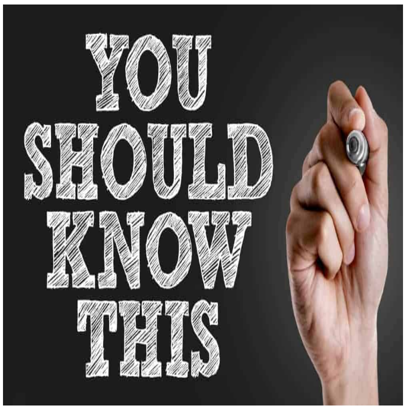

TFSA Investors: Stop Making This Common Mistake

Description

Mutual funds, exchange-traded funds (ETFs), investment management companies, and real estate investment trusts (REITs) are all popular options for investors seeking long-term gains in their Tax-Free Savings Account (TFSA).

Some of the best asset managers and stock pickers in the country have had a phenomenal run over the past few decades and delivered billions in capital appreciation to faithful shareholders.

Some, like **Fairfax Financial's** Prem Watsa, **Brookfield Asset Management's** Bruce Flatt, and **Onex's** Gerald W. Schwartz have been so successful at picking investments that they've become some of the richest people in the country. Since their companies are all publicly listed, it's tempting to assume you can add this investment magic to your portfolio by buying their stocks.

However, that temptation is the result of the most common mistake TFSA investors tend to make — relying on past performance to inform future expectations.

A bad indicator

Historic performance is readily available, which is why it's so easy to rely on. However, academic research seems to suggest that outsized returns from stock picking in the past have little to no correlation with an asset manager's future performance.

A study by Vanguard revealed that a surprisingly small number of actively managed mutual funds, 8.4%, in Canada outperformed the **S&P/TSX index** over the past decade.

That's not all. Two-thirds of all active funds were not accounted for because they disappeared (or failed) during that 10-year period. Also, Vanguard found that the top performers in any given year did not sustain their performance over the next year or beyond. In other words, the top performers were different every year.

Meanwhile, taxes, fees and transaction costs reduced the net returns for shareholders even further. In short, investors are unlikely to pick mutual funds or investment managers who win consistently over long periods of time.

What can you do?

The two things most investors can do to avoid this issue and boost returns is to seek out low-cost index funds. Passive investing has become more mainstream in recent years.

However, active managers can still outperform if they focus on estimating *future* returns rather than relying on past performance. If, for example, you believe the private equity industry and Canadian real estate are overpriced, avoiding Onex and residential REITs may be a good call.

However, if you believe India's economy will outperform in the future or technology stocks are likely to keep growing at higher-than-average rates, **iShares India Index ETF** or **S&P/TSX Capped Information Technology Index** may be better bets.

You can also analyze a company from the bottom up, using metrics like retention ratio and return on investment to make an educated guess about the company's future growth rate.

To paraphrase Wayne Gretzky, investors should go where the puck will be, not where it is.

Foolish takeaway

Past performance isn't an accurate indicator of future returns. Nonetheless, most TFSA investors tend to believe that an experienced asset manager or stock picker who has had some success in the past will continue to outperform in the future.

Avoid this mistake and pick stocks or funds based on future potential instead.

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