

YOU ARE THE KEY

JUNE 2008

Every newsstand has publications that offer commentary which claim to hold keys to investment success. One of the contrasts that we have highlighted over the years is how the media spends most of its time obsessing about the short term while noting that a long term perspective is critical to success.

Much of this stems from the economics of advertising. If viewer count or circulation is low, advertising drops. Therefore, headlines must grab attention. Stories need to disturb, and then comfort the reader to keep you coming back.



In a world where we have so little control over the many variables that affect our financial security, feeling informed and current is comforting.

Of course, there is nothing wrong with seeking comfort. In fact, comfort may be goal number one for some with respect to their finances. When the source of that comfort is the short term focused media, there is a potential for problems. One way this happens is that people abandon a long term approach in favor of chasing what is hot -- or fleeing what is not. Humans have been doing this for centuries. We warn about this often and for good reason.

Many studies have shown how investors earned much lower return than the funds offered. DALBAR has been looking at this issue since 1994, updating the information through 2007. Though the markets have behaved wildly over this time, investor behavior has been the same: "Based on an analysis of actual investor behavior over the 20 years ended December 31, 2007, the average equity fund investor would have earned an annualized return of just 4.48% -- underperforming the S&P 500 by more than 7% and outpacing inflation by a mere 1.44%. Fixed income investors would have fared far worse, losing their purchasing power by an average of 1.49%"

This difference is attributable to poor buying and selling choices. People buy after a run-up when prices are high and sell after prices have declined, opposite from the buy low/ sell high formula.

While recent conditions were deemed different by the media, the outcome was the same. In the late 1990s, fund investors again paid a high price for the focus on the promise of the technology-driven information age, and on the promised land of the great bull market. The price they paid can be measured both by the timing errors as well as fund choice.

John Bogle, founder of the Vanguard fund family, provides new data in a column he wrote recently for the Journal of Indexes.



Figure 1

“The first two charts reflect those destructive patterns. The timing penalty (Figure 1) was evidenced by the fact that fund investors placed little money into equity funds during the cheap markets of the late-1980s and early-1990s (less than \$10 billion per year), but invested more than \$500 billion at the peak market levels of 1998–2000.

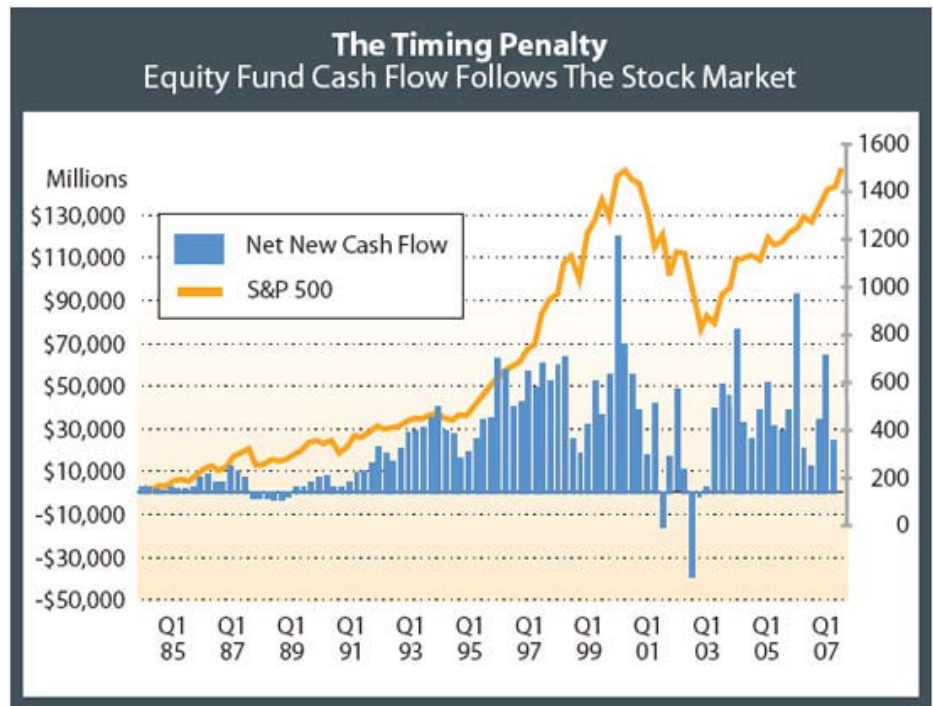
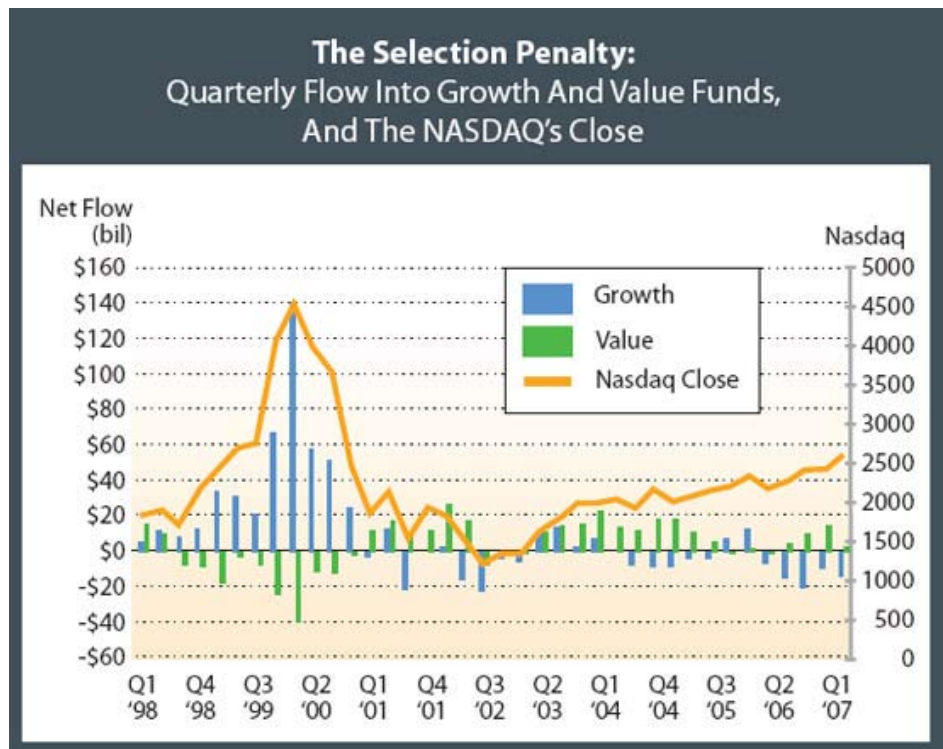


