

Pick good mutual funds, then commit to long term

BY ROB CARRICK

If you invest in mutual funds, you're bound to notice a disconnect every so often between your actual returns and those reported by your fund company.

While your fund company is boasting of excellent long-term gains, your own funds are up only a little, or maybe they're even down. This, unfortunately, is typical.

A study by research firm FundMonitor.com shows that investors often make significantly less than published returns over the long term. The shockingly sad conclusion: Only one in 17 investors in Canada's 100 largest mutual funds have matched or surpassed their funds' published returns for the 10 years to Sept. 30.

For example, Templeton Growth made 9.6 per cent a year for the decade to Sept. 30, but FundMonitor estimates that investors actually made 4.3 per cent on average.

FundMonitor analysts Aaron Brown and Duff Young say published fund numbers are best used as a means of comparing the performance of various managers.

To measure the returns of actual investors, they suggest a measure called a dollar-weighted rate of return. Whereas the traditional time-weighted return looks only at how funds did from one point in time to another, the dollar-weighted measure looks at both returns and the monthly flows of cash in and out of a fund.

What's the advantage here?

"Suffice it to say that the rate of return shown in the newspaper relies on the assumption that a person buys and holds the fund for the full period," the study says. "Our study shows this is extremely uncommon."

Not only do investors tend to sell rather than hold for long periods, they also tend to buy funds after a big runup.

If the fund tails off, then actual returns could be quite a bit less than published returns.

The study says the average investor in the 100 largest funds posted returns for the 10 years to Sept. 30 that were more than four percentage points a year lower than the funds' own annual numbers.

One of the most egregious examples of how bad timing by investors can kill returns involves the AGF International Value Fund.

As the FundMonitor.com analysts tell it, this fund had a brilliant run over its first 10 years, outperforming 98 per cent of its rivals. Later, as the fund continued to excel, assets quickly grew. In the two years to March 31, 2002, this fund was one of the top sellers, with net new sales of \$4-billion.

Talk about bad timing. In the first nine months of 2002, AGF International Value fell 30 per cent. Net result: Most of the fund's current unit holders haven't done nearly as well as the time-weighted returns would suggest.

Here's how it breaks down. For the 10 years to Sept. 30, AGF International Value averaged 13.5 per cent a year. But if you factor in money flows through monthly purchases and redemptions over that period, the average investor's return falls to only 4.9 per cent. In other words, the performance shortfall as a result of bad timing amounts to a hefty 8.6 percentage points.

Another fund where investors have hurt themselves is Fidelity International Portfolio, which made 9.6 per cent a year in the 10 years to Sept. 30. According to FundMonitor.com, investors on average lost 0.1 per cent in the fund, which is to say they pretty much went nowhere.

Investors in Templeton International Stock were almost as hapless, making an estimated 1.4 per cent on average while the fund itself returned 9.9 per cent.

FundMonitor.com also uncovered some funds where investors did nearly as well as the fund itself.

Investors Dividend made 8.4 per cent a year for the 10 years, while investors on average made 7.7 per cent. An identically small gap of only 0.7 per cent was linked to The Trimark Fund, which made 15.1 per cent annually over 10 years.

MD Growth Investment made 11.2 per cent annually, while its unit holders averaged 9.9 per cent. Royal Canadian Equity made 9.8 per cent, its unit holders 7 per cent.

What's especially interesting about the FundMonitor.com report is the perspective it offers on the debate about the sense of buy-and-hold investing.

Prompted by the bear market, self-styled contrarians have decided that buy and hold is sheep-like behaviour encouraged by the mutual fund industry to hold on to its assets. Smart investors, the thinking goes, will trade judiciously and end up ahead of the game.

As an investing approach for the masses, this is just garbage. The problem, it should now be obvious, is that investors are trading too much, not too little.

So here's what to do. Go out and pick some good mutual funds, or have your adviser do it, and then make a commitment to stick by them for 10 years at least.

If you can't make that kind of commitment, equity funds probably aren't a good idea. If you can, then you stand a better chance than many of not squandering the work of your fund managers.