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Should You Dump That Slumping Mutual Fund?

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Let's say you are invested in equity mutual funds. That same fund which did so well last year has turned stone-cold. Is it time to fish or cut bait? Sooner or later in your investment lifetime, you will confront this thorny question of whether to dump a lagging fund.

From the outset, I want to acknowledge unequivocally that this is a most difficult question to answer. But if you are to enjoy long-term financial success and wealth accumulation, you must have a good batting average in answering this question correctly at critical junctures during your investment lifetime.

A well-known and widely cited study by DALBAR shows that many mutual fund investors repeatedly make the wrong decision when confronted with this difficult question. They tend to cut lagging funds that are about to rebound and chase hot funds that are about to lag. This is very similar to the investor who sells a moribund stock just before it finally takes off, while he piles into a hot stock that is about to decline.

The DALBAR study shows that the average mutual fund investor fails to capture an extra 7% per year in return (i.e. the opportunity cost amounts to 7% per year) by investing with a rear-view mirror. This is tragic, often representing the difference between a secure retirement and unfulfilled financial objectives. The evidence shows the average investor does a very poor job distinguishing a superb fund going through an inevitable rough patch from a poor fund that will stay lousy.

One of the many reasons why an investor might be tempted to dump a lagging fund is his incorrect expectation that good funds are supposed to do well all the time. If this is indeed his expectation, he will conclude wrongly that lagging investment results ***prima facie*** indicate something is amiss with the fund. In reality, even the most stellar funds will have disappointing and lagging periods. Later in this article, I will present overwhelming evidence to substantiate this. But first, let's examine why this is so.

Over the long run, the market is pretty efficient in valuing the underlying progress of the economy and the individual companies that make up the economy. Over the short run, however, mass psychology has a much bigger effect on stock prices than business fundamentals. The short-term market valuation mechanism is distorted by the fear and greed of the investment masses, causing it to process information very inefficiently by over-extrapolating short-term trends.

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As the future unfolds bit by bit, the market begins reacting, and often over-reacting, to the relevance of information flow on the economy and markets, producing random and unpredictable market movements. One day investors may fall in love with commodities if there is a whiff of inflation in the news, while the next day people might be tripping over themselves to buy financial companies, because some Fed governor said the Fed might have room to cut interest rates if inflation is contained – that is until some other Fed governor contradicts this the following day.

This short-run randomness means it is impossible to experience robust investment progress all the time, unless you are able to predict what is about to capture the fancy of market participants on a day-to-day basis, and act on it ahead of time. This is impossible to do consistently no matter how good an investor or psychologist you are.

To correctly predict what is about to catch people's fancy and therefore to position yourself in the investments that are about to experience increased demand and higher prices, you literally would, among other things, have to alternate between rational and irrational behavior over and over. This is because the markets sometimes value investments rationally, but often irrationally as well.

For example, during the tech bubble years, the only way to keep up with the markets was to throw common sense and caution to the wind and sink money in untested companies with nary a business plan and no customers. If you followed a sensible, deliberate and disciplined investment strategy, you would have stayed away from these sorts of "investments," which turned out to be foolish speculations. For a couple of years, you would have experienced slow progress and probably been teased and ridiculed by your friends, colleagues and neighbors. But in hindsight, such rationality was subsequently rewarded in the aftermath of the tech bubble, during which period speculative investment strategies were punished. It is too much to expect that anyone can predict which way the wind will blow from day to day, and then position oneself in the path of the tailwind.

Because of the foregoing reasons, all equity mutual funds will suffer lagging periods. There is plenty of evidence that even top funds frequently experience slow, frustrating periods. For example, Tweedy Browne (a highly respected investment management firm) published some very interesting research a few years ago. The Tweedy Browne study found that even for investment managers with market-beating returns over the long run, it was not uncommon for them to underperform their benchmarks 25-40% of the time on a calendar-year basis. In fact, the legendary Sequoia Fund, Pacific Partners and Windsor Fund experienced such underperformance for as long as 3 to 4 years in a row! Pacific Partners narrowly missed underperforming its benchmark 6 years in a row! Yet, all these funds did much better than the market cumulatively over time.

The Tweedy Browne study confirms that even the greatest investors have lagging periods, and you should not expect such periods *necessarily* to indicate that trouble is brewing. While lagging results could really mean further problems down the road, they could also represent inevitable slow periods on the way to a rebound.

Tweedy Browne emphasized that if you are prepared for this reality, you are more likely to do the right thing when you face this situation repeatedly throughout your investment lifetime. They advised that: "You can think of investing as a long-term journey with many starts, stops, changes of scenery and occasional bumps. We believe that you are much more likely to enjoy the journey, or at least endure it, and reach your destination safely, if you know what to expect along the way. Your own psychology and ability to handle the emotional ups and downs of investing are likely to be important determinants of your long run investment success." I could not agree more with this advice.

