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YOUR MONEY

The High Cost of Investing Like a Daredevil

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Strategies

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Live in the moment: If you're skiing, surfing or scuba diving, that's the way to go. But if you're investing, that approach can lead to disaster.

The numbers show that most people who are lucky enough to have money to invest end up underperforming the markets by staggering margins. A big reason for that is living in the moment — acting in response to ephemeral events. Most of us would be much better off we focused relentlessly on the far horizon, sticking with a simple and cheap plan for getting there.

"When investors think short-term and try to time the market, they haven't done very well," Louis S. Harvey, the president of Dalbar, a Boston research firm, said in an interview. "They have been leaving a lot of money on the table."

His company has been chronicling mutual fund investors' efforts to beat financial markets for many years, and it has found that as a group, typical investors almost invariably lose.

The numbers are devastating.

For the two decades through December, Dalbar found, the actual annualized return for the average stock mutual fund investor was only 5.19 percent, 4.66 percentage points lower than the 9.85 percent return for the Standard & Poor's 500-stock index. Bond investors did even worse, trailing the benchmark Barclays Aggregate Bond index by 4.71 percentage points.

In isolation, these figures, which aren't adjusted for inflation, may seem small. But they aren't when they recur year after year. In fact, because of the effects of compounding — in which a positive return in one year adds to your stash and can grow further in subsequent years — those annualized numbers translate into life-changing disparities.

Consider a $10,000 investment in the S.&P. 500 index. Using the Dalbar rates, my calculations show that with dividends, that $10,000 would grow to $65,464 over 20 years, compared with only $27,510 over the same period for the return of the average stock mutual fund investors.

That gap grows over time. At those rates after 40 years, with compounding, the nest egg invested in the plain vanilla stock index would grow to about $428,550, compared with only $75,680 for the average returns of stock mutual fund investors, a $352,870 difference. Disparities of this order have been showing up year after year in the Dalbar numbers. And with so many Americans forced to rely on their own investing acumen because of the decline of traditional pension plans and lax government rules about financial advice, these awful returns really matter.

Why do typical mutual fund investors do so badly? For multiple reasons, and I've written about some of them in recent columns. Briefly, actively managed mutual funds over long periods tend to underperform the market, and, as a group, don't do markedly better than would be expected from flipping coins. Expenses eat into returns. Buying — and holding — a low-cost index fund over an extended period would improve the returns of most people radically, the Dalbar numbers suggest.

That's where living in the moment comes in. People tend to make big mistakes in periods of big up or down market moves, when finance is in the news, Dalbar has found. And while chasing better returns, investors often buy into funds that don't match market returns, once costs are included. When you factor in those choices, typical investors actually earn less "in many cases, much less — than mutual fund performance reports would suggest," the Dalbar report says.

By buying and selling too frequently and at the wrong times and not benefiting fully from compounding, people typically do even worse than they would have done if they simply held on to their investments — even if those investments were in mutual funds that themselves trailed the market, Dalbar found. In short, investors have been penalized multiple times — for buying funds that underperform, for

selling those funds at the wrong times and, often, by generating unnecessary costs by trading relatively frequently.

Some clues as to why this happens year after year appear when you review long-term market returns. I did that, using historical data from Morningstar's Ibbotson unit. I examined the monthly returns of a large capitalization stock index and an index modeling the medium-term United States Treasury market over hundreds of rolling one-, five-, 10- and 20-year periods going back to 1926. I also looked at the blended returns of those two indexes in simple asset allocation portfolios.

On the positive side, the numbers show the beneficial effects of simply buying and holding portfolios based on the simplest and most straightforward of plain vanilla market indexes over long periods. Over 20-year periods, if investors had been patient enough to wait that long, they could have had remarkably consistent, favorable returns, as the Dalbar study suggests. Over short stretches, though, the data shows that the pure stock portfolio produced stomach-churning variations. Looking at these numbers, it's no wonder that investors have been alternately frightened and enticed, driving up their own costs by shifting their holdings incessantly into hot funds, usually at inopportune times. But if you had lengthened your perspective, it would have been easier to stay in the market. As the holding periods extended, the growth in the $10,000 portfolio became more consistent. The $10,000 stock portfolio, after 20 years of compounding, ranged in size from a bonanza of $286,386 in the two decades through March 2000, to the modest sum of $14,539 in the 20 years through August 1949. In every rolling 20-year period — and there were 833 of them — the returns were positive.

Bond returns were generally lower but steadier, and when you mixed bonds with stocks, as modern portfolio theory suggests you should, you had extremely smooth returns. In fact, a simple portfolio composed of 60 percent stocks and 40 percent bonds never produced a loss over *any* 10-year stretch in nearly 90 years. The average annual return for those periods was nearly 9 percent, and it was more than 9 percent for the 20-year periods.

It isn't hard to set up a portfolio like this, either. It can be done by buying low-cost index funds, either as exchange-traded funds or mutual funds, and rebalancing them every so often; many asset allocation funds will do all the work for you. Investors can diversify further by including foreign stocks and bonds but, as John Rekenthaler, vice president for research at Morningstar, said in an interview, "It's

not just about buying hot mutual funds. It's important not to chase hot asset classes, either. Long-term and steady, both of them, are important."

But to pull off a strategy like this, you would need to ignore the moment and take the long view. If you had done that, you would have beaten most investors and most comparable mutual funds, and you would have an impressive stash.

Past performance definitely does not guarantee future returns, and this approach might not work as well over the next five, 10, or 100 years. But it's a baseline. I'm not sure that anything else is better, at least not for those of us who don't invest full time. The beauty of this method is that it can be accomplished at low cost by anyone with enough money and discipline, or obliviousness, to take a really long view.

Live in the moment, by all means. But invest in the future.

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