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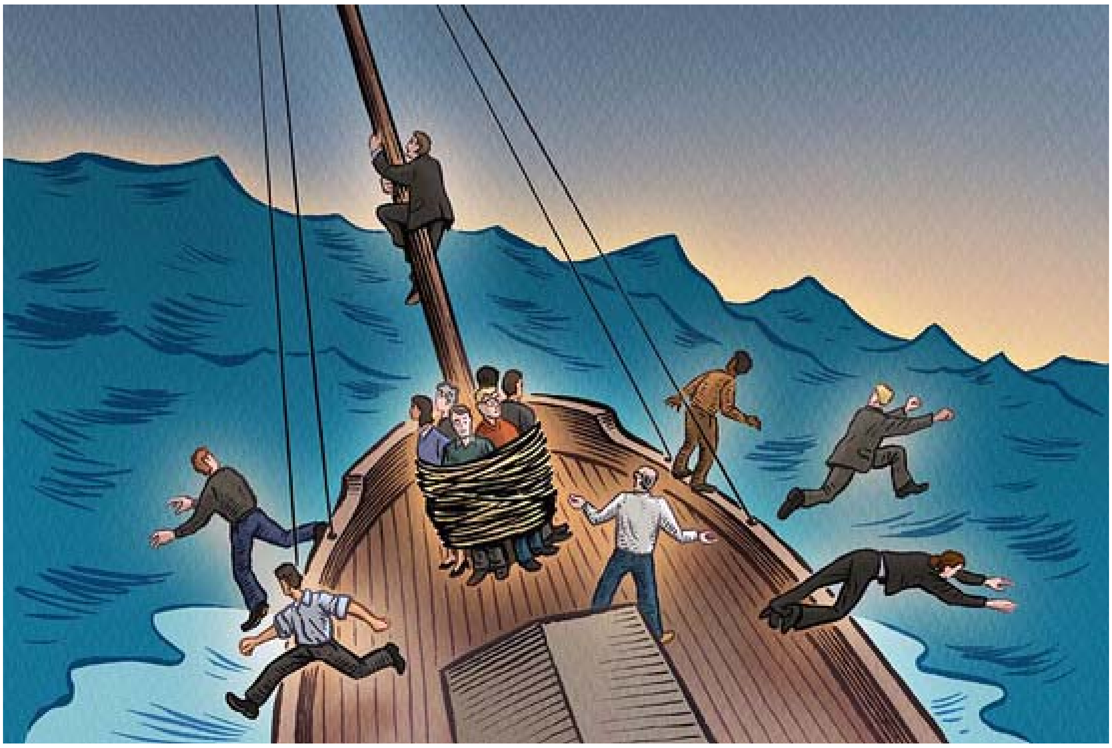
Just How Dumb Are Investors?

ByJason Zweig



Christophe Vorlet

Investors may not be as stupid as some researchers think, but they still need to fight their own fear and greed.

The Intelligent Investor
By Jason Zweig
COMMENTARY

A new study finds that the average investor in all U.S. stock funds earned 3.7% annually over the past 30 years—a period in which the S&P 500 stock index returned 11.1% annually. That means stock-fund investors underperformed the market by approximately 7.4 percentage points annually for three decades, according to Dalbar, a financial-research firm in Boston that has updated this oft-cited study each year since 1994.

How is that possible? The return of a fund—or a market index like the S&P 500—is calculated as if investors put all their money in at the beginning and keep it there, untouched, until the end of the measurement period. But most people put money in and take it out along the way—investing a recent bonus, making a housing down payment, paying tuition, withdrawing money in retirement.

Making matters worse, most funds lag the S&P 500, accounting for roughly one percentage point of the gap Dalbar finds between the performance of investors and the broad market.

Fees and expenses account for at least another percentage point.

But the biggest factor is that investors chase returns—jumping aboard after a streak of hot performance and diving over the gunwales after it goes bad. Because of that buy-high, sell-low behavior, investors in the typical fund have a lower average return than the fund itself.

Imagine a mutual fund as the Amtrak train that runs from Chicago to the San Francisco Bay Area. The California Zephyr traverses the entire 2,438 miles, but only the people who get on at the beginning of the trip and get off at the end will go the full distance. Some might get on in Ottumwa, Iowa, and get off in Omaha, Neb., or Denver; others might board in Salt Lake City and stop in Reno, Nev., and so on. The train goes all the way, but not all the passengers do.

Likewise, an investment might earn 6% annually for 10 years—but only those people who held their investment constant for the full decade will match that return. A lucky few might do even better if they bought low and sold high. Most will do worse.

"In hot markets, money flows in," says Ilia Dichev, an accounting professor at Emory University. "In down markets, people get scared and leave." As a result, stock investors lagged behind the stock market itself by 1.3 percentage points annually between 1926 and 2002, according to research by Prof. Dichev. Even pension plans and other "sophisticated" investors earn an average of at least three percentage points less than the hedge funds they buy. And several studies have shown that mutual funds outperform their own investors by between one and two percentage points annually.

Why is the gap found by Dalbar so much wider? To calculate investor return, all the other studies use a standard formula that adjusts the results to account for when the performance was earned and when money moved in or out of the fund. Dalbar, however, uses a quirky formula of its own.

According to three leading experts on calculating returns—Prof. Dichev, finance professor Travis Sapp of Iowa State University and David Spaulding, founder and publisher of the Journal of Performance Measurement—there could be something amiss.

Dalbar's formula, according to these experts, has the effect of taking returns over the full period and dividing them by the total assets at the end—including money that wasn't in the funds from start to finish. The result, they say, could significantly inflate the amount by which investors appear to lag behind their funds. (Another issue: Dalbar compares the returns of fund investors to an index rather than to the funds themselves.)

Louis Harvey, Dalbar's president, says, "We have comfort that our method is reasonable," although he adds that "every method has its flaws." Whether other measures of return are better, he says, is "a fight for another day." He adds, "The annualized returns may be overstated or understated based on what one believes to be true."

Investors aren't nearly as dumb as Dalbar's numbers suggest. But everyone can still get smarter.

"Even if you're a disciplined investor, it will hurt your results if you buy a hot-money fund," says

Stephen Janachowski, president of Brouwer & Janachowski, an investment adviser in Tiburon, Calif., that manages roughly $1.1 billion.

A rush of money coming in at the top of the market forces a portfolio manager to load up on overpriced stocks. Conversely, when investors bail out of a fund at the bottom, the manager has to sell stocks just when they have gotten cheap.

Adding insult to injury, after the manager sells stocks to cash out the investors who flee, any resulting capital-gains taxes will be paid exclusively by the investors who stay.

At Morningstar.com, the "performance" tab at each fund's page enables you to compare fund returns against investor returns. If the gap between the two numbers is greater than one or two percentage points, find another fund less hospitable to hot money.

And you can do better than your fund if you add money when markets fall and stand pat (or trim a little) when markets are on the rise. You might never be able to beat the market, but you can beat your own fund if you buy when you feel like selling—and vice versa.

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