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## The Sound Investor Series #62

### To Be or Not To Be Average

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Do you want to be average - of course not! From the time we are little children, Americans are told that there is something very special in each one of us. The key is to find out how we are special and develop to the best of our abilities.

This makes perfect sense for many aspects of our lives, but is not always the best strategy when it comes to investing for retirement. Investing is not a game and there is no silver lining for losers. Keep “character building” exercises to lost Little League games and failed business ventures - not falling behind on your investments.

Investors need to understand how the average return of all mutual funds compares to the market’s average return. The highest returns in the market are not earned by mutual funds; they are earned by Wall Street firms, and other large investors.

Retail investors, for the most part, can only invest in the stock market via mutual funds. And when we overlay the returns of mutual funds on the returns of the whole market we see that only about 25 percent of mutual funds beat the market.

This means a mutual fund investor has to pick a fund that beats 75 percent of the other funds just to perform in line with the market. If the investor is not that lucky and over time chooses funds in the middle of the pack, he will under-perform the market. Earning the average mutual fund return is not the same as earning the market’s average return.

Many clients just can’t come to grips with index investing and accepting the market’s average return. I sympathize and know most people feel the same way - we all want to win. But at the end of the day, investors need to take a hard look at the facts and acknowledge the poor performance of mutual funds.

Unfortunately, most investors will not wake up until their portfolios take a serious hit. And even then most won’t realize how their portfolio has performed and the risks they are taking. It is not easy to figure this out and few brokers or advisers are going to tell them.

Maybe we should “spin” the message another way to make ourselves believers. Rather than telling ourselves we are buying index funds to get the average return, we should focus on the fact that our index strategy is designed to outperform 75% of all other mutual fund investors. Now that feels better.

If you are still not convinced, what is your plan for picking the mutual funds that will be in the top 25 percent? What do investors know about mutual funds? Not much is the answer. We can see a fund's holdings and the manager's name, but how does that help? We can also study a fund's past performance. Although we are told not to rely on past performance, what else are we going to look at? If a fund loses money every year, we stay away - if it beats the market, we buy it.

Over the short term, past performance predicts future gains just as well as anything else. But investors have no way of knowing when the music will stop.

A good example is Legg Mason's Value Trust fund, managed by Bill Miller. Mr. Miller has done a superb job and the fund has outperformed the S&P 500 for 15 consecutive years. He is a long-term investor and proud of his performance, but believes the "yearly" streak is luck.

Last weekend, The Wall Street Journal and Barron's, both published articles detailing Mr. Miller's deteriorating performance. This year the fund is down over 10% and trails the S&P 500 by 13 percentage points. For investors that have held the fund for 10 or 15 years, that's no big deal as the fund still handily beats the indexes. However, if you bought it in the last 5 years, your performance falls well behind similar funds.

I hope Value Trust regains its footing and beats the market again this year. I don't want anyone to lose money. I am just using Mr. Miller's excellent record as an example of how difficult it is to pick winning mutual funds, consistently, year in and year out. If only there was a way to identify the next Bill Miller.

On a different point, remember mutual fund companies use advertising to trick us any way they can. For example, Columbia Funds ran advertisements earlier this year touting the performance of its funds' Morningstar rankings. This seems pretty good except for two facts. First, most funds under-perform the market, so doing slightly better than other funds still doesn't get you very far. Much more disturbing is Columbia had shut down or merged many of its weaker funds and left them out of that analysis. Shame on them and buyer beware!

In summary, Americans do not want to be average; we don't play for a tie. But investing is not a game and losing has real consequences. Rocking away your sunset years, telling your partner how much you learned from your mistakes, just won't be any fun.

*Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at [farmcreeksecurities.com](http://farmcreeksecurities.com). Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses. Remember, past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.*