Trust Health Care AlphaDEX ETF (FXH)	30.7	26.0	2.5	3.6	—	—	4,133	1,002	—	0.66	0.62	—
iShares US Healthcare Providers (IHF)	30.6	26.0	**7.3**	3.6	—	—	1,029	685	—	0.45	0.44	—
Guggenheim S&P 500 Eq Weight HC ETF (RYH)	29.9	25.4	5.1	3.6	—	—	798	603	—	0.40	0.40	—
iShares Dow Jones US ETF (IYY)	17.3	17.3	11.4	11.1			959	1,165		0.20	0.20	

Source: AAII's Top ETFs Guides for 2011 through 2018. Data from Morningstar, Inc. Returns that are in the top 25% of all ETFs within the investment category are shown in boldface. Fund names reflect the name at publication date for each year.

There simply were not enough funds with longer histories to rank them by five-year returns. It took the launch of funds in several of the smaller equity categories as well as within the various fixed-income categories for us to be able to extend the look-back period to a full five years. While ETFs may seem ubiquitous now, the industry is not very old. Slightly less than half of all exchange-traded funds currently in existence (as of June 30) were launched within the past five years. Three-quarters of all current ETFs were launched within the last 10 years.

Funds that use leverage to provide double or triple the return of their underlying index or that follow inverse strategies (they rise in price when the underlying index falls) were excluded from the historical analysis. These funds are designed to be held for short periods of time, not several years.

Some Funds Stayed on Top, But Not Most

Some persistence did exist as 11 different exchange-traded funds appeared on the top-performer list on at least two occasions between 2011 and 2015. Guggenheim Spin-Off (CSD), iShares US Home Construction (ITB), iShares US Pharmaceuticals (IHE) and SPDR S&P Homebuilders (XHB) all made appearances in back-to-back years. IShares Nasdaq Biotechnology (IBB), SPDR S&P Biotech (XBI) and SPDR S&P Retail (XRT) each were top performers for three consecutive years. SPDR S&P Pharmaceuticals (XPH) also made the list on three occasions, though not consecutively. First Trust NYSE Arca Biotech Index (FBT) was a top performer in four years—two back-to-back appearances (2011, 2012, 2014 and 2015) with a break in 2013. The four-year streak for PowerShares Dynamic Pharmaceuticals (PJP) ran between 2012 and 2015.

Persistence was not the rule. None of the 20 other top-performing ETFs made the list more than one time. The largest number of one-timers occurred in 2012, when seven of the 10 ETFs didn't reappear on a subsequent top-performers list. Many of these ETFs were from the real estate category. Their high returns for the three-year period ended in 2012 reflected a big rebound in prices following the 2008 financial crisis. The one-time appearance of these funds shows the impact sector and industry trends can have on ETF returns.

Calculating Post-Publication Returns

The number of times an ETF appeared is one measure. Another is post-publication returns. How did an ETF perform after it appeared on the top-performers list? Did its returns stay high? Did the fund continue to beat its peers?

To find an answer, we looked at how each fund performed over three- and five-year periods (when possible) after appearing on the top-performers list. We did this for each year, meaning if an ETF made more than one appearance, its post-publication returns were calculated following each appearance separately. We also looked at how their total assets changed and whether their expense ratios changed.

In doing so, we sought out two benchmark comparisons to measure performance against. The first was the average three- and five-year performance for the funds' respective categories. A former top ETF may still be worth considering even if its performance declined after appearing on the top-performers list if it continued to best most of its category peers.

The second benchmark was a broad market index fund. Specially, we used the iShares Dow Jones US ETF (IYY). This market-capitalization-weighted ETF invests in the largest 1,200 U.S. companies. Its inclusion represents the alternative investors always have: The ability to simply track the returns of the market rather than relying on a fund with a much narrower investing scope.

Can't Count on Continued Overall Outperformance

Not surprisingly, the ETFs that appeared in the top-performers list in consecutive years were the most likely to top the iShares Dow Jones US ETF benchmark over the subsequent three-year and five-year periods. The First Trust NYSE Arca Biotech Index ETF beat the benchmark over the following three- and five-year periods after appearing in top-performers list in 2011 and 2012. It also outperformed the IYY over the subsequent three-year period after it was included for a third time in 2014.

The iShares Nasdaq Biotechnology ETF outperformed IYY during the three- and five-year periods following its first inclusion in the top-performers list in 2013 but failed do so again after its subsequent inclusion in 2014 and 2015.

The PowerShares Dynamic Pharmaceuticals ETF topped the IYY over the subsequent three- and five-year periods following its first appearance as a top performer in 2012. After its 2013 inclusion, the ETF bested the benchmark over the following three years, but not over the following five-year period. PowerShares Dynamic Pharmaceuticals lagged the IYY over the three-year period starting in July 2014.

The SPDR S&P Biotech outperformed the IYY over the three- and five-year periods following its first inclusion in 2013. It also beat the benchmark over the following three-year period starting in July 2014.

Note that all of these are health care-related funds. We saw a wave of high relative returns for health care ETFs in the first half of this decade, leading to the outperformance. When sentiment shifted, the returns of the aforementioned ETFs lagged. Over the three-year period beginning in July 2015, First Trust NYSE Arca Biotech, iShares Nasdaq Biotechnology and PowerShares Dynamic Pharmaceuticals all underperformed the iShares Dow Jones US ETF benchmark. The strong returns and subsequent underperformance show how much impact sector and industry momentum can have on ETFs.

