Chapter 2

Investor Results: Perception versus Reality

The easiest thing of all is to deceive one's self; for what a man wishes, he generally believes to be true.

Demosthenes

Saving money on a regular basis is an important part of any retirement plan. Equally as important, if not more important, is the rate of return you earn on your retirement savings. Without an adequate return on investment, decades of saving may not be enough to maintain your lifestyle in retirement. This chapter discusses elements of your personal investment performance that you may not have considered, or have not adequately addressed. These issues focus on your investment results in the financial markets, as opposed to the returns of the markets themselves. There is a big difference. Ironically, a sizable gap exists between the return of the markets and the average investors return in those markets.

When most people talk about investing, they generally discuss how the stock market is performing today or how a particular company is fairing this year. Few people talk about their returns in the context of their total portfolio holdings, and no one, it seems, discusses long-term results. There are reasons for this. First, the public has only a vague idea of how their total portfolio is performing. Second, individuals tend to believe they are earning well above average. When asked to quantify the results with accurate numbers, most people cannot. The default answer is to say that they are holding their own against the market, which is typically not the case.

The problem of investor performance has caught the eye of the [former] Securities and Exchange Commission (SEC) director. There is talk from time to time of requiring mutual fund companies to report individual performance on client statements. This is different than the performance of a mutual fund you see in the newspaper. The calculation for personal investment performance is much different than the way results are calculated for the paper. Appendix #1 provides the formulas for doing these calculations. Until the SEC requires all brokerage firms to calculate performance, the only way for most people to know their account return is to calculate it on your own.

By the way, do not rely on your stockbroker or other financial advisor to calculate this return for you. Most are ignorant about the math involved. Besides, most advisors are paid commissions or fees for their investment advice. Issues involving performance measurement of their advice tend to question the quality of that advice, and the purpose for paying the advisor.

Wise investors will check the results of their portfolio on a regular basis and compare it to an appropriate market index. Monitoring portfolio results will help expose any performance gap that exists

between the return of the markets and your returns. We will discuss in future chapters how investment costs, market-timing errors, and portfolio turnover contribute to the performance gap, and how you can easily eliminate most of the gap in your portfolio.

An Introduction to Investor Returns

It is no secret the stock and bond markets have returned unprecedented gains since the early 1980s. Low inflation and the lengthy economic expansion have provided a windfall for investors in financial assets. Although the performance of the financial markets has been exceptional, the average individual investor has had a very difficult time capturing those returns. According to DALBAR Financial Services, the average stock and bond mutual fund investor achieved only about half the returns of the markets they invested in during the period.[1] Having personally calculated hundreds of individual investor returns over the years, my experience concurs with the DALBAR data (see Chapter 3 for details on the DALBAR data and similar studies).

Obviously, in any study of investor returns, no two people achieve the exact same results, and the range is wide. However, as a group, the performance of individual investors is remarkably low. There may be people that actually performed better than the markets over the long- term, but they are a small group indeed, and I have never met one. A vast majority of investors have not come close to the returns of the stock and bond markets they have invested in, and the trend will continue in the future.

Most Investors Have Only a Vague Idea of Their Investment Results

Surveys show that most investors have only a vague idea of how their portfolios are performing. In 1997, SEC Chairman Arthur Levitt spoke to a large gathering of individual investors and asked the audience, "How many of you know precisely how you've done?" Only one third of the audience raised their hand. If so few of these informed investors knew their actual investment results, one can only guess the small percentage of the entire investing population that know theirs.

If a person does not know their actual rate of return, they tend to make an educated guess. This estimate is usually much higher than the actual result. Studies show people generally believe they are performing 3% to 4% higher than is the case.[2] Sometimes investors have a selective memory when it comes to total return. They only remember periods of good performance and tend to forget periods of poor performance.

Typically a person is aware of the performance of their best picks, such as a hot mutual fund or top performing stock, but the estimate degrades when their entire portfolio is taken into account. When asked to comment on long-term results, many people quote the return of their best investment as the long-term

return of their entire account, even though one may have little to do with the other.

