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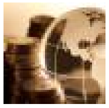

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Why The Average Investor's Investment Return Is So Low

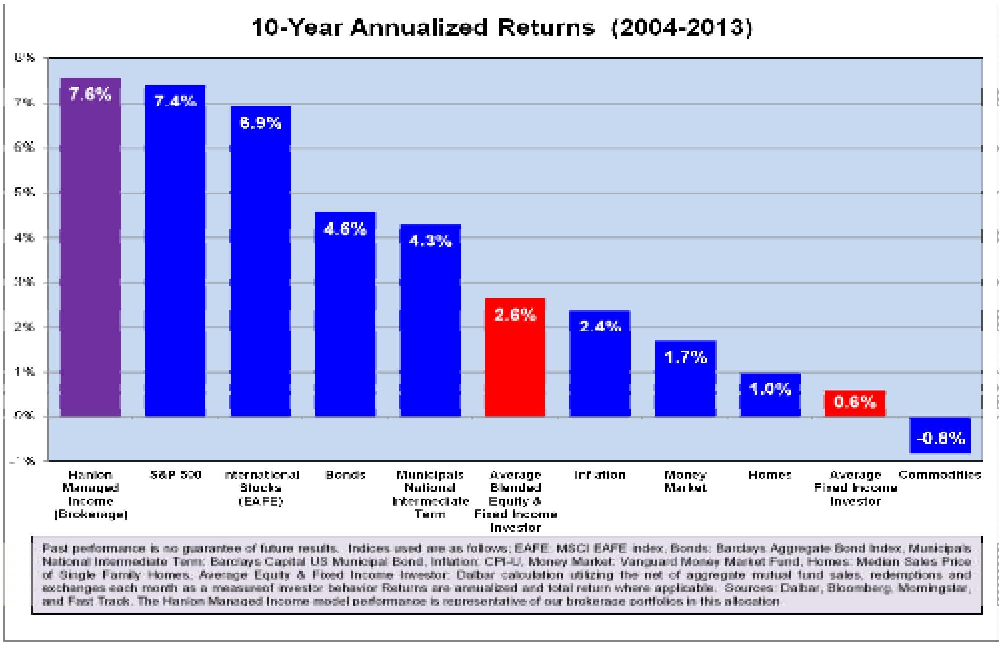
Sean Hanlon , Contributor

According to the latest 2014 release of Dalbar's Quantitative Analysis of Investor Behavior (QAIB), the average investor in a blend of equities and fixed-income mutual funds has garnered only a 2.6% net annualized rate of return for the 10-year time period ending Dec. 31, 2013.

The same average investor hasn't fared any better over longer time frames. The 20-year annualized return comes in at 2.5%, while the 30-year annualized rate is just 1.9%. Wow!

The average investor exclusively investing in just fixed-income funds has had an even worse experience. The annualized return is 0.6% over 10 years, 0.7% over 20 years, and 0.7% over 30 years.

Just who is the "average investor?" The QAIB states the average investor refers to "the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor." This universe would include small and large investors as well as professionally advised and self-advised investors.



It is plain to see in the preceding chart that the average mutual fund investor has seriously underperformed against a variety of asset classes and has barely exceeded the rate of inflation. The average fixed-income investor has lost to inflation, losing valuable purchasing power. Why does the average investor underperform?

Investors may only have themselves to blame. According to Dalbar's QAIB, investors make poor investment choices that hurt their investment returns. These decisions, including when to buy and sell, are often driven by emotion.

Conventional financial theory suggests that investors are rational and seek to maximize their wealth through objective, non-emotional investment decisions. That makes sense. Nobody invests with the goal of losing money. However, the emotions of fear and greed, along with herd instinct, have long been thought to be the main drivers of markets and investor behavior and lead to irrational investment decisions. This thinking has given rise to the field of behavioral finance.

Behavioral finance is the study of emotional phenomenon displayed by investors, such as "regret and pride." Let's look at an example of that.

> An investor owns two stocks, stock A and stock B. The investor purchased stock A for $1,250 and purchased stock B for $750. We will assume a 20% capital gains tax rate and that the future outlook for both stocks is precisely the same.

Over time stock A declines to $1,000, meanwhile stock B increases in value to $1,000. Now the investor needs to raise $1,000. Which stock does the investor sell?

Investors will typically sell stock B, which has gone up because they are proud of having made an investment that has increased in value. Stock A is at a $250 loss and the investor does not want to face the regret of loss in that transaction.

Selling stock B will establish a $250 capital gain, which, at the 20% tax rate, will incur a $50 tax liability. This nets the investor only $950 of the $1,000 after accounting for taxes due.

If the investor had sold stock A, then there would be a $250 capital loss and no tax would be due. The investor would have the full $1,000 of necessary capital and also have a loss of $250 that can be used to offset other capital gains or income, perhaps making stock A the prudent choice.

We saw the regret and pride response in action beginning in March 2000, the largest purchase of mutual funds in the history of the stock market. Fast forward to 2008, just before the “Great Recession” market downturn, and stock prices were falling, but investors refused to sell at a loss. As the market continued to fall, investors held off until they simply couldn’t take it any longer. Many sold their stock near the bottom and missed the following upswing that began March 2009.

What many investors may not realize is just how difficult it is to then make up that loss. For example, a 50% loss would require a 100% gain just to break even—a concept known as negative compounding.

Potential Portfolio Investment Loss	Gain Required to Get Back to Even
-10%	+11%
-20%	+25%
-30%	+43%
-40%	+67%
-50%	+100%
-60%	+150%

Investing your own money is a very difficult thing to do. To properly invest, you need to emotionally detach yourself from your money. This is more than many investors are capable of doing.

Investors incapable of removing their “gut feelings” from the equation can hire an advisor or money manager. However, advisors and buy-and-hold style money managers are also at the mercy of volatile markets. The investor may then find themselves second guessing their advisor and perhaps searching for another. As the market heads back up, the investor feels satisfied with their new advisor—until the next downturn. The whole process will begin again and later repeat itself. This behavior makes it difficult to achieve personal investment goals and a life of financial independence.

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