COMPASS WATCH

DAVID M. CARLSON **CHARLES M. KELLEY** **DALE L. WALTZ**

A quarterly newsletter of Compass Capital Management, Inc. *Volume 17, Number 1: Spring 2005*

INVESTMENT MISTAKE #1: CHASING RETURNS

Chasing returns is one of the worst and most common mistakes made by investors. There are, of course, many reasons why investors do this. Sometimes, it is just crowd behavior - - "if enough people are doing it, it must be okay." (The dot-com mania of the late 1990s and today's rush to hedge funds and energy stocks comes to mind.) In other cases, investors may feel they don't have enough money to reach their goals sensibly (retirement, for example), so they take on unreasonable risk in the hope that good fortune will bail them out of their predicament ("buying as well as betting the farm"). In many cases, however, simple greed is the motivator, the urge to get something for nothing (which usually works out as getting nothing for something).

In fairness, the financial services industry is very good at tempting investors with a bewildering array of products and ideas "too good to be true." (In March 2002, for example, there were 8,353 mutual funds, some touting remarkable and largely unsustainable results.) Professional money managers and institutional investors frequently succumb to the same temptation, so this problem afflicts many, not just individual investors.

Wall Street has taught that investing is largely a matter of jumping from one investment or style to another in the vain hope of grabbing the highest return. Unfortunately, evidence suggests this has not worked out well. In 401(k) plans, for example, where participants are frequently given a number of investment options to choose from, the Wall Street Journal has found "401(k) performance isn't measuring up to the performance of professionally managed pension plans." Alicia Munnell, director of Boston College's Center for Retirement Research, reported in the same article that "the do-it-yourself aspects of 401(k) plans 'are not working….' ("A Lesson for Social Security: Many Mismanage Their 401(k)s," Wall Street Journal, December 1, 2004).

A study by Dalbar, a Boston-based financial services research firm, has provided even more convincing evidence regarding investor returns in mutual funds (Quantitative Analysis of Investor Behavior - - QAIB - - released in 1995 and updated July 15, 2003). Dalbar studied performance information for a nineteen year period (January 1984 – December 2002) and found that the average stock mutual fund investor earned only 2.6% annually during this nineteen year period vs. 11.2% for those same mutual funds themselves. Dalbar observed that most investors don't invest for long periods of time. Most jump in and out of the market and frequently switch funds by trying to chase the best short-term performers. In the June 2002 issue of Money magazine, Jason Zweig reported similar results. Zweig found that between 1998 and 2001, the average mutual fund investor earned only 1% annually, while the fund they were invested in averaged 5.7%. Investors tend to sell funds that have lagged for a few years and buy the "hot" funds, just as they are about to cool. Zweig observed that investors now hold their funds for only 2 ½ years on average. This is an investment strategy based on emotion and wishful thinking, not reason. Buying high and selling low has always been a formula for losing, not making money.

Using a sensible long-term discipline **and sticking with it** takes much of the destructive emotion out of investing. It is no surprise that this is the way great investors such as Warren Buffett and Peter Lynch have produced their remarkable results.

Following the best long-term disciplines, however, has one characteristic which frustrates many investors - - the approach is sure to lag other styles at times. And these periods of underperformance can last several years. The August 2002 issue of Financial Advisor reported that over the ten years from 1992 to 2002, "98% of the top-ranked managers performed poorly during at least one three-year period." Many clients become uneasy after three years of underperformance and may leave, just as the style is about to outperform. Morningstar, the well-known mutual fund advisory firm, has also found this to be true. In an article dated January 18, 2005 (Morningstar Advisor.com), the author pointed out "it's worth remembering that any good strategy… is going to hit a rough stretch at some point; it's virtually impossible not to if one is going to stay true to a discipline. That means investors shouldn't be totally alarmed by one, three, or even five years of underperformance, especially if the reasons for their purchase remain intact. That is, if the strategy isn't altered and the same management is around, don't be too eager to pull the trigger."

Successful investing isn't "getting lucky." It is following a sensible, long-term discipline and being patient, even when temporarily out of favor.

Suite 400 Baker Building · 706 Second Avenue South · Minneapolis, MN 55402
(612) 338-4051