Discipline, not fear, reaps rewards

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Investors who 'chased the market' didn't even keep up with inflation

by Austin Lemoine

The results are in and they're horrible!

The earnings of mutual-fund investors who 'chased' investment returns didn't even keep up with inflation, according to the 2003 update of Dalbar's widely quoted study, "Quantitative Analysis of Investor Behavior" (QAIB).

The QAIB study, originally conducted in 1994, examined actual investor returns from stock, bond and money-market mutual funds from January 1984 through December 2002 -- 19 years of one of the hottest markets in history. By tracking aggregate cash flows into and out of the mutual funds on a monthly basis, Dalbar -- a market-research firm serving the financial services industry -- documented how investor behavior impacted performance.

What the research showed was that, driven by greed and fear, investors poured money into stock mutual funds on market upswings and were quick to sell on downturns.

But their timing was abysmal.

Most investors were unable to time the market and were left with returns that were, unbelievably, lower than inflation! Over the 19 years, the average stock-fund investor earned a paltry 2.57 percent compounded annually, compared to a 3.14 percent per year inflation rate. At the same time, the compound annual return of the Standard & Poor's 500 Stock Index was 12.22 percent.

To see how dreadful those paltry returns were, $1 compounding at 2.57 percent a year grows to $1.62 after 19 years. But with inflation that becomes 88 cents in terms of purchasing power by 2003. Compare that with one dollar growing to $8.94 when compounding at 12.22 percent, or $4.87 in real terms (after inflation) over the same period.

Achieving enviable results should have been a no-brainer during the two decades that generated above-average returns and included one of the most powerful bull markets in history. Investors could have pursued the naive strategy of buying and holding the S&P 500 index -- a simple and economical approach that would have been over five times more effective.

However, by attempting to improve on that strategy, stock-fund investors managed to shoot themselves in the foot economically with their buy-higher-sell-lower routines -- proving once again that one's own behavior is the biggest risk some investors face. There is no way to characterize the outcome other than a massive failure, an economic calamity for those push-the-market investors.

Dalbar found that the buy-higher-sell-lower investors are not swayed by major political events but by running after the market itself. Cash flows follow market performance in an all too predictable and vicious cycle. The market declines and investors sell, after a time lag. The market recovers and investors buy, after a time lag.

When money moves within the mutual-fund universe, it flows from a class of assets that recently under-performed to one with higher recent performance -- a prescription for disaster, always several steps behind the curve.

Stock mutual funds are intended to be long-term investments -- the longer the holding period, the better the anticipated performance. Yet Dalbar found the average holding time for stock funds is steadily decreasing, the average being a short 29.5 months.

The link between investor behavior and achieved performance is crystal clear.

Yet the average investor appears to be constitutionally incapable of connecting the dots that link their actions to their results.

Market timing, performance chasing and rapid turnover are proven losing tactics. Investors need to educate themselves, draft a strategic long-term plan that meets their needs, execute that plan with discipline and resist falling back into their losing ways. If they can't or won't do that, they need to find someone who can or get out of the market.

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