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No Lake Wobegon For Investors

When they start out, and for quite a while thereafter, most investors confidently assume *they* can achieve above-average returns. After all, the glowing advertisements by mutual fund "winners" and the optimistic sales pitches of professional investment managers make it look easy to do well.

But, alas, investing is not at all like life in Lake Wobegon, the mythical upper Midwest town in Garrison Keillor's "A Prairie Home Companion," where *everyone* is above-average. Actually, in investing most people end up with below-average results. The figures are compelling: in the past twenty years only <u>19%</u> of all U.S. mutual funds outperformed the Standard & Poor's 500 stock index. And the average net return of all funds was 10.9% annually, vs. 13.0% for the S&P in that favorable period.

Investment newsletters have done even worse. Since 1980 the recommendations of only 14% of these letters have outpaced the market.

Why has this happened, when the simple law of averages tells us that in any group 50% should do better than average, and 50% worse? There are several reasons.

First, is the two primary costs of managing portfolios. Management fees for mutual funds average 1.5% per year. For separate accounts managed by professionals they are lower, but including custody, management expenses are usually over 1%, except for very large accounts.

Added to these changes are trading expenses, the costs of buying and selling blocks of stock. Commission rates are dirt cheap nowadays, only a few pennies per share for all institutional trades, but the *market impact* of transactions can be quite significant.

When a fund sells or buys a million dollars or more worth of any stock, which happens all the time, the weight of that trade pushes down the market price of the stock being sold, or pushes up the price of the one being bought – often by one-quarter to one-half percent, depending on the size of the company involved and the normal trading volume of its shares. Given the rapid turnover (i.e., trading in and out of stocks) of most professionally managed portfolios today, analysts have concluded that market impact costs most funds at least 1% per year, and often more.

So in a world where long-term stock returns have averaged 10.5% annually, management fees and trading costs drain away 1.5-2.5% of those returns every year. Thus, a manager has to "beat the market" by earning 12-14% before expenses in order to achieve just an average *net* return. That's hard to do, and few are able to accomplish it.

Another factor holding down returns, for both professionals and do-it-yourselfers, is the inevitable pressure to be "with it" by investing in the most popular and best-performing stocks of the moment, such as technology in the late 1990s and energy in the past several years. Clients and many managers themselves like to be riding the current winners, even if the high valuations of those stocks almost guarantee low returns ahead.

The third obstacle to above-average returns is failure to stay the course when the going gets tough. In plunging markets, for all stocks or a particular industry group that is fundamentally sound, the psychological pressures to sell at depressed prices when all looks gloomy are extremely hard to overcome. "I give up" are fateful words for investors.

I remember a frenzied call I got from a good friend and client in August 2002, as the market was plummeting to new lows, with top-quality stocks down 50% from their 2000 highs, and speculative (mostly technology) issues off a sickening 75%-95%. My friend said, "I've *got* to sell some stocks today. They're too risky for me and I want to have a lower stock ratio from now on." I told him he was the best signal I had seen that the market was about to make a low and that it was an odds-on bet for stocks to rise in the next 12 months (which they did).

Unfortunately, this normally sensible person wouldn't listen and selling a bunch of good stocks then doomed him to below-average performance for years to come. This example can be multiplied by millions of investors.

A logical question from what I've said is: if even most professional managers achieve below-average returns, how can I find a manager that is likely to beat the odds and give me good returns? That's easy to ask and hard to answer.

Most important, I think, is to find a manager who has a carefully-thought-out, long-term strategy that he follows with great consistency through thick and thin. And this should be based on soundly analyzing the *fundamentals of businesses*, not on some sort of market trading techniques. (All the studies I've seen show that portfolios with low turnover far outperform the frenzied in-and-outers who are so prevalent today.) The manager should also be very sensitive to stock *valuations*, because the extremes that valuations typically go to at times can be very beneficial and at times extremely dangerous.

Finally, as I've learned from specific unhappy examples, a management firm that is owned by the people doing the work for it is far more likely to do well by its clients than one with outsider ownership – because such firms put their clients' interests first. It's no accident that the best U.S. mutual funds are run by American Funds, Dodge & Cox, and Vanguard, all self-owned. And that the best large institutional manager in Boston is Wellington, also self-owned. An unfavorable example on the other side is Putnam, owned by Marsh & McLennan, the insurance broker.

Striving to be above-average in investing is a noble goal, but that must be pursued with care and humility, because the chances of achieving superior results are not very high. I might add that beyond stocks the same is true in spades: in venture capital, private equity, hedge funds, and all the other "alternative investments" now so popular. There the odds of doing well are also no more than one in five, the average funds do rather poorly, and the worst performers have horrendous results.

So yearn for Lake Wobegon, but recognize that it's only a mirage for investors. Beating the market by even a fraction of one percent is doing very well.

We are happy to be able to provide you with Ruminations. Please be aware that while Mr. Perry is a member of our Advisory Board, he is not an employee and his opinions are his own and not necessarily those of Marble Harbor Investment Counsel, LLC.

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