On Course Financial Planning
Facing the Future with Optimism and Courage
May 2010
Vectors

geo@oncoursefp.com
425-861-9997

What If It's True?

After a long and prosperous life, a retired airline pilot comes to the end of his life's journey. At the Pearly Gates Joe meets St. Peter, who looks up his name in The Book. "It says here that you've led an exemplary life, no smoking or drinking or chasing women. You were good father, a faithful husband and generous to those less fortunate than you. You never called in sick to go fishing. You never lied when ATC asked, "Say speed." You're just the kind of person we like to have here in Heaven. But I'm sorry to inform you that our quota of airline pilots is full. I'll have to send you to Hell."

"Now wait just a minute, that's not fair" Joe protests. "I can see why you would have a quota for politicians or lawyers but why airline pilots?" "I'm not sure" says St. Pete, "But it has something to do with being bad tippers." Joe becomes frantic and in a desperate attempt to salvage his eternal fate asks, "How about if we make a deal? Let me into heaven for one week to see if I can convince another airline pilot to trade places with me." "Well, says St Peter, we've never done anything like that before but I don't think it would break any rules. You seem like a nice guy so I'll let you give it a try. You have until 6pm next Friday to find one of our pilot residents to trade places with you."

Next Friday at 6pm, St Peter sees a long line of airline pilots coming down Main St. in Heaven walking towards the Pearly Gates. They're carrying suitcases and the first in line asks St. Pete for directions to Hell. St Peter is bewildered to see Joe at the end of the line, also carrying his suitcase. "Joe, what's going on?" Joe replies, "I told every airline pilot that I met that Hell has executive lounges where they can get free food, free beer and free newspapers. If anyone wanted to check it out, I told them to meet me here at 6pm on Friday."

"That was brilliant. You've earned your place in Heaven" says St. Peter. "I've changed my mind, I'm going with them" says Joe. St. Peter is stunned. "Are you crazy? Why did you change your mind?"

"Are you kidding?" says Joe. "What if it's true?"

What if it's true? Perhaps more money has been lost after these four words have been thought, whispered or spoken than any other phrase in the English language including "Stick 'em up!" and "Your money or your life!"

What if it's true that you can create a great portfolio by buying the 10 best performing mutual funds of the last 5 or 10 years and putting 10% of your money in each fund? It would certainly simplify financial planning. Unfortunately, it's probably the worst tactic imaginable and far too many people invest their money using some variation of this strategy.

US mutual funds hold over $11 trillion in assets, including almost 25% of all outstanding equity shares of US public companies. Approximate 45% of American households own mutual funds, even those with moderate income or wealth. Mutual fund ownership is the primary way that Americans save for retirement, approximately 25% of all retirement savings are invested in stock, bond and money market mutual funds.

An extensive body of research has examined every aspect of mutual fund investing. Since most investors are generally uneducated about financial subjects, many studies have examined how investors decide which funds to purchase. Past performance has been identified as one of the primary factors influencing investors. Real-world data confirms the research, investors are drawn to funds with good past performance and withdraw money from those with disappointing performance. This should come as no surprise; past performance is the primary filter used by the electronic media, financial magazines and rating services to identify top fund managers. What's worse, many investors follow the advice of financial professionals who use past performance as their chief criteria when recommending one mutual fund over another.

It has been repeatedly demonstrated that there is little or no correlation between past and future fund returns. Top performing funds generally do not continue to outperform the competition. This is because exceptional returns, more often than not, are a matter of luck and good luck generally does not persist. The role of luck, or

chance, in mutual fund performance is barely mentioned by commentators and not understood by most investors. There are thousands of equity mutual funds; a select few will always outperform market averages even if managers picked stocks randomly. A foolproof way to identify in advance those few managers who will outperform their benchmark index has yet to be discovered. Our friends at Russell Investments keep trying but their track record has been less than stellar. Despite repeated warnings that high-performing mutual funds generally do not continue to outperform their peers, unenlightened investors still flock to funds that have performed well.

Fund companies exploit and encourage performance chasing when they place advertisements in personal finance periodicals that prominently display the past performance of their best performing funds. These ads often include a mentioned that the fund has a four or five star Morningstar rating. They do this even though Morningstar cautions investors that their star ratings measure relative past performance among similar funds and should not be used to predict future performance. These ads are expensive so we must assume that they are effective in attracting new investors. As more money flows into a fund, management fees increase and the fund becomes more profitable. But there's little evidence that investors who respond to these ads do well since good past performance, more often than not, has been a precursor to poor future performance.

Numerous federal securities statutes and rules exist that govern mutual fund advertisements. There are two significant ways in which these statutes help investors -

- Funds are regulated as to how past performance must be calculated and displayed in advertisements. Standardizing the calculation of past returns helps potential investors make apples to apples comparisons between two similar funds. It also eliminates a mutual fund company's ability to cherry pick time periods during which a fund's performance was exceptional.
- Advertisers are required to prominently display in the body of the ad (not in a footnote), in a font size as large as the primary font size used in the ad, a disclaimer that includes the following caution -

> ***Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value and return will vary and you may have a gain or loss when you sell your shares.***

Advertisements that proclaim lofty past performance catch the attention of investors. We must assume that mutual fund companies wouldn't be spending their advertising dollars on ads if they believed that the "past performance" disclaimer caused potential investors to disregard the published performance figures.