We tend to alter reality to fit our perception of our abilities. Many investors for whom I have calculated results thought they were beating the markets, when in fact their performance was much less. Author Peter Bernstein explains the reason for this cognitive error:

> We like to believe we are above average in skills, intelligence, farsightedness, experience, refinement, and leadership. Who admits to being an incompetent driver, a feckless debater, a stupid investor, or a person with an inferior taste in clothes?[3]

Common Errors when Calculating Investment Returns

The best way to know how a portfolio is performing is to calculate the return on a regular basis. While this exercise may seem easy, the math can get tricky. Mistakes are common and sometimes they compound into very large errors. I find there are two common mistakes people make when calculating returns. Both errors are explained below.

Counting Deposits and Withdrawals as Investment Gains and Loses

A common error when calculating investment returns is to treat deposits as investment gains, and withdrawals as investment losses, rather than treating them as additions or subtractions to an account. Here is one embarrassing real life example of a group that counted deposits as investment gain:

> The Beardstown Ladies are members of a famous investment club formed in the early 1980s. The ladies rose to prominence in the mid-1990s after the club proclaimed fantastic investment results. For 10-years ending 1993, the club reported a compounded return of 23.4% in their stock portfolio versus 14.9% for the S&P 500. The ladies bought stocks of companies they knew, like McDonald's and Coke. The investment success propelled the ladies into stardom. They appeared on TV shows and in commercials, spoke on radio programs, and not to miss a moneymaking opportunity, published best selling books on the subject of personal finance and investing.
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> The world changed for the Beardstown ladies in late 1997. A reporter from the *Chicago* magazine noticed something peculiar about their published investment results. After calculating the numbers several times, he concluded that a gross error had been made. The error was so large, that the accounting firm of Price Waterhouse was called in to clear the air. In the final tally, the clubs worst fears were realized. The ladies' actual return was only 9.1%, far below the 23.4% they reported, and well below the S&P 500. For years the ladies deposited monthly dues into their account and classified it as an investment gain, rather than additional capital. An embarrassed treasurer blamed the error on her misunderstanding of the computer software the club was using.[4]

It is natural to make return calculation errors in a bull market. Investors expect their account to be performing well. An error may not be large enough to effect performance in the short run, but if not corrected, the distortion compounds over time. Deposits and withdrawals are never treated as investment gains and losses with one exception, withdrawals used to pay direct investment expenses such as manager fees and trading costs are treated as a loss. This exception will be covered in more detail later in this chapter.

Buying and Selling Can Cause Return Calculation Errors

Flip through the mutual fund section of your local newspaper and you can quickly tell how your funds are performing. Although the return of a fund is listed correctly in the paper, it may not tell you much about the performance you have personally experienced in the fund. Investment returns can become distorted if you make frequent transactions in your account, such as adding money to a 401(k) plan each month. The following example highlights this problem:

> At the beginning of the year, you invest $1000 in a stock mutual fund. By the end of the year that mutual fund is up 15%, therefore, you made a $150 profit. Satisfied with this result, at the start of the second year you place another $1000 in the mutual fund bringing the total to $2150. Unfortunately, during the second year the market moves down and the fund falls 10%. Overall, your account lost $215, leaving you with a balance of $1935.

Here is an interesting question. During the two-year period, what was the return of the mutual fund and what was your actual return?

> The mutual fund gained 15% the first year and lost 10% the second. A $100 investment grew to $115 after the first year and fell to $103.50 after the second. That's a total gain of 3.5% for the period and an annualized return of 1.7%. Although the fund had a positive return, you did not make any money. You lost $65. Your annualized return was -2.0% based on average two-year investment of $1575 ($1000 the first year and $2150 the second). In affect, the return of the mutual fund was not the same as your return.

The return to the investor is not determined by the performance of the markets, it is determined by the behavior of the investor. In the example above, the fund did not cause the $65 loss, a timing error by the investor caused the loss. Let's look at this phenomenon in a larger picture. The stock market returned about 18% annually over the last 20 years, however, the average investor did not experience returns close to that number in their personal portfolios. As we will learn in Chapter 3, the average stock investor earned *significantly* less than the stock market. The timing of cash flows into and out of various investments was a large cause for the difference.

