"Wants" and "Shoulds"

This past quarter the global equities market reminded us why it is that stocks return more than cash in the long run. We've experienced the arrival of some moderate market volatility. Ironically, nearly all of us *need* the unpleasantness associated with a temporary market dip.

The difficulty, of course, is that investors do not like to experience volatility. Some ill-advised folks who lose sight of their goals may tell you that they would rather have the relative certainty of a 2% return from a certificate of deposit (CD) rather than invest in a balanced portfolio, where historic returns average close to 9% percent.[1] Unfortunately, they ignore the fact that inflation has historically averaged 4%. All they've accomplished is a reduction in volatility and likely guaranteed that their long-term goals cannot be accomplished.

Well-advised investors know to embrace the volatility of the stock market. It's the volatility that produces the 10% or so return, and that's been the case since the mid-1920s. If stock prices were stable, the returns would not be as high. The investing profession calls this a "risk premium," but if we were rewriting the financial textbooks at the leading universities we would call it the "volatility premium." In an intelligently designed portfolio, if an investor exhibits tolerance for the volatility, that investor should be rewarded with a higher long-term return.

The conundrum is that we *want* our investments to go up and never go down – yet intellectually we know we *should* expect the volatility that we so desperately need.

Dr. Meir Statman first introduced us to the concepts of "wants" and "shoulds." He is the Klimek Professor of Finance at Santa Clara University and his research focuses on behavioral finance. We found his research fascinating and thought we'd share some of it with you in our own words.

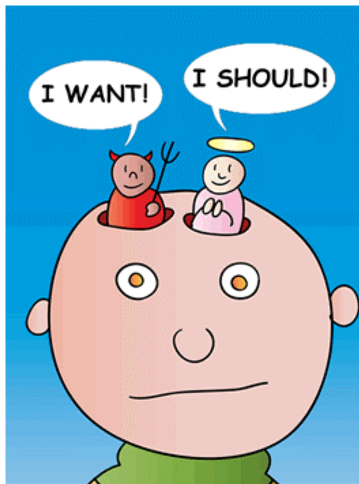
We, meaning collectively the investing public, want high returns from our investments. We may not admit it, or for that matter be aware of it, but we actually want much more. We want to foster hope for riches and expel the fear of poverty. We want to be the best investor and beat the market. We want to feel pride when our investments do well and avoid regret and fear when they falter.

We want the status associated with winning investments, glitzy hedge funds, exclusive private equity, and shrewd maneuvers. We want good advice from magazines, TV, and the Internet. We want to be free from government regulations, yet be protected by regulators. We want financial markets to be fair, yet we search for an edge that would let us "win." We want to leave a legacy only for our children or those we care about – and leave nothing for the tax man.

Unfortunately, statistics and portfolio science will show that our wants will almost certainly lead us down a path of disappointment. Take for example the regrettable case of the beat-the-market investor.

Beat-the-market investors are not unintelligent people. They are willing to work hard to try to find investments whose returns appear to be higher than their risks. They may spend hours looking at stock charts. They may ask friends for

names of winning money managers. They read financial magazines or watch TV programs recommending stocks, bonds, gold, or oil. They believe that investing is simply a subset of the American dream and that if they work harder than their peers then they can beat the market. It is this cognitive error that somehow leads beat-the-market investors to falsely believe that there are investments whose returns are higher than their risks.



An abundance of advice means that our "shoulds" are just as numerous as our "wants." We should diversify. We should buy and hold. We should spend less and save more. We should avoid the temptation to get rich quickly. We should exhibit self-control and avoid indulgence. We should participate in markets, not spend our day figuring out how to beat them.

As stand-alone investors, we will always be "normal" – that is, rarely rational. Our wants and shoulds will almost always wage a ceaseless conflict in our psyches. In the end, our only option is to increase the ratio of smart behavior to less-than-smart behavior by recognizing our cognitive errors before they happen and implement structure in our planning to overcome them.

It's our duty as advisors to recognize these phenomena and to engineer your strategic investment plan accordingly. That is precisely why you have a written investment plan, a structured allocation, and a formulaic plan to keep your portfolio insulated from your wants and squarely aligned with your goals.

It's okay to embrace our wants. They will always be a part of who we are as investors and people. We just need to continue to ensure that they don't find their way into your portfolio decision making.