A university study was conducted to determine if the classic disclaimer gives investors a strong enough warning about the insignificance of a fund's past performance. Since most evidence seems to indicate that the current disclaimer is ineffective, the experiment also attempted to determine if a stronger worded disclaimer would be more useful.

Participants in the study were shown an advertisement that appeared in *Money* magazine in which the name of the fund was fictionalized to protect the guilty. The test subjects were divided into four groups. There were two control groups. The first saw the ad without the disclaimer. The other control group saw the ad with no disclaimer and no performance chart. A third group saw the ad with the traditional disclaimer and the fourth group was shown the same ad with what was called a "strong" disclaimer –

> ***Do not expect the fund's quoted past performance to continue in the future. Studies show that mutual funds that have outperformed their peers in the past generally do not outperform them in the future. Strong past performance is often a matter of chance.***

After viewing the ads, participants answered a series of questions. Did they believe that a fund's past returns were a good predictor of future returns? Did they believe that the advertised fund would outperform similar mutual funds in the future? They were asked to estimate the fund's total return during the next 12 months. Finally, they were asked if they would invest a portion of their retirement savings in the fund and, if so, what percentage they would be willing to invest.

The study's results showed that the responses of potential investors who read the ad with the standard disclaimer were not statistically different than those of the control group that read the ad without the disclaimer. Participants who read the ad with the strong disclaimer were less likely to believe that the fund would outperform, less likely to invest in the fund and would invest a lower percentage of their retirement money into the fund. The stronger disclaimer virtually eliminated investors' reliance on advertised performance data, suggesting that it would be a more effective warning to investors than the one currently in use. In fact,

participants who viewed the ad with the strong disclaimer had similar answers to the control group that saw the ad with no performance data and no disclaimer.

It would be fine by me if mutual funds were forbidden to advertise past performance. In its current form, mutual fund advertising is nothing more than misleading propaganda. Those who rely primarily on past performance in their decision-making process tend to disregard important factors such as a fund's fees and expenses, its investment strategy or downside potential. They don't stop to consider if the fund is appropriate for their own risk tolerance. Your financial strategy, not a fund's past performance, should be the primary filter of what gets into your portfolio. If the SEC called me up today I would recommend that they mandate that the following disclaimer be used in all mutual fund advertisements –

> ***Stop! We know what you're thinking. You're looking at the past performance in this advertisement and asking yourself "What if it's true that I can get these returns?" Who are you kidding? When was the last time you chased past performance and weren't disappointed? Past performance is prominently displayed in this ad because the fund company hopes that you're too dim-witted to realize that there is no statistical probability that these returns will continue into the future. If we told your mother what you're doing it would break her heart - she'd think that she raised a fool.***

There are two diametrically opposed investment philosophies. Passive investors buy and hold broad asset class index funds and are content to receive market returns on their invested dollars. They realize that historical market returns have been sufficient to meet almost anyone's long-term needs. Their financial plans contain strategies to meet financial goals assuming average market returns. They don't give a moment's thought to figuring out how to beat the market. They know that performance chasing is a loser's game. Only a small portion of individual investors follow a passive investment philosophy.

On the other hand, active investors are constantly searching for managers, stocks, or can't miss investments that promise to beat the market. Their success or failure will depend on how well they time the market, pick stocks or find fund managers who are on a hot streak. For these investors, pouring over past performance data is a ritual. Whether they realize it or not, most individual investors are practicing active management without a license and are receiving only a fraction of the market's return for their efforts. Professionals cannot beat the market because they are the market. As a group they will get the average return of the market, minus expenses. Active investing guarantees extra costs but not higher returns. Active investors are forever looking for the needle in a haystack. Passive investors are content to own the haystack.

The media is on a constant quest to attract eyeballs. For them, boring is bad; it causes viewers to grab the remote. They prefer guests who will say exciting things that are wrong over guests who will say boring things that are true. How else can you explain Jim Cramer? Not surprisingly, most guests on financial TV shows are proponents of active management. They eagerly give their opinion about where the market or the economy is headed and pontificate on the best stocks and mutual funds to buy today. Many show up with performance charts to prove whatever point they are trying to make. On the other hand, a guest who believes in passive management might answer questions with, "I really don't know." "I hesitate to speculate." or "It doesn't really matter in the long run." It's hard to get on TV if that's all you have to say -- even if it's the honest truth.

Performance chasers live fretful, frustrating financial lives. They're trying to beat the market even though most have never calculated if they can attain their financial goals with average market returns. They're easily led astray by "What if it's true?" which is often followed by "What was I thinking?" They hunt for tomorrow's performance by peering into the past, racing into the future at full speed astern. Hopefully they'll someday realize that it's foolish to waste time and energy trying to handicap hares. I've read the back of the book -- the tortoise wins.

Disclaimer - The information in this article is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how the content of this newsletter should be applied to their investment portfolio. This newsletter is not a solicitation to sell investment advisory services where such an offer would not be legal. Investing in stocks and mutual funds involves risk and the potential loss of principal. Historical data is from sources believed to be reliable. Past performance is not a guarantee of future returns.