

Bad Behavior Translates to Bad Returns

Dalbar, Inc. bills itself as the financial community's leading independent expert for evaluating, auditing and rating business practices, customer performance, product quality and service. Dalbar was launched in 1976 and each year they publish their "Qualitative Analysis of Investor Behavior" (QAIB). The studies cover 20 year periods and the latest was published last month. It covers the 20 year period 1991-2010. The study lists the returns of the S&P 500, the returns of the average mutual fund equity investor and the average holding period for the average mutual fund investor. Here are the recent results for the 20 year period ending 12/31/2010;

Average Return of the S&P	9.14%
Average Return for the average equity Mutual Fund Investor	3.83 %
Average Holding Period for the Investor	3.27 Years

Not very impressive returns for the average investor but what is even sadder, is that these findings do not significantly differ from any of the previous 20 year QAIB findings. The **AVERAGE INVESTOR DOES NOT ACHIEVE MARKET RETURNS!**

It is true that you cannot invest directly in the S&P 500 index or any other index for that matter but there are surrogates. Why does the average equity mutual fund investor achieve such poor results?

In my opinion, it is because the average investor believes what stock brokers and many financial advisors taut as the ability of the mutual fund companies and brokers that they can beat the market for the investor. In fact, according to a recent article in the May 2011 issue of Financial Planning Magazine by Larry Swedroe, principal and director of Buchingham Asset Management in St. Louis, a typical stock broker pitch when an investor asks about indexing as an investment strategy is; "If you index, you will get average rates of returns. You don't want to be a (sic) average, do you? We can help you do better." As Swedroe points out, this is an appeal to the all-too-human need to be better than average. It also confuses average returns with market returns. Look at the Dalbar results above. The S& P 500 represents market returns. I have not heard of anyone who would not be happy with an average annual return of 9.14% over those 20 years. Remember that the 20 year period ending in 2010 had two major market corrections- one in 2000 and another in 2008.

Although past performance is not a guarantee of future results, what should an investor do to try to achieve market results? Here are 10 resolutions for Investing;

1. I will not confuse entertainment with advice. I will acknowledge that the financial media is in the entertainment business and their message can compromise my long-term focus and discipline, leading me to make poor investment decisions.
2. I will stop searching for tomorrow's star money manager, as there are no gurus. Capitalism will be my guru because with capitalism there is a positive expected return on capital, and it is there for the taking. And for me to succeed, someone else doesn't have to fail.

3. I will not invest based on a forecast—whether it is mine or anyone else’s. I will recognize that the urge to form an opinion will never go away, but I won’t act on it because no one can repeatedly predict the future. It is, by definition, uncertain.
4. I will keep a long-term perspective and appropriately consider my investment horizon (i.e., how long my portfolio is to be invested) when determining my performance horizon (i.e., the time frame I use to evaluate results).
5. I will continue to invest new capital and work my plan because it is time in the market—and not timing the market—that matters.
6. I will adhere to my plan and continue to rebalance (i.e., systematically buying more of what hasn’t done well recently) rather than “unbalance” (i.e., buying more of what’s hot).
7. I will not focus my portfolio in a few securities, or even a few asset classes, as diversification remains the closest thing to a free lunch.
8. I will ensure my portfolio is appropriate for my goals and objectives while only taking risks worth taking.
9. I will manage my emotions by learning about and acknowledging the biases and cognitive errors that influence my behavior.
10. I will keep my cost of investing reasonable.

Finally, just as successful athletes rely on coaches and trainers to help them achieve their goals, most investors can probably benefit from having a “financial coach” to remind them about these 10 resolutions and keep them on track toward a more prosperous future.

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