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Time out for investor bad behavior

Human beings can't help but use the past to envision the future, regardless of how many warnings of "past performance does not guarantee future results" we see.

It's a type of representation, one of the common heuristics — or mental shortcuts people use to make decisions — identified by behavioral economists. Behavioral economists have also discovered that no matter how rational we think we are, we actually make very emotional decisions, especially where our money is concerned.

Repeated studies show that the average investor fares poorly when compared with broad market returns, usually by a significant percentage.

For instance, in Dalbar's 21st annual Quantitative Analysis of Investor Behavior, the average equity investor underperformed the S&P 500 by 8.2 percent in 2014. Things don't improve over longer time periods either; in the same study, the average equity investor earned a meager 3.8 percent return over the last thirty years ending last Dec. 31, compared to the S&P 500's much more robust 11.1 percent.

The easy answer might be to invest in the market itself, and many people are looking at passive management as a solution both to reduce fees and to try to take emotional decisions out of the picture.

But an interesting, little-known Morningstar metric shows that even generating market returns may not be so simple, and that those emotional decisions have a way of creeping in no matter what. Morningstar's "Investor Return" shows a dollar-weighted return: rather than the typical time-weighted return, which shows the performance of a fund over time assuming a buy-and-hold strategy during that time, the dollar-weighted investor return takes into account dollar inflows and outflows to measure the return investors actually achieved in the fund.

An investor's returns depend not only on the fund's performance, but also on the timing of share purchases, which is what the "investor return" measure captures and illustrates.

If investors bought the fund low and sold high, they could theoretically earn a higher return than the fund's time-weighted performance. I say "theoretically" because that rarely happens. Looking at most funds' investor returns is a giant wake-up call: almost always, investors buy high and sell low.

For example, one of the top mid cap value funds had, as of April 30, a 10-year total return of 10.1 percent, but an investor return of only 5 percent over the same time period — half the return. The 15-year gap is even worse: 13.5 percent versus an investor return of 6 percent. While not all funds will show quite the same drastic difference, a recent study from Morningstar demonstrated that the average investor earned 4.8 percent per year, as compared with an average fund gain of 7.3 percent.

The study found the largest gaps in international and sector funds, but the gap was evident in all asset classes they measured.

Even a one or two percentage point difference per year adds up quickly and can have a significant impact on a portfolio's long-term return.

It's easy to imagine why investor returns lag time-weighted returns, and it all goes back to judging funds on past performance.

An investor sees a fund that's been doing well, and jumps in (buying high). Then the fund begins to underperform, and the investor waits in the hope of a rally, holding out just long enough for it to drop some more before selling and locking in the losses (selling low).

It's simply human nature, and we are all susceptible. Ironically, this issue is just as pernicious for investors in passive funds as those in actively managed funds; it's an equal opportunity problem.

So how should we counter these faulty instincts when it comes to investing? Well, the first step is knowing that the buy high/sell low plague is highly contagious. Be on the alert for symptoms such as feeling attached to your money and eager to earn more of it.

If you suffer from these symptoms, as most of us do, you have some options. Some people may be able, with a firm and conscious effort, to divorce themselves from the emotions of investing.

This requires the ability to make decisions that may seem to be counterintuitive, but are strategic rather than emotional.

For example, imagine rebalancing your portfolio to sell the stocks that have been on an upward trend while purchasing shares of those stocks that may be out of favor. If this is outside of your comfort zone, then finding help from an impartial expert may be important for you.

Bryan Shipley is senior research analyst and head of traditional and real assets investments for Arnerich Massena.

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In either case, your investment strategy should not be based on past performance, but should be forward-looking, based on your investment objectives. If you do evaluate past performance, take it with a grain of salt.

And remember that the timing of share purchases affects passive funds as well as actively managed funds. If you're thinking of choosing a passive portfolio, don't do it because you expect it to eliminate this problem, because it won't.

Take a look at your investor return periodically in addition to your funds' returns, and make a comparison. If you find a significant gap, it may serve as a reminder to take a "time out" and examine your behavior.

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