

Are Investors Capturing the Returns of their Mutual Funds?

We have met the enemy and he is us.

- Pogo

In our last newsletter we discussed the difficulty of active mutual fund managers in beating a comparative index. This newsletter will look at how investors do compared to the mutual funds they own.

There have been various studies over the years that show that mutual fund investors under perform the actual mutual funds that comprise their investment holdings. One study showed that investors under perform their investments by nearly 10% a year. While I do not believe that investors fair quite that poorly, there is a new study by Morningstar to consider.¹ I have reproduced the table from the study lower down on the page.

For the 10 years ending in 2005 all no-load index mutual funds² earned a total return (TR) of 8.65%. Yet, the dollar-weighted return (DWR), or the return that investors actually received was only 7.07%. This is 1.58% **less** than the actual returns of the index funds. These investors are only earning 82% of what the funds offer.

Dimensional Fund Advisors (DFA) offers its passively managed funds through independent fee-only advisors who undergo training on the merits of passive investing and in portfolio construction theory. While similar to index funds in that they are passive funds, the underlying construction of the funds is somewhat different than a traditional index fund. The goal of an index fund is to simply track the performance of widely-quoted index like the S&P 500 index.

For the same 10-year period, DFA mutual funds earned a total return of 9.90% (an improvement over traditional index funds by 1.25%). The dollar-weighted return of DFA mutual funds provided a **higher return** than the total return of the funds themselves! Over the 10-year period the dollar-weighted return for DFA funds was 10.81% or 109% of the return of the funds.

	10-Year DWR %	10-Year TR %	+/- Difference	Success %
DFA Funds	10.81	9.90	+0.91	109
All No-Load Index Funds	7.07	8.65	-1.58%	82

¹ <http://indexes.morningstar.com/Index/PDF/MorningstarIndexesYearbook2005.pdf>

² A no-load mutual fund is a mutual fund that investors can purchase without paying a commission to purchase that fund. An index fund is simply a mutual fund that tracks an index such as the S&P 500 index. Index funds effectively invest in all the stocks of companies that comprise that particular index.

In this study, the DFA mutual funds provided investors with a return that was 3.74% higher than traditional index fund investors. Put another way, the DFA investors' returns were more than 50% greater than the traditional index fund investor's returns.

How could this be? Part of this higher performance has to do with improvement of the returns of the funds themselves. In this case, the DFA funds provided a higher return of 1.25% compared to the no-load index funds. This has to do with fund construction which is outside the scope of this newsletter.

But, the biggest explanation has to do with the education the advisor is providing to the investor regarding investment strategy and sticking with a discipline strategy. While most investors are buying high and selling low, clients of advisors who are properly educated are buying low and selling high. This is done through enforcement of an agreed-upon investment policy in advance.

While the market provides returns that are never guaranteed, one is likely to improve their chances of investment success through implementation of a thoughtful, disciplined strategy. Most importantly, this strategy should be written down in advance of any investment implementation.

For additional information, feel free to contact Ken Weingarten at (609) 620-1770.

Disclaimer: Weingarten Associates sends this newsletter as a public service. Information has been obtained from sources believed to be reliable, but its accuracy and completeness, and the opinions based thereon, are not guaranteed and no responsibility is assumed for errors and omissions. Nothing in this publication should be deemed as individual investment advice. Consult your personal financial advisor and investment prospectus before making an investment decision. Any performance data published herein are not predictive of future performance. Investors should always be aware that past performance has not been shown to predict the future. If in doubt about the tax or legal consequences of a legal decision, it is best to consult a qualified expert.