Litman/Gregory Analytics, another highly respected mutual fund consultant and management firm, also conducted an exhaustive study in September 2006 of how highly successful mutual funds go through underperformance along the way to their market-beating returns over the long haul. The study examined 266 mutual funds that had beaten their respective benchmarks cumulatively over a 10-year period. It concluded: "**The data shows that among funds with the best long-term records, most experienced a prolonged period of underperformance relative to their benchmark…Consistently applying a superior investment approach should lead to long-term outperformance, but it simply won't work for all the people all the time. In other words, the results of our study tell us that on the road to long-term outperformance, not only should we expect underperformance, we should be prepared for it to last for *years*.** *(bold added)"* In fact over rolling 3-year periods, some of these outstanding funds not only lagged their benchmarks, they lagged by a mile. For example, anywhere from roughly half to three-quarters of the top funds lagged by 5% or more *per year* over at least one 3-year period.

More compelling evidence is found in another study by the Brandes Institute, which is part of Brandes Investment Partners that manages more than $100 billion. The study looked at 531 equity mutual funds, with the top 10% or 53 funds outperforming the S&P 500 by around 1% per year over a 10-year period. And yet, over quarterly or calendar-year snapshots, every single one of the top funds had mediocre or worse periods. Even after the snapshot was stretched out to three years, nearly all the top-performing funds (49 out of 53) had at least one below-average 3-year period.

The Brandes study in particular pointed to Bill Miller's widely acclaimed and admired Legg Mason Value Trust, which was the top fund out of 531 over the ten-year snapshot being analyzed. The study disclosed the worst one-year performance of Miller's Value Trust Fund was a ranking of 491 out of 531, while its worst three-year ranking was 418 out of 531. Even over a period as long as five years, the fund once finished 221st. Imagine that – a widely praised and respected mutual fund manager looking less than ordinary over some pretty long stretches. His top-ranking 10-year results, however, suggest that he rebounded each and every time after a dry spell.

Christopher Davis, the celebrated co-manager of the Davis New York Venture Fund and Clipper Fund, reinforced this reality in the 2005 Annual Report for the Clipper Fund: "Importantly, just as the market inevitably will go through bad periods, it is also certain that the Clipper Fund will suffer through periods of poor results. This is not mock modesty. A study of managers with the best 10-year records indicates that more than 90% of these top managers fell into the bottom half relative to their peers for three years in a row during that period. Almost two-thirds of these top managers fell into the bottom quartile relative to their peers for at least three years in a row. Even if we are successful in producing satisfactory long-term results, a bad three-year patch is not just possible, but inevitable."

Davis then continues in the 2006 semi-annual shareholder report for the Clipper Fund: "For example, more than 90% of the top-quartile managers over the last 10 years spent at least three years of the 10 in the bottom half compared to their peers. Almost 70% spent a three-year period in the bottom quartile relative to peers. If investors use a three-year measurement period, they would have fired the vast majority of the top-quartile managers of the last decade!" Indeed, some impatient and undisciplined shareholders were calling for Warren Buffett's head while Berkshire Hathaway stock lagged during the tech bubble years.

Now that we have hopefully convinced you that lagging periods are an inevitable part of even the best investment records extant, unfortunately your conundrum is not yet solved. While lagging investment results do not *prima facie* show something is amiss, they certainly *could* indicate problems that must be addressed, perhaps by dumping the fund altogether.

Unfortunately, a good fund going through a slow stretch (but which will rebound) looks exactly like a poor fund going through a bad stretch that will persist. So how do you distinguish between them? Here are several factors or questions you should focus on to help you make the distinction.

- What drives the performance during the good times and are those factors likely to return? For example, a rational value-oriented fund will likely do better during sober than speculative times. You should give the value fund more time if the fund is struggling because there is a speculative market backdrop.

- Do the fund's investment philosophy and strategy make sense to you as a reasonable way to achieve solid returns over time? For example, if the mutual fund's strategy is simply to chase stocks with positive momentum during a speculative period, a change in the fortunes of the fund is likely permanent if the speculative period has ended.

- Is the fund willing to own out-of-favor names, make decisions based on the long run and ignore short-term volatility or pressures? If so, then you should wait it out some more because over time these investment traits have been proven to lead to superior investment results.

- Is the performance lull explained by a market backdrop that tends to be hostile to the investment style of the fund? Are funds with similar styles and philosophies also struggling? For instance, when judging a lagging growth-oriented fund, you should examine whether most or all growth funds are facing similar headwinds. If yes, then you should not be that concerned. Otherwise, you need to dig deeper.

- Is the performance lull due to the manager changing her investment style? Does she remain disciplined and maintain conviction about her strategy despite short-term difficulties? If a fund seems to be having trouble executing because it has adopted a style or strategy that is not its strength, that is a red flag.

- Does the manager favor more concentration in her portfolios, so that any out-of-sync periods will be more pronounced? To do better than the market, she will necessarily have to invest differently than the vast majority of investors; for instance if energy is hot and she is not in energy, she will lag through stretches. However, a concentrated portfolio, if managed properly, should ultimately lead to outperformance.

- Does the manager have a history of rebounding strongly after slow periods in the past? If so, how many such periods has this manager experienced in the past and did he manage to rebound after each and every time? Obviously, a long history of successful rebounds after slow periods should give you more reason to stay with the fund.

While there is no fool-proof way, except in hindsight, to tell whether you made the correct decision to stay with a fund going through a slow stretch, undisciplined guessing is harmful to your financial health. By analyzing the factors above as they apply to your fund or funds, you have a reasonable framework to guide your decisions. It is well worth your effort, as success at making the right decision at critical junctures could mean the difference between a secure retirement rather than a lifetime of financial insecurity.

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