How do you determine your exact performance? You must calculate returns regularly and compare them to an appropriate benchmark. See Appendix A details.

Why Accurate Investment Results Are Not Provided for You

Instead of calculating a rate of return on your own, why not take the easy way out and ask your broker or financial advisor to do it for you? Good luck. Many advisors are not willing or able to produce accurate performance reports. Some advisors simply do not have the technical know-how, while others realize it may not be in their best interest to disclose performance information.

Believe it or not, most stockbrokers and financial advisors are not trained in performance reporting techniques. Performance calculation formulas are not covered under the stockbroker exam (Series 7), nor are they part of the Investment Advisor exam (Series 65). Having worked in the industry for several years, my experience is that advisors generally avoid discussing long-term investment performance with their clients. When someone brings up the question, the classic advisor response is "your account is doing fine."

Wrap Fee Ambiguity

Some stockbrokers and independent advisors do offer limited performance reporting services. "Wrap fee" programs typically include performance monitoring as part of the package. Wrap programs bundle several portfolio costs together into one fee. These services include account management, commissions, custody services, and performance monitoring. The fee is typically deducted from a client's account on a quarterly basis.

I find the performance reports of most wrap fee programs to be confusing and ambiguous. The reports tend to highlight an account's "gross" investment return rather than its "net" return. This means the fee paid for the service is added back into the account before a return is calculated.

If your investment advisor reports gross returns, they are obviously overstating the results. Assume you open a wrap fee account in January for $100,000 and agree to pay a 3% fee. During the year securities are bought and sold, and $3,000 in fees is deducted. By the end of December the account value is $98,000. Most wrap fee reports from brokerage firms will report a gain of 1% on the account, while a logical person can clearly see there is a 2% loss. Why the difference? Most wrap fee programs do not consider the 3% fee as an expense. Instead, fees are considered a withdrawal from the account. As a result, the 1% gain is highlighted on the report.

Hogwash! Unfair! Reporting gross returns to individual investors is a deceptive and unethical

practice. The SEC should ban this standard practice used by most brokerage firms. Although the SEC does require fees to be disclosed, and net-of-fee performance to be someplace on the report, many firms place that data near the end of the performance report and make it as obscure as possible. In my opinion, the reason brokers shun net performance is because the account has failed to achieve its investment objective, and the brokerage firm is trying to hide the truth. In a related matter deserving of SEC attention, many brokers use vague marketing material, highlighting select performance numbers that excludes fees and expenses. Although advisors are obligated to show a prospective client their net results, they often forget to point out the fine print.

Performance reports given to individual investors should be clear, easy to understand, net of all fees, and compared to an appropriate market benchmark. For example, an account that contains small stocks should be compared to an index of small stocks, not the overall stock market. Unfortunately, many advisors choose a benchmark that makes them look good, rather than comparing their results to an appropriate index. On one occasion, I sat in on a meeting where an investment advisor tried to convince my client that his firm's risky high-yield junk bond portfolio was a good choice because the returns were better than the returns of super-safe Treasury bills!

Until the SEC cracks down on performance reporting shenanigans, you need to look long and hard at the reports you're getting from your investment advisor. More than likely those reports are not worth the paper they are printed on. Your best protection is to calculate performance numbers on your own, and then compare those results to an appropriate market index.

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[1] *DALBAR Special Report: Quantitative Analysis of Investor Behavior*, DALBAR Financial Services, Boston, MA, April, 1994, covering a period from 1984 through 1994, updated to 1996.

[2] W. N. Goetzmann and Nadav Peles, "Cognitive Dissonance and Mutual Fund Investors," *Journal of Financial Research,* Summer 1997. Of two groups of investors, one group consisted of people who were members of an investment club, and the others were less informed participants in a small retirement plan. The informed group had no better record of guessing their performance than the uniformed group.

[3] P. Bernstein, *Against the Gods: The Remarkable Story of Risk*, New York: John Wiley & Sons, 1996, pg. 269

[4] Calmetta Colman, "Beardstown Ladies Fess Up to Big Goof, *Wall Street Journal*, Mar18, 1998, p. Cl.