THINK ADVISOR

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Why Investors Often Underperform the Funds They Own

Morningstar's latest annual 'Mind the Gap' report boosts the argument for why investors need advisors

Much has been written about the performance of mutual fund managers, especially actively managed funds, but what about the performance of investors, who can incur losses or smaller gains simply by buying or selling fund shares at inopportune times?

That question is at the heart of Morningstar's new annual report on investor returns called "Mind the Gap," which it has expanded beyond U.S. and European investors for the first time. The gap refers to the difference between the average asset-weighted investor return and average fund total return; the average investor return is usually lower. Morningstar calculated the investor returns by adjusting fund returns to reflect monthly flows, compounded over time.

The study, which excluded ETFs because of the difficulty in estimating investor intent, found that overall the average investor collects a smaller return than the average fund, but the gap is smaller and maybe even positive when investors use systematic investment programs, as many do in their 401(k) plans, and when they invest in lower-cost funds.

“Steady investment contributions to saving plans and automatic rebalancing proved to be key in generating positive investor returns in countries including Australia, South Korea and the United States,” said Russel Kinnel, chairman of Morningstar’s North America ratings committee and editor of the Morningstar FundInvestor, in a press release.

The average U.S. investor in asset allocation and concentrated equity funds outperformed the average fund annually by a small margin – five basis points and one basis point, respectively, over 10 years, while the average investor in superannuation funds in Australia (a type of retirement fund mandating contributions from employers and voluntary for workers) and in bond funds in South Korea bested the average fund there by 53 basis points and 47 basis points, respectively, over five years.

While systematic investment programs boosted returns, higher fund fees had the opposite effect. “Investor returns declined as funds rose in cost, often by more than the difference in costs, suggesting that behavior of investor and manager alike in high-cost funds was poor, while low-cost funds represented a meeting of smarter investors and managers,” wrote Kinnel.

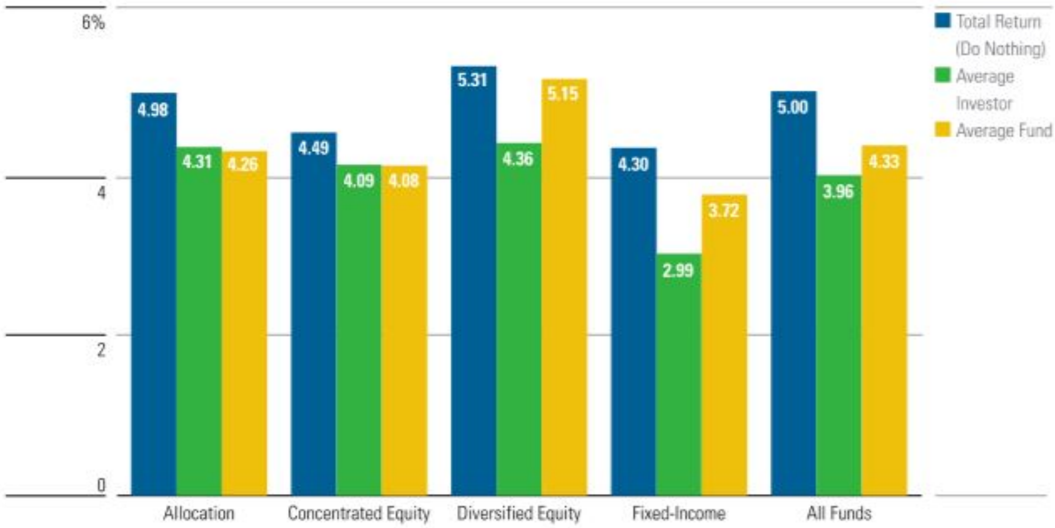
Higher cost funds tend to take greater risks to overcome their higher fees, according to the study. “Lower cost and lower risks are important,” says Kinnel.

It found that in the U.S., the investor return gap in 2016 was an annualized 37 basis points for “all funds” over 10 years, down from 54 basis points in 2015. The average fund returned 4.33% annually compared with the average investor collecting 3.96%.

Contributing to the narrower gap: yearly flows that didn’t keep pace with asset growth. “The aggregate mutual fund investors are making fewer market-timing calls that can harm results,” according to the report.

While the average U.S. investor in allocation funds and concentrated equity funds actually did better than the average fund in that category, the average U.S. investor in diversified equity funds and bond funds did worse. They underperformed the average fund by 79 basis points and 73 basis points, respectively.

10-YEAR INVESTOR RETURNS IN THE U.S.



Source: Morningstar Inc. Data as of Dec. 31, 2016.

The biggest factor for the gap in bond funds had to do with muni bond funds, says Kinnel. Almost all the news on munis that reached investors was negative news – Puerto Rico's bankruptcy and analyst Meredith Whitney's 2010 call about the coming collapse in the muni market (which hasn't happened yet), he said.

In the U.S., the best performance among funds was in the category known as "do-nothing" portfolios, buy-and-hold portfolios, measured at the beginning and end of the time period, with no additional flows to or from. These essentially theoretical portfolios did better than the average investor fund or average mutual fund over 10 years.

The average do-nothing fund gained an annualized 5% (versus 3.96% for investors and 4.33% for the average fund). The biggest gap was in the bond category, where buy and hold earned 4.3% but the average gained averaged just 2.99%, a difference of 1.31%.

For advisors the study illustrates the "big cost to be paid for not sticking to a plan," said Kinnel, noting that all the figures are in the aggregate and individual investors making bad decisions could perform far worse than that due to market timing. "The big value added from advisors is keeping people on a plan and preventing them from making big mistakes."

He added that investors and advisors should be careful not to get "caught up in the 24-hour news cycle."

Other takeaways from the study, according to Kinnel: Fees and risks matter, emotional decision making can lead to bad decisions and automatic investments should be encouraged.