Is the market beating you?

The answer is worse than you think

By: Troy Sapp, CFP®
Commencement Financial Planning LLC
September 2010

It would seem logical to think that the average investor should be able to get at least average market returns, but they're not. They are actually getting badly beaten by the market. What in the world is going on here?

A groundbreaking study by Morningstar recently showed that during the decade ending Dec. 31, 2009, average investor returns lagged the average return of all types -- including stock funds and bond funds – by 1.5 percent annually. This may not sound like much until you realize this difference would have caused an investor with $100k invested 10 years ago to lag an average market valuation on December 31, 2009 by over $18k. So why, over the past decade, were average investors unable to achieve even average market returns? The main reasons: fees and market timing.

Investors are constantly bombarded by friends, media, and so-called investment professionals with talk of what's hot and what's not. It's easy to see why it works. Buying and selling is sexy. It makes the average investor feel like he is in control. "Playing the market" reminds us of the investor that made a fortune in Starbuck's or Microsoft. Most of us want to believe we too can be that person. Who wouldn't want to be that "winner"? The problem is, much like casino gamblers, we only hear about the winners and not the losers even though the losers are much more numerous.

Unfortunately, many investment professionals play into market timing sentiment by leading investors to believe they have special insight into the future of markets. They often do so without a reasoned process designed for steady long term results. This strategy does work for many investment professionals. They receive commissions and fees upfront while investors happily pay them in return for the comfort of believing the professional knows what the future holds. The fact is that no one can consistently time the market. By the time main street acts, all available information has been priced in by scores of institutional analysts. If anyone implies they know where the market is headed, run and run fast.

Most investors do tend to shun high cost mutual funds for those with lower cost. This is a very good sign. Morningstar recently provided a study that showed that, all things being equal, fees were the number one determinate of outperformance when comparing similar fund types. I applaud the frugal investor. In my experience I've found there is a large group of investors that continue to pay too much, though. These investors are typically steered toward investments with high sales charges and internal fund fees. Though

these arrangements are quite lucrative for financial professionals, they severally hamper their clients' ability to achieve even average long term performance.

A study published in the Journal of Indexes (JI) recently found independent investors were simply bad at market timing. This supports Morningstar's finding that market timing was the number one reason for lagging even average market returns. If history has shown us that market timing is not a good way to outperform the market (it's actually the best way to get beat by the market), then why does the average investor continue to do it? The JI study found there were two types of investors: those that know they don't know and those that think they know, but don't. It turns out that the first group tends to turn to investment professionals and funds that heavily advertise. The second group believes they have insight into the future direction of the market. Though these two groups assume differing paths, the conclusion is the same. Both groups are simply attempting to time the market and are getting beat by it in the process.

The tendency to time the market seems to be part of who we are as humans. Dumping an underperforming asset to buy one that has performed well simply feels right. Selling one that has performed well to buy one that hasn't is quite uncomfortable. Historically (the recent past is no exception), doing what is uncomfortable actually causes us to sell high and buy low; the exact thing one must do to achieve superior long term results. Developing a long term strategic portfolio allocation and occasionally rebalancing to its targets will greatly increase the odds you will sell high and buy low. Chasing performance will likely lead you to purchase investments when they are expensive.

We would all like the market to get us rich quickly, but the fact is few of us do and most not only don't get rich quickly from the market, but grow poorer attempting it. Getting rich slowly may not be sexy, but it's the surest way of success. The foundation of this approach is to utilize low-cost funds in a strategic allocation developed around your goals and risk tolerance. Further, if you don't understand how an individual investment complements your overall strategy, you simply should not own it. Using a sound process to develop a strategic target allocation, fulfilling the allocation with sound low-cost investment vehicles, then occasionally rebalancing to the target allocation keeps one from losing to market timing, the single most damaging thing to average investor returns over the past decade.

An investment professional that places your interests first will help you develop a strategy best suited to your situation. When seeking professionals, be sure not only to know their education and credentials, but also how they are compensated. Knowing how they are compensated helps determine if their interests are aligned with your own. A good financial advisor will help you keep costs low and avoid the pitfalls of market timing. Do your homework. Your future depends on it.