One-Time Outperformers

Not reappearing in the top-performers list did not guarantee underperformance. Some funds continued to outperform the market benchmark in the years following their only appearance in the list.

The First Trust Dow Jones Internet Index ETF (FDN) beat the iShares Dow Jones US ETF benchmark over the three- and five-year periods starting in July 2011. The Vanguard Consumer Discretionary ETF (VCR) and the Consumer Discretionary Select Sector SPDR ETF (XLY) did the same following their inclusion in the 2013 top-performers list. After being part of the 2014 top performers, the iShares US Home Construction ETF (ITB) went on to beat the IYY over the following three-year period.

Most Top Performers Lagged the Market Benchmark

While several ETFs did continue to best the market benchmark, this was the not case for the majority of the ETFs appearing in our top-performer lists. Following 2011 and 2013, five of the top performers went on to beat the IYY over the subsequent three-year period. During the three-year periods starting in 2012 and 2014, seven of the top performers lagged. In 2015, all 10 top performers lagged the IYY over the following three years. (Note: All 10 of the ETFs in 2015's top-performer list were from the health care sector.)

The high levels of underperformance show the difficulty of picking the ETFs that are likely to have the best longer-term returns in the future solely by looking at past returns. Outperformance over a three- or five-year period does not guarantee future outperformance.

Even looking for industry or sector representation by more than one fund in the top-performers list does not assure that future returns will be above the benchmark. In 2011, three precious metals ETFs ranked among the 10 best in terms of three-year returns: iShares Gold Trust (IAU), iShares Silver Trust (SLV) and PowerShares DB Precious Metals (DBP). Over the following three-year period, IAU trailed the IYY by 20.9 percentage points on annualized basis. SLV and DBP fared even worse, trailing by 32.5 and 24.2 percentage points, respectively, on an annualized basis.

What About Beating Their Category Average?

Sector and industry factors have significantly influenced the returns of many exchange-traded funds. As is the case with mutual funds, business cycles and shifts in investment sentiment toward an industry, sector, asset class or even style of investing can all affect how a given ETF performs on an absolute-return basis.

The better mutual funds do outperform their peers over longer periods of time. Low expense ratios and manager skills impact how these funds perform relative to their category averages. Most ETFs are tied to the construction of their underlying indexes, though differences in expense ratios can also have an impact. Given this, it is worthwhile to ask whether the top-performing ETFs continue to best their category peers.

For each top-performing ETF, we compared their subsequent three- and five-year return (when possible) against their respective category averages. The goal was to see whether or not looking at a list of the top performers could be a starting point for finding ETFs likely to remain among the higher-returning funds in their respective categories.

The results varied by year, but at best, they were inconclusive on a three-year basis. Not surprisingly, ETFs that went on to reappear in the top-performers list bested their category peers on average. There were also several ETFs that only had one appearance on the top-performers list that went on to outperform their category peers over the following three-year periods [e.g., iShares FTSE NAREIT Residential Real Estate (REZ) in 2012 and PowerShares Dynamic Leisure & Entertain (PEJ) in 2013]. Notably, seven of the ETFs appearing on the 2014 top-performers list underperformed their category peers over the following three-year period.

Extending the period out to five years was less encouraging. In both 2011 and 2013, half of the top-performing funds failed to beat their category average returns over the next five years. Of the 10 ETFs comprising the 2012 top-performers list, eight went on to underperform their category averages over the next five years.

Even cutting fees did not make a discernable difference in terms of which funds went on to outperform.

A Few Takeaways

Investing in a sector- or industry-focused exchange-traded fund solely based on its past performance is risky. Neither the outperformance nor the factors leading to the higher returns may persist. Even if there are indications of sustained outperformance, future returns may not be as good.

This said, periods of momentum do exist. Some outperforming funds will continue to outperform for a period of time. These above-average returns can reflect favorable industry/sector trends and/or favorable investor sentiment. Such trends should be monitored, as they will eventually end. In some cases, the trends will reverse, with big losses following big gains. An example are the losses incurred by precious metals ETFs between 2011 and 2014—a time when domestic equity ETFs were realizing large gains.

It's rare to see a broad index fund appear in the top listings due to their inherent sector diversification. From an asset allocation standpoint, starting with broad index funds makes sense. The mix of basic asset classes—particularly stocks and bonds—will have the greatest impact on building wealth. Getting this mix right and staying disciplined about adhering to a well-thought-out long-term strategy is far more important than constantly trying to be allocated to the right sector or industry at the right time.

A good portfolio can be supplemented from time to time with small allocations to specific ETFs. It's far harder to achieve the same results by constantly chasing after the best-performing fund.

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(continued from page 11)

Vice Versus Virtue

Far more virtue stocks pass the screens than vice stocks. The reason is the respective size of the universes. The vice stock universe was limited to a few industry groups, most of which are small in terms of the number of companies they encompass (e.g., there are only nine exchange-listed tobacco companies). The virtue universe covers a far broader range of industries.

Investing directly in vice companies requires making a purposeful effort to target such industries. An investor who is indifferent as to whether their portfolio includes vice stocks can screen the entire universe of stocks.

Had we run the value and growth screens without purposely seeking out vice or virtue, we would have found 520 value stocks and 551 growth stocks. Some of these stocks would have fallen into either the vice or virtue realm.

Virtue investing requires either excluding certain industries or favoring companies with specific environmental, social or governance traits. It purposely omits certain companies from a portfolio, which can cause an investor to sacrifice potential upside, a cost some may find justifiable given the desire to adhere to personal values.

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