

Time in the market versus timing the market

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Investors are taught that markets are unpredictable, that past performance is no guide to the future! Why then is past performance used by the average investor when making fund selection decisions? The following example is rather old but holds true today and provides an insight into why the Tacit thought process steers clear of forecasts.

Between 1984 and 1995 the average equity mutual fund in the US returned over 12 per cent per annum. During this period however, the average investor in equity mutual funds earned a return of just over six per cent per annum.

These two statements appear inconsistent at first glance. How can funds earn more than the people who invest in them? Many would argue that charges are to blame for this differential and that the industry should be shot for extortionate pricing policies. The reality is actually much simpler. Most investors are not 'buy and hold' investors and are influenced by marketing and press articles. If they are holding a fund which has performed poorly (in their opinion), they will move out of this fund in an effort to maximise their returns.

This is common in both the UK and US and in recent years, as the number of funds has multiplied and the availability of the information about them has increased in availability, switching has become increasingly common. The average holding period for funds has halved over the past twenty years to just over six years.

The following is quoted from a book published in 2000 entitled 'Why smart people make big money mistakes' and illustrates how investor psychology affects returns to holders of funds:

"In 1997 Zweig – along with Money reporter Malcolm Fitch and former Securities and Exchange Commission economist Charles Trzcinka – analysed the total returns reported by more than one thousand US stock funds for 1996 and more than eight hundred funds for the three years that ended in December of that year. Among their findings, the average shareholder at more than a dozen profitable US stock funds actually lost money in 1996. And many more investors, who weren't quite so unlucky as to lose money while their fund was profiting, nonetheless fared far worse than they might have expected.

Zweig illustrated his point with the case of PBHG Core Growth, an aggressive stock fund that had more than \$50 million in assets at the beginning of 1996. In the first three months of the prior year, while the benchmark S&P 500 index of stocks rose 5.4 per cent, PBHG Core Growth zoomed an even more impressive 18.2 per cent. Indeed, for the entire year the fund returned a whopping 32.8 per cent, compared with better than 28 per cent for the S&P 500. The problem, though, was that most people who invested in PBHG Core Growth that year missed most of the good stuff. Here's the math: At the end of March the fund had just US\$31 million in assets."

But after its eye-popping performance in the first quarter – duly noted in the press and in the fund's ads – a pack of fund

hoppers pounced into the fund in May and June and they added more than \$200 million to PBHG Core Growth's assets. Too bad, since in the second half of the year the fund lost 3.8 per cent. So even though the fund gained more than 32 per cent over the year, its average shareholder lost 3 per cent."

This research is very relevant at this juncture as most investors will be using the strong returns of the past to make investment decisions. Looking forward is a more difficult task.

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