
Fund Spy**How Did Investors Really Do?**

By Christine Benz | 11-13-06 | 06:00 AM

We've all heard horror stories that illustrate investors' tendency to buy high and sell low. But just how bad is investors' timing, really? To answer that question, we took a look at investor returns, also known as asset-weighted returns, which Morningstar recently began calculating for funds in its database. On Morningstar.com, Investor Returns appear on a tab alongside Total Returns; to see an example of Investor Returns for an individual fund, click [here](#).

By factoring in the timing of investors' purchases and sales, investor returns depict the returns earned by the typical investor. In aggregate, the data show that investor returns have generally lagged those of funds' published total returns, which assume a buy-and-hold strategy. Investor returns vary widely by category and individual fund, however, and in some cases, funds' investor returns actually outpace their total returns. Moreover, a fund's volatility appears to be a key determinant in whether its investor returns are good or bad.

How We Calculate It

A fund's investor return takes into account the fact that not all of a fund's investors bought it at the beginning of a period and held it until the end. To use a simple example of investor returns in action, assume a fund generated a 10% total return in a calendar year, with most of those gains coming in the year's first quarter. If investors added substantial sums of money to the fund after its first-quarter runup, the fund's investor returns for that year would be lower than the fund's 10% total return.

Basic Findings

So, are the anecdotes about investors' poor timing overblown, based on Morningstar investor returns? No. Although most fund categories' total returns and investor returns were fairly close to one another over the past three- and five-year periods, the gap between the two widened substantially over the trailing 10-year period. That's likely because the 10-year period encompassed the late 1990s' bull run as well as the bear market, and both extremes tended to stimulate poor decision-making.

In fact, in every diversified stock-fund category and all but a handful of sector categories, funds' 10-year investor returns lagged their total returns. The divergence was, in several cases, quite striking. For example, technology-sector funds have, on average, generated 10-year total returns of 6.4%--not great, but not absolutely terrible, either. But investors have, in aggregate, had a terrible experience in these funds, losing an average of 4.2% on an annualized basis over the past 10 years. It was a similar story for growth funds, which generally posted 10-year investor returns that fell far short of their total returns. Ditto for communications and health-care funds.

There were a few bright spots. All of the fund categories that mix stocks and bonds posted 10-year investor returns that nearly matched or even outpaced their total returns. Investor returns for bond funds also tended to stay within close proximity of their total returns.

Link with Volatility

The disastrous investor returns of high-octane growth and technology funds, as well as the better investor returns from conservative fund types, led us to pursue another angle: Within categories, is there a link between volatility and investor returns? In an effort to determine whether high-volatility funds tend to stimulate poor investor decision-making, we grouped all of the funds in each of our categories into quartiles based on their standard deviations.

From there, we examined whether the low-risk quartile posted better investor returns over the past 10 years than the high-risk quartile. The answer was a resounding yes. In every diversified domestic-equity category, the investor returns of the low-volatility group trounced those of the high-volatility group. It's worth noting that in many cases the low volatility group had better total returns (that is, not accounting for asset inflows and outflows) than the high-volatility group, so naturally the investor returns of the former are also better than those of the latter. But even where the high-volatility funds had better total returns than the low-volatility funds, the low-volatility group produced superior investor returns.

Within the large-blend group, the high-standard-deviation quartile posted a 10-year total return of 7.98% whereas the low-standard deviation group's 10-year return was 7.11%. But the tables turned when it came to investor returns: High-volatility large-blend funds posted investor returns of 5.81%, whereas the lower-volatility large-blend offerings posted investor returns of 6.20%. That's not a huge difference, of course, but it does illustrate the extent to which investors often erode any return advantage of high-volatility funds by mistiming their purchases and sales.

Examining individual funds' investor returns underscores the connection between high volatility and a poor shareholder experience. Many of the funds with topflight total returns and poor investor returns employ risky strategies within already-volatile categories. For example, [➤ RS Diversified Growth \(RSDGX\)](#), a high-octane small-growth fund, has a top-quartile 10-year return ranking, but its investor returns land in its category's bottom quartile. By contrast, [➤ Dreyfus Appreciation \(DGAGX\)](#), a staid blue-chip-focused large-blend fund, boasts middling 10-year total returns, but its investor returns are among the category's best.

The link between high volatility and poor investor returns (and lower volatility and better investor returns) makes intuitive sense. After all, high-volatility funds often exhibit large short-term gains, which in turn entice investors. But such offerings are also often taking outsized risks to score those gains, and when performance drops off--often sharply--investors get spooked. Low-volatility funds, by contrast, tend not to attract fickle short-term investors with explosive gains and also do a better job of protecting shareholders' capital during downturns. In turn, they inspire investors to hang on--or perhaps even add more to their holdings--during the lean times.

The Average Investor vs. Category Averages

On the bright side, things look better when we asset-weight investor returns on individual funds and compare them with category average total returns. In other words, investor returns in giant funds such as [➤ American Funds Growth Fund of America \(AGTHX\)](#) get a much larger weighting than small funds such as [➤ Phoenix Nifty Fifty \(PANFX\)](#). Doing this reveals yet another surprise: The average investor actually earned about the same return as the category average and sometimes more. This means that even though investors have bad timing, they tend to choose pretty good funds. Thus, they overcome timing problems with good selection. Consider that the official 10-year returns of Growth Fund of America are 13.07% through September 2006, but bad timing reduced investor returns significantly to 10.43%.

Caveats and Takeaways

Trailing investor returns, like trailing total returns, are subject to end-period bias--that is, results may be skewed by recent market action, and certain funds and categories may look substantially better or worse than they would at other points in time. That helps explain why the 10-year trailing investor returns for certain volatile asset classes, such as precious metals and emerging markets, are quite good--investors have recently been rewarded for adding to their shares in these categories.

Moreover, the link between investor returns and volatility points up the fact that low volatility should be an even more important criterion in more investors' fund-selection process, as it's correlated with better shareholder results over the long haul.

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