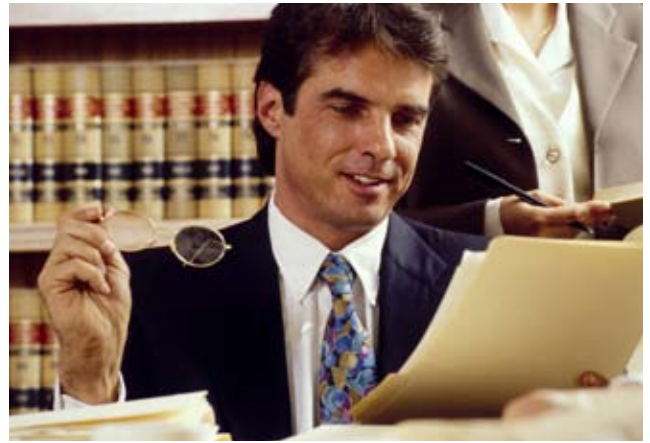
Figure 2

The selection penalty (Figure 2) made a bad situation worse. Investors poured the lion’s share of that \$500 billion into those “new economy” growth funds, technology funds, telecommunication funds and even Internet funds. It was these funds that led the market upward, and then led the market downward, with late-to-the-party fund investors paying an awful price. Ironically, at the height of the bubble, investors were actually liquidating their stodgy old value funds, which would provide excellent downside protection during the bear market that followed.



Begin with the fact that during the 25-year period 1980–2005, when the S&P 500 Index rose at a 12.3 percent annual rate, the return of the average fund averaged 10.0 percent annually, or 2.3 percentage points less. But the returns earned by fund investors fell far short of that 10.0 percent return. We can’t be sure of exactly how far short, but an analysis of the past decade suggests that the gap was huge.

For example, the 200 funds with the largest cash inflows during the five-year period 1996–2000—essentially the duration of the late, great bull market—reported an average return of 8.9 percent for the 10 years from 1996 to 2005. But the dollar-weighted return of those 200 funds—the return actually earned by their shareholders—was just 2.4 percent, only 25 percent of the annual returns reported by the funds themselves.



The consistency of this pattern is remarkable. Among those 200 funds, the shareholders of 198 funds actually earned less money than the funds reported. In only two cases did the shareholders do better - in the best case, by just 0.5 percent per year; in the other case, by a minuscule 0.05 percent per year. When we compound these shortfalls, the results are little short of astounding. For fully 76 of the 200 funds, the cumulative shortfall ranged from minus 50 percent to minus 95 percent!"

Additional comments from Bogle point right back to how the media works. "Hot" funds are advertised heavily and PR departments get interviews for their "star" managers.

FINANCIAL STATEMENT		Change
Last Trade	0.00	0.00 (0.00)
Jun 8 - 8623.29	Bid	N/A
Day's Range	0.00 - 0.00	Earnings/Share
52-week Range	0.00 - 0.00	N/A

"Unsurprisingly, given the marketing ethos of today's mutual fund business, the funds that reported the highest returns during the bull market experienced the largest gap between fund returns and shareholder returns, and vice versa. (The data)..... makes it clear that the higher the performance quartile in the bull market, the lower the returns earned by investors....."

In March 2000, the month the market hit its high; there were 44 equity funds that advertised their performance in MONEY magazine. The average advertised annual return was +86 percent. Imagine! (During the next three years, these funds

were to plummet by 39 percent.) Unsurprisingly, after the fall, in the October 2002 issue of Money, there were only four funds that advertised their performance."

DALBAR put it well in its latest study. "Investment return is far more dependent on investor behavior than on fund performance. Mutual fund investors who hold their investments typically earn higher returns over time than those who time the market."