Executive Summary

This paper examines two prominent, return-diminishing investment behaviors.

Topics Include:

Market Timing — why investors attempt it, how the environment encourages it, and if it’s actually possible.

Performance-Chasing — the investment industry and human nature foster it, this can put a financial advisor in a difficult situation.

A Compelling Study — a mutual fund titan shows what actually happens when investors keep pursuing higher returns.

Know the Course — the keys to intelligent, long-term wealth creation.

THE VALUE OF PATIENCE

Introduction

Many investors find it difficult to achieve their financial goals for a number of reasons. Unexpected and uncontrollable events can wreak havoc on a financial plan. But often it is the investor’s own actions that cause them to fall short of their objectives. There is a branch of science called behavioral finance dedicated to exploring how people’s propensities and predilections can short circuit rational investment decisions. Unfortunately, the investment environment comprised of academicians, practitioners, pundits, and the financial press is complicit in steering the investor to return-diminishing behaviors such as Market Timing and Performance-Chasing. Fortunately, awareness aids avoidance. This paper covers these two prominent self-defeating tendencies as well as a rational approach to combat them.

Market Timing

Simply put, market timing is selling stocks just before a person thinks the market will fall and, conversely, buying stocks just before one believes the market will rise. The reason an investor would want to try to time the market is to accomplish dual goals: preserve capital and achieve outsized returns. Moreover, the investment environment not only validates market timing, but it also leads investors to believe that they can and should be doing it. There is a question frequently asked in the financial news, “Is this the time to buy (sell) stocks?” This question is exacerbated throughout the media. For example, The Wall Street Journal cites market strategists who advocate changes to stock holdings based on predictions of how financial markets will react to geopolitical events, economic data releases, or even past movements in the markets. Additionally, investment newsletters tell subscribers when to “get in” and “get out” of stocks, bonds, and other assets. Yet financial markets are inherently unpredictable and there is overwhelming evidence that not only does market timing not work, but it diminishes long-term returns.

Is Market Timing Possible?

A market timer must make two clairvoyant decisions: when to buy and when to sell. In a 1975 study, Nobel Laureate William Sharpe determined that investors had to be right on market calls 70% of the time to beat a buy-and-hold strategy. Follow-up studies put the required winning percentage even higher – difficult to do even if the individual believes that financial markets are predictable. The costs of being wrong are significant because long-term returns are often driven by a just a handful of substantial days in the market. If an investor misses those days, their performance suffers. For instance, if a person remained invested in the S&P 500 Index for the 20 years ending 2013, their annualized return was 9.22%. Missing the five best performance days (during 5037 trading days) caused returns to fall to 7.00% while dropping the 10 best days created just a 5.5% return. Finally, missing the top 30 (just .6% of total trading days) would have garnered a meager .9%!

The assertions in this white paper are based on Fenimore Asset Management’s opinion. Fenimore Asset Management is the investment advisor to FAM Funds.

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1 Snider Advisors and Index Fund Advisors
Despite the long odds and costs of being wrong, the following graph details money flowing in and out of equity mutual funds and demonstrates that investors are still tempted to try to time the market. The Investment Company Institute’s study overlays net new cash flow into equity mutual funds and the corresponding returns on equities. Additionally, we superimposed the S&P 500 Index performance in green. This study confirms that investors pour money into equities at peaks and are significantly invested as markets fall; they then sell stocks at low points and are less exposed to stocks just as they rebound.

The investing mantra – buy low and sell high – is turned on its head.

**Net Flows to Equity Mutual Funds Resumed Historical Correlation with Returns – 1990 to 2014**

![Chart showing net flows to equity mutual funds](chart)

*Sources: Investment Company Institute, Morgan Stanley Capital International, and S&P 500 Index*

**More Evidence**

Financial research firm DALBAR has been studying investor behavior for years. In their “Quantitative Analysis of Investor Behavior 2014” they tally just how costly market timing has been. They found that average equity investors’ compounded annual returns over the 20-year period ending December of 2013 were 5.02% – more than 4% lower than the 9.22% return on the S&P 500 Index. Between December 2010 and December 2013, these investors underperformed the market by 5.3% returning 10.87% per year versus 16.18% in the S&P 500. Much of this difference was due to ill-fated attempts to time the market.

Morningstar uses mutual fund flow data to estimate the dollar-weighted return of the average investor versus the average return for each asset class in order to track the cost of poor market timing. The deduction is that by buying and selling different asset classes at the wrong time, the average investor underperforms a buy-and-hold strategy.

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2 **DALBAR’s 20th Annual Quantitative Analysis of Investor Behavior 2014**

3 **Morningstar**
Performance-Chasing

Our industry, and human nature, conditions investors to strive for maximum returns and entices them to always seek more, often in comparison to others. Investors are compelled to chase performance: to sell funds (fire managers) that are underperforming and buy those funds (hire managers) that are outperforming. After all, how can one be maximizing returns if someone else is doing better? For financial advisors the temptation may be amplified when a client asks the penetrating question, “Why are we keeping this underperforming fund?”

In a Vanguard research study titled, “Quantifying the impact of chasing fund performance” the mutual fund firm found that performance-chasing often diminishes returns. Their study used actively-managed U.S. equity mutual funds available in Morningstar’s database that had been in existence for at least three of the 10 years ending 12/31/2013 (3,568 funds). There were nine style categories divided into blend, growth, and value of large-, mid-, and small-cap funds. It analyzed two approaches: performance-chasing versus buy-and-hold.

The performance-chasing strategy invested in any fund that had above median 3-year returns for the period 2004 to 2006. Funds that achieved below median returns for a rolling 3-year period were sold and replaced with a fund that achieved an average annual return within the top 20 performing funds over the prior 3-year period.

The buy-and-hold strategy was simple: invest in any fund, sell only if the fund was discontinued, and replace a discontinued fund with one of the median-performing equity funds within the style box.

The results, detailed in the charts below, were conclusive: performance-chasing may actually be a hindrance to capital appreciation and wealth building. Furthermore, the Sharpe Ratio (referenced in Figure 2) in each study indicates that performance-chasers experienced more volatility en route to their subpar returns.

Figure 1.
Buy-and-hold was superior to a performance-chasing strategy across the board: 2004-2013
Figure 2.

Notes: All returns and Sharpe ratios shown are median annualized; for “Difference,” numbers may not compute because of rounding. Area under the curves represents frequency of returns realized under either strategy, similar in effect to a histogram. Dotted lines represent median return of the distribution. Investors prefer distributions with higher median returns and less dispersion, or volatility, around the median.

Sources: Vanguard calculations, using data from Morningstar, Inc.’s nine equity style boxes.

Buy-and-hold takes a great deal of discipline and patience, both of which are in short supply in today’s investment environment. And while performance-chasing sounds plausible, it relies on a shaky premise that the past can predict the future. There is a good reason why investment managers are required to include the disclaimer “past performance is not indicative of future results” when presenting investment returns.

Conclusion
How should investors steel themselves against internal and external temptations to attempt to time the market or chase performance? As advisors know all too well, having a comprehensive, understandable investment plan is foundational; it is hard to stay the course if you don’t know the course. Of equal importance is to be patient and ignore what others are doing. Ultimately, long-term wealth building requires discipline and an ability to remain steadfast so that self-defeating behaviors are avoided.

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