

KEYSTONE FINANCIAL PLANNING
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Muzzle your urges, boost your return

The stock market has delivered an average annual return of 12.9% over the 20 years ended in March, and individual investors have had access to plenty of decent stock mutual funds that have come close to that return. Why, then, has the average investor realized vastly inferior returns over this period?

A study performed last year by DALBAR, an independent research firm, indicated that the average stock mutual fund returns 9.6% annually from 1984 through 2002, yet the average stock mutual fund investor enjoyed an annual return of 2.7%. Wait—2.7% instead of 9.6%? What in the world is going on here? The answer may be as simple as this: lack of self-control.

“Investors continue to chase investment returns to the detriment of their pocket books,” DALBAR said. “Motivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation.” In other words, they can’t keep their hands off of their portfolios. DALBAR studied the flows of fund investors’ money into and out of funds to come up with its measly estimate of a 2.7% average annual return from stock funds. Lest you think that conservative bond fund investors did any better, think again: DALBAR found that the average fixed income investor earned 4.2% per year, compared to an annualized return of 11.7% return from one long-term government bond index.

Billionaire investor Warren Buffett once wrote that successful investing is not just a matter of intelligence. Instead, he said, “what you need is the temperament to control the urges that get other people in trouble with investing.” Obviously, this underperformance by investors can’t be because the majority picked mutual funds that performed poorly. In fact, investors had placed hundreds of billions of dollars into some of the top-performing funds.

The problem was in the average investor’s behavior. Many studies have shown that brokerage account customers who have control over their trading decisions do progressively worse as they trade more frequently. Too many trade too often. Recent studies have shown that mutual fund owners hold their funds for an average of months, rather than years as they did in the past. They do this because they make several mistakes:

- They react to current market trends, buying on upswings and selling on downswings, or selling in the face of bad news.
- They do not diversify adequately, instead making bets on individual markets or sectors.
- They speculate, getting sucked into investment “themes,” such as the failed Internet and e-commerce schemes of the late 1990s.
- They simply pay too much attention to the markets and their portfolios. Frequent evaluations lead to frequent decisions and frequent action—all activities that have been shown to lead to depressed portfolio returns.

Investors should go back to Buffett with regard to the latter mistake. Buffett has said that he would be happy if the stock market shut down for years on end so that he and other investors would be forced to hold their investments without pressure to make bad decisions. If you are looking at and making changes to your investments daily, weekly, or even quarterly, you should sit back and relax. A little inactivity may help you to get better returns.

Magellan's woes: It isn't easy to beat the index

Once upon a time there was a mutual fund named Fidelity Magellan that seemed to do no wrong. Under the leadership of its dynamic portfolio manager, Peter Lynch, the fund racked up an eye-popping average annual gain of 29% over 13 years. Investors took notice and poured billions of dollars into the fund, making it the largest stock mutual fund at one point.

Today Fidelity Magellan can seem to do nothing right. It is on its third manager since Lynch wisely retired at the top of his game in 1990. Rather than the market beating returns of Lynch's tenure, the subsequent three managers have had trouble keeping up with the market. Over the 10 years ended in March, the average annual return was 9.5% a year, respectable but lagging the Standard & Poor's 500 Index by 2.2 percentage points per year.

The investors who still have some \$67 billion in the fund may wonder what happened and whether they should stick it out or get out. What they are getting is an expensive lesson in the active vs. passive investing debate. Someone who invested \$10,000 in an S&P 500 Index fund, such as the Vanguard 500 Fund, over the past 10 years would have done better than risking money in the Magellan fund. The Vanguard fund investment would have grown to \$29,994 vs. \$24,782 in Magellan.

Should investors be mad at current manager Bob Stansky? Not really: Stansky is doing a decent job considering the handicaps he faces. Stansky can no longer take big gambles in the small and mid-cap stocks that helped boost Lynch's portfolios. He has so much money to invest he has to stick to the big, well-known names in the S&P 500 Index, such as Citigroup, General Electric, and Microsoft. He also has the headwind of the costs associated with active portfolio management. Finally, he has the risks associated with active investment decisions. For instance, Stansky held down the fund's investments in technology stocks last year because he was worried about valuations. That move helped put the fund behind the S&P 500 again by almost 4 percentage points.

Stansky wants to beat the S&P 500 by 3 to 5 percentage points a year. Whether he can remains to be seen.

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