



William Hammer, Jr.

Better Investments or Investors

By William Hammer, Jr.

"It won't be the economy that will do in investors; it will be investors themselves."

-Warren Buffett

We live in a timing and selection investment culture that believes everything would be fine if we could time the market or pick winning investments. But the truth is investment returns are not the same as investor returns.

This year's Dalbar study -- *Quantitative Analysis of Investor Behavior*¹ - shows the gap between mutual fund returns and mutual fund investor returns. We might expect there to be a gap. . .but not one this big.

For the 20 years ending December 31, 2010, equity mutual fund investors lagged the S&P 500 index by **5.31%** a year. In real dollars this amounted to **about 3.6 times their original investment**. This means today's average return for someone who invested \$1 million 20 years ago would be about \$3.6 million **less** than that earned by the S&P 500.

Poor investor behavior was the primary cause of this performance gap. Investors poured money in and took money out at exactly the wrong times.

Emotional investing is natural in the equity markets, but surely we wouldn't expect that kind of behavior with bond investors. Sadly, the study showed that the performance gap in bond mutual funds was even worse. Those investors lagged the Barclays Aggregate Bond index by **5.88%** a year on average.

We all know that clients can underperform their own investments because human tendencies and good investing do not generally mix. So, we need to help clients realize that choosing winning investments does not necessarily make them winning investors.

An alarming example of a good investment with bad investors was the best performing equity mutual fund over the first ten years of this century: the CGM Focus Fund². It delivered average returns of more than 18% a year between 2000 and 2009 - astonishing given this was a tough decade for stocks. With fund performance like that, the investors probably retired early, right?

Wrong. Not only did the fund's investors underperform their own investment, but they lost money - about 30% per year on average. How could this be? How could investors lose money with the best mutual fund of the decade? Simply by emotional responses to volatility - pouring

money into the fund after good years and pulling it out at the first sign of a temporary dip. Irrational behavior that's all too common.

Ultimately, the greatest value we can bring to clients is not helping them to choose better investments, but to **make them better investors**. Choosing great investments is meaningless if our clients engage in poor investor behavior that causes them to underperform their own holdings.

Investment Returns – Cost of Bad Behavior = Real-Life Investor Returns

This equation is something our clients need to understand. Hypothetical returns are very different from the returns earned by real human beings with emotions. Many advisors spend most of their time trying to increase the returns of their clients' investments when they should be trying to reduce the cost of bad behavior.

So what is an advisor to do? First, convince your clients that your biggest value to them is helping them become better investors. Teach them the difference between investment returns and investor returns and how you help them bridge the gap. Your ability as a behavior manager will always trump your prowess as a money manager.

Secondly, take stock of your conversations with clients and make sure you are part of the good client behavior solution, not the bad client behavior problem. Do you constantly find yourself responding to the crisis of the week? Do your clients feel more portfolio turnover means better returns? Do your clients understand how and why they are invested this way? If they do not understand their investments, you can be sure that they will want to do the wrong thing at the wrong time.

Finally, help clients understand that it is natural to be fearful of the market at times but successful investors do not act on that fear. We can never react our way to investment success.

It is not enough for us to give great investment advice. Our clients have to follow it to succeed.

¹ <http://www.qaib.com>

² <http://online.wsj.com/article/SB10001424052748704876804574628561609012716.html?KEYWORDS=cgm+focus>

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