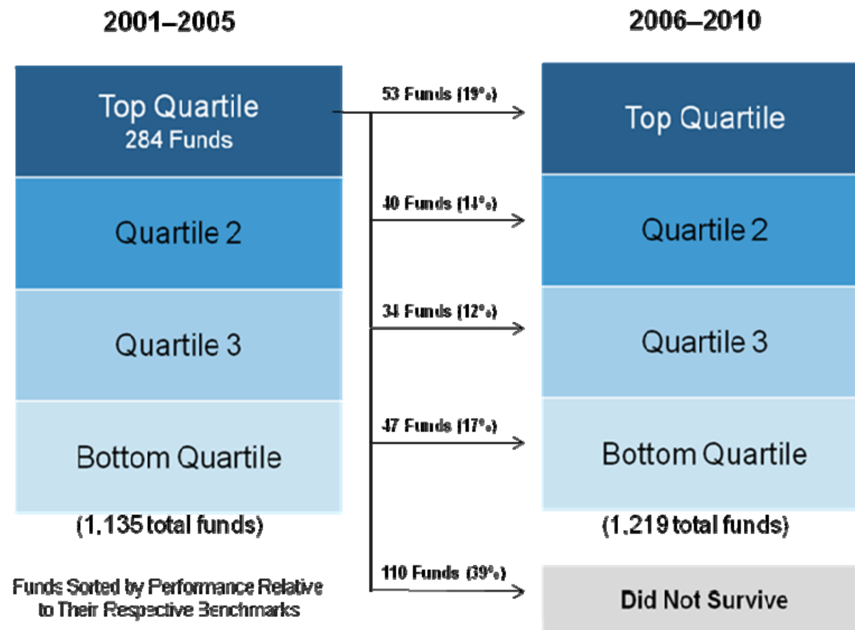
Putting Our Data Where Our Mouth Is

One of the core covenants of our investment philosophy has been that active management (meaning stock picking or market timing) simply does not work. We've maintained that, despite massively funded marketing campaigns by fund companies, choosing mutual fund managers based on past performance does not create higher future returns.

We've looked at the top-performing funds over a five-year period to determine whether they were able to repeat their performance in the following five years. Specifically, we've examined the data to see if there is any persistence of performance.

We've sorted all the US equity mutual funds by cumulative five-year performance relative to each fund's benchmark. As shown on the following page, the top-performing quartile from years 2001 through 2005 comprises 284 of the 1,135 US stock mutual funds.

Subsequent Performance of Top 25% of US Equity Funds
As of December 31, 2010



Source: CRSP Survivor-Bias-Free US Mutual Fund Database.

The right side of the graphic shows how these top-quartile funds performed relative to their benchmarks in the subsequent five-year period. The arrows indicate the movement of these top funds into their new performance groups.

Only 19% of the top-quartile funds repeated their top performance in the subsequent five-year period. Forty-two percent of the funds dropped to the second, third, or bottom quartiles. More significantly, **39% of the original top-quartile funds did not survive** the next five-year period.

These top managers, who were perceived as the most skilled in the US equity market, showed no ability as a group to repeat their top-quartile performance. Instead, almost four out of 10 funds did not survive, and the funds that did survive were as likely to end up in the bottom 25% as to repeat at the top.

Trust us when we say that you will not see an advertisement for a five-star mutual fund that says, **"It is less likely that this fund will still be in existence five years from now than it is for us to repeat our performance."**

It's quite clear that choosing actively managed equity funds according to past success does not guarantee an equally successful investment outcome in the future.

A similar analysis of US bond funds for the same period reveals a nearly identical finding. We analyzed results of the subsequent performance of 148 US bond funds in the top 25% of performance (relative to their respective benchmarks).

Similar to the equity fund analysis, a low percentage (23%) of the top-quartile bond funds repeated their high performance relative to their particular benchmark, while 35% failed to survive the period. The remaining 42% were dispersed in the second, third, and bottom quartiles.

Although investors may attribute a manager's top ranking to superior knowledge and skill, these stock and bond fund studies suggest that relative performance among actively managed funds is mostly random, and investors cannot use past returns to predict future winners. So what does that mean for you?

It means that a portfolio of low-cost, tax-efficient, and globally diversified institutional mutual funds continues to be the ideal tool for implementing your strategic investment plan. It means that focusing on your goals, investor behavior, and asset allocation are now and always will be the elements of continuing success.

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[1] *Past performance is not a guarantee of future investment returns. Data set is from DFA's 60/40 "balanced" passive and index portfolio for the 34-year period covering 1973 through year-end 2010. The numbers provided are from sources believed to be reliable but cannot be guaranteed.*