

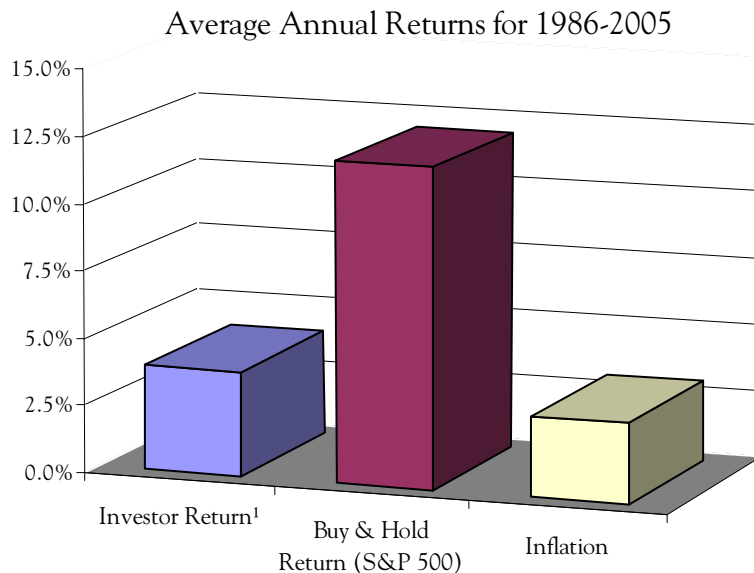
June 2007

S&P 500 is Back; Average Investor Lags

Principal Culprit is Market Timing

Last month, the S&P 500 stock index finally reached the level seen at the peak in March 2000. Does this mean that investors in the stock market have fully recovered from the “Dot-com” crash? Probably not. DALBAR’s most recent study of investor behavior shows that most investors fail to behave in ways that would allow them to obtain the market’s long-run returns.

DALBAR, a prominent financial research and consulting firm, annually compares the average returns obtained by equity mutual fund investors over the past 20 years (among other periods) with the performance of the S&P 500. The principal results of their study are shown in the chart below.



¹Based on net equity mutual fund flows.

Although it seems reasonable to assume that the performance of a major equity index, such as the S&P 500, represents the returns that can be obtained by investing in the U.S. equity market, the study shows that this has not been the case for the average equity mutual fund investor. While the S&P has provided an 11.9% average annual return from 1985 through 2005, the average investor has received only a 3.9% return!

How can this be? Clearly, the differential cannot be explained by the slight lag (0.33%) between the performance of the average mutual fund versus its benchmark index due to management expenses. The answer is better revealed by statistics in the study that cast light on the poor consistency of average investor behavior.

Strong Tendency to Time the Market

The study shows that over the past 20 years the average equity mutual fund investor holds an investment in a fund for only 2.9 years. Instead of utilizing a buy-and-hold strategy, most investors frequently move from one fund to another. Because the study shows that the typical investor has a poor record of anticipating market direction, larger investments tend to be made at the wrong time. This “flipping” also increases transaction costs and is tax inefficient.

Benefits of Being Coached

These data demonstrate to us once more how important a long-run commitment is to successful investing. We can appreciate that staying invested through the market’s advances and declines is difficult for most individual investors operating on their own. The short-term performance of investments can dramatically affect an investor’s sense of security and self-worth. The ever-present noise of the financial press and market prognosticators certainly doesn’t help.

We know from experience that we do our greatest service (in our role as investment counselors) when we help clients understand the long-run statistical performance of the markets so that they can manage emotions that arise from portfolio volatility and stay invested. We help them resist the temptation to “chase returns” by buying “what’s working” just before a manager’s investment style (e.g. value, growth, etc.) or asset category (e.g. small caps, emerging markets, etc.) rotates out of ascendancy. Instead, we focus on keeping a broadly structured portfolio that, through rebalancing and moderate tilts, allows us to provide an orientation toward those asset classes that we believe offer better relative value over a reasonable horizon.

The value of this discipline is not only in the financial rewards it provides, but it reduces the anxiety inherent in investing. One client recently gave us what we consider high praise and what he probably thought was simply an honest answer: When we asked “how are we doing?” he answered, “Well, I don’t worry about things anymore.”

If you have comments or questions regarding this letter, as always, we welcome your call.