



Mutual Fund Returns vs. Investor Returns

Every year since 1994, the mutual fund market research firm Dalbar has published an study of mutual fund returns vs. the returns of mutual fund investors. The same thing? No, actually -- not at all. Dalbar's 2008 study was published recently, and confirmed what previous studies showed: the average mutual fund investor earns significantly less than mutual fund performance reports suggest.

Mutual funds report their performance using a time-weighted rate of return, which is calculated on the value of \$1 invested in a fund at the start of the period vs. the value of that same dollar at the end of the period. This is an appropriate calculation of rate of return to judge a fund manager's performance.

However, this time-weighted rate of return for any given period is only representative of an investor's actual rate of return if an investor made a lump sum purchase into the fund at the beginning of the period, and held it throughout. That's not how people invest; they add and subtract dollars from a fund throughout time, so to calculate an investor's rate of return, you have to take into account cash inflows and outflows from a fund. And that's the crux of the matter: Dalbar's study shows that the timing of when investors have added dollars to mutual funds, and when they have sold funds, has resulted in inferior performance.

For example, the average annual return for a US stock mutual fund for the last 20 years, 1988-2007, was 11.6% (according to Dalbar, that's the average annual return for all funds listed in Lipper's US Diversified Equity fund classification). However, the average stock fund investor earned only about 4.5% annually over the same period, based on actual cash inflows and outflows from stock mutual funds - hugely underperforming the average fund return. Dalbar's conclusion? **Investment return is far more dependent on investor behavior than on fund performance.**

This information is timely. It's perfectly natural to be disturbed/scared/anxious about the bear market and the headwinds facing the US economy. However, it can be extremely harmful to long term performance to act on that fear.

Dalbar's data suggests that on the whole, mutual fund investors buy high and sell low, typically holding their stock mutual funds for about four years. We want to encourage more patient behavior - behavior that is required for you to reap the long term rates of return generated by various asset classes.

Sometimes our most important role is to stand between a client and their money, providing reassurance and historical perspective to help a client resist the urge to flee when markets turn down, and overindulge when markets are roaring.

--Therese Govern. Posted 08/15/08.