

What Investors Really Do ... and How to Counteract It

An Interview with Dalbar President Louis S. Harvey

By Andy Hyer, CIMA®, CMT

Editor's Note: While this interview is based on data from the Quantitative Analysis of Investor Behavior 2008 report, the 2009 report was released in March 2009. For more information, visit <http://www.qaib.com/default.aspx?PageID=freeLook>.

The average investor, to varying degrees, earns significantly less than mutual fund performance reports suggest. Investment return is far more dependent on investor behavior than on fund performance. Mutual fund investors who hold their investments typically earn higher returns over time than those who time the market. Dalbar's *Quantitative Analysis of Investor Behavior* (QAIB) has been measuring the effects of investor decisions to buy, sell, and switch into and out of mutual funds for the past 15 years.

In other words, whether the mutual fund industry is enjoying rapid expansion in times of economic boom or is being battered by the bears, key findings in a recent Dalbar analysis confirm those uncovered in its first study in 1994.

Based on an analysis of actual investor behavior over the 20 years ended

December 31, 2007, the average equity fund investor would have earned an annualized return of just 4.48 percent—underperforming the S&P 500 by more than 7 percent and outpacing inflation by a mere 1.44 percent. Fixed-income investors would have fared far worse, losing their purchasing power by an average of 1.49 percent per year. Asset allocation fund investors would have done a bit better, beating inflation by 0.41 percent per year. Over shorter time periods, the results were far better for equity fund investors (see table 1).

Andy Hyer, of Dorsey Wright Money Management, interviewed Dalbar's founder and president, Louis S. Harvey, in November 2008 to gain greater insight to these findings.

Andy Hyer: Dalbar is a pioneer in the field of behavioral finance. Can you give me some background on how and why Dalbar began its study of behavioral finance?

Louis Harvey: We started studying behavioral finance around 1990, well before it even had a name. The impetus for our study was our observation that investors were not earning as good returns on their mutual fund investments as was shown in the marketing

material used by mutual fund companies. For years, mutual fund companies have been marketing their products using the long-term results of a lump-sum investment. The results typically show that the funds' annualized returns have outpaced their designated benchmarks and inflation, implying that if investors purchase fund shares and hold them for similar time periods, they may achieve similar results. We observed that investors were not earning those same returns and we wanted to understand why.

Andy Hyer: What is the central message of Dalbar's 2008 QAIB report?

Louis Harvey: Investors generally have a harder time making correct decisions when markets are declining than they do when markets are rising. It is crucial for investors to understand that markets recover from declines. If equity investors do not have a better place to put their money, they should just stay put. Putting their cash under their mattress only ensures the loss of purchasing power over time.

Andy Hyer: Given that investors have done better, relative to relevant benchmarks, over the past one, three, five, and 10 years than in the past 20

TABLE 1: AVERAGE INVESTOR ANNUALIZED RETURNS VS. INFLATION

	20 Years	10 Years	5 Years	3 Years	1 Year
Equity	4.48%	5.66%	12.51%	9.61%	7.13%
Fixed Income	1.55%	0.93%	1.33%	0.56%	1.09%
Asset Allocation	3.45%	4.06%	6.62%	4.83%	2.73%
S&P 500	11.81%	5.91%	12.83%	8.61%	5.50%
Lehman Aggregate	7.56%	5.97%	4.42%	4.56%	6.97%
Inflation	3.04%	2.67%	3.03%	3.35%	4.08%

Data sources: Investment Company Institute, Morningstar Associates, and Lehman Brother



years, do you think that investors are getting smarter?

Louis Harvey: Yes. For example, our study of mutual fund flows following the 1987 crash were very different than the flows following the 9/11 crisis. Far fewer clients were cashing out after 2001 than after the 1987 crash. I attribute this to the ever-increasing efforts of the financial advisory community to warn their clients about the risks of selling at the lows. That said, I believe that investor behavior may not be so good coming out of this current bear market. This bear market has coincided with the presidential election in which candidates have made every effort to convince the country that the sky is falling. This rhetoric has been covered nonstop by the media and I believe it has caused investors to sell their investments in droves.

Andy Hyer: I was surprised to see how poorly fixed-income investors have performed versus their benchmark compared to equity investors versus their benchmark in light of the fact that fixed income is less volatile than equity. What do you think accounts for this?

Louis Harvey: Few retail investors speculate on fixed income. When investors invest in fixed income, it often is done as a reaction to poor equity performance. It serves as a temporary parking place. For the last 10 years, investors' holding period for fixed income has been less than investors' holding period for equities. As a result, fixed-income investors have poorly timed their fixed-income investments.

Andy Hyer: In what type of market environment are investors most likely to make poor investment decisions?

Louis Harvey: Clearly, investors make more mistakes in down markets. The first factor contributing to actual investor performance is the timing of purchases and sales. Dalbar's "Guess Right Ratio" measures how often the average equity investor correctly "guesses" the direction of the market. Net mutual fund inflows and outflows

are used to determine if investors made short-term gains by correctly anticipating the direction of the market. The average investor guesses right when there is either net inflow each month followed by a market rise or net outflow followed by a downturn. We have found the Guess Right Ratio to be very low during down markets. In years where the broad market declines, investors have a tendency to pull money out of funds just before the market rises or to add money to funds just before they fall.

Andy Hyer: From your perspective, what is the solution to this problem?


Louis Harvey: In light of current events, we should have the government guarantee investor returns. More seriously, sales practices of financial advisors should focus not only on the long-term returns but also should focus heavily on volatility. If a financial advisor shows a client a fund that has earned 20 percent over time, that client expects 20 percent consistently. Financial advisors should point out periods of time when that particular strategy performed poorly to give them an idea of what to expect. With such a focus on volatility as well as returns, more investors will stand firm during the bad times. I don't believe that this would adversely impact sales. Financial advisors must help clients to develop realistic expectations.

Andy Hyer: In Dalbar's 2008 QAIB report, you suggest that systematic investment plans are a solution. Do you have any insight into the average holding periods of investors employing a systematic investment plan?

Louis Harvey: I do not have quantitative data to address that question. However, I do have anecdotal evidence which suggests that the holding period of investors employing systematic investment plans is much longer than those without systematic investment plans. 401(k) investors, for example, employ systematic investment plans. The holding periods of mutual funds within such plans can be decades

as opposed to the average holding period of three to four years for all mutual funds. I expect that the returns achieved by investors with systematic investment plans would be far superior to those without such a plan.

Andy Hyer: How are financial advisors doing in addressing the challenges of behavioral finance? Are they helping to improve the problem or are they making the problem worse?

Louis Harvey: Financial advisors have become net contributors to helping improve the situation. The transition from commission-based compensation to fee-based compensation surely helped to lengthen the time horizon of investors. Greater emphasis also has been placed on educating financial advisors and investors about the perils of trying to time the market. That education has paid off to some degree. 

Louis S. Harvey is the founder and president of DALBAR, Inc. He has held governance positions at a number of institutions including the National Association of Securities Dealers, Federal Reserve Bank, Bentley College, and Plimoth Plantation. He earned a bachelors degree in physics from the University of the West Indies. Contact him at communications@dalbar.com.

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