

## U.S. STRATEGY REPORT

## SEVEN MISTAKES WHEN EVALUATING PERFORMANCE

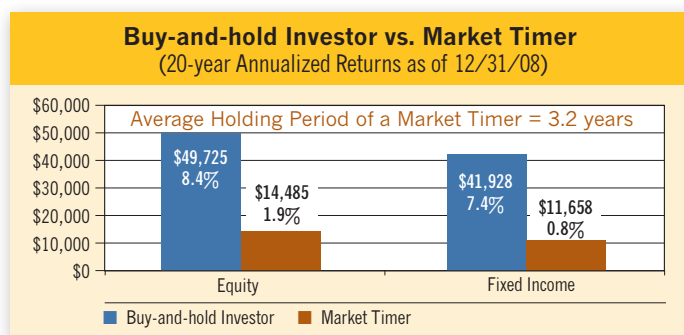
When it comes to evaluating your portfolio's performance, or even an individual investment, many people think "gains are good and losses are bad." That's fine unless you're making an investment decision based on that approach. We believe, however, that a limited view of investment performance can lead to big mistakes.

We believe investors should always consider certain factors before making an investment decision based on performance. Using a disciplined approach when making investment decisions should help you avoid common mistakes, especially when the markets are performing poorly. We believe avoiding these "Seven Mistakes When Evaluating Performance" can help you work toward your long-term investment goals.

### 1. Evaluating Performance over a Short Period of Time

People tend to buy investments that have performed well and sell those that have performed poorly over the short term. This habit of "buying when you feel good and selling when you feel bad" can be the equivalent of buying when prices are high and selling when prices are low.

A study performed by Dalbar compared a "buy-and-hold investor" with the "average investor" who tried to time the market. Although investors cannot directly purchase an index, Dalbar used an index to theoretically portray a buy-and-hold investor, while monthly net mutual fund purchases and redemptions are used to simulate the "average investor return." The data showed that the average investor tried to time the market by having a short investing period, and earned significantly less than the buy-and-hold investor. It's interesting to note the average investor holds a stock or bond only a little more than three years. The following chart compares the estimated difference on a \$10,000 investment during the past 20 years for investors who tried to time the market with those who followed a buy-and-hold approach.



Source: Dalbar QAIB 2009. Equity benchmark is the S&P 500; fixed-income benchmark is the Barclays Aggregate Bond Index.

**Recommended Action:** Discuss your situation with your financial advisor. We have tools that can help you evaluate your current investment strategy to see if you're still on track to meet your long-term goals.

### 2. Blaming the Manager/Financial Advisor for Factors beyond His or Her Control

Has the value of your investment fallen because it's a bad investment or because the overall stock or bond market fell? Market declines are an inevitable part of the investing process and not a reason to sell quality investments. The following chart shows this has been the second-largest decline in the U.S. stock market in modern history. Corporate bonds and international stocks have also experienced sharp declines.

Worst Bear Markets (1926 - 2008)	
	Cumulative Loss %
9/16/1929 - 6/1/1932	-86.2
10/9/2007 - 3/9/2009	-56.8
3/6/1937 - 3/31/1938	-54.5
3/24/2000 - 10/9/2002	-49.2
1/11/1973 - 10/3/1974	-48.2
11/9/1938 - 4/28/1942	-45.8

Data Source: Ned Davis Research, Bloomberg; S&P 500 without dividends. The S&P 500 is an unmanaged index and is not available for direct investment. Past performance is not an indication of future results.

Assuming poor management or bad advice is the reason for your investment's decline can be a mistake. Even professional investors sometimes fire a manager after a period of weak performance, only to watch that same manager post strong results elsewhere.

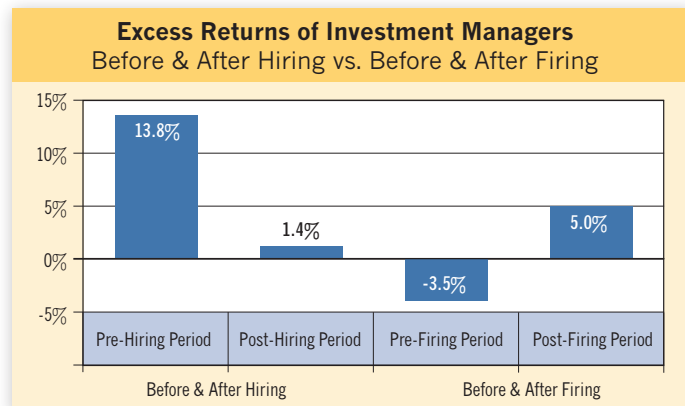
An Emory University research study<sup>1</sup> showed an interesting trend:

- Investment plan sponsors tend to hire investment managers after they have earned returns in excess of the market for up to three previous years.
- The newly hired managers don't deliver returns in excess of the market. The plan sponsors then fire them because of underperformance.

1 Source: *The Selection and Termination of Investment Managers by Plan Sponsors*, Goizueta Business School, Emory University, November 2004. Excess return measured as the difference between investment managers' fund and their benchmark index. Studied 3,400 investment managers between 1994-2003.

- These same managers frequently go on to post large gains for their next employers.
- The study found that if the plan sponsors had kept the same investment managers, their excess returns would have been larger than those actually delivered by the newly hired managers.

In other words, even professional investors can hurt their returns by constantly hiring and firing investment managers, as illustrated below.



Source: *The Selection and Termination of Investment Managers by Plan Sponsors*, Goizueta Business School, Emory University, November 2004. Excess return measured as the difference between investment managers' fund and their benchmark index. Studied 3,400 investment managers between 1994-2003.

**Recommended Action:** When evaluating performance, take recent market conditions into account. It's not realistic to think this crisis could have been anticipated. Realize that even the best managers will have periods of poor performance. Constantly "hiring and firing" can lead to higher transaction costs and prevent you from pursuing your goals.

### 3. Failing to Consider the Impact of Money Moving into and out of the Account

A proper performance appraisal will factor in the amount of money being invested and withdrawn. If you don't do this, you could come to the wrong conclusions about an investment's performance.

As a somewhat humorous example, let's consider the Beardstown Ladies investment club.<sup>2</sup> The ladies became wildly popular in the 1990s for their extraordinary performance of 23.4% from 1984 to 1993, far exceeding the 14.9% return of the S&P 500. They appeared on talk shows and at investment conferences, dispensing advice and autographing copies of their books. Fame and fortune seemed to be their destiny until it was learned their performance failed to account for money added to their account. In reality, their stocks had returned only 9.1% – badly underperforming the market.

**Recommended Action:** Before you judge your account's value, be sure to consider its cash flow.

<sup>2</sup> Source: *The Wall Street Journal*, May 1, 2006.

### 4. Looking Backward Instead of Forward

The legal disclaimer appearing on nearly all investment literature states that "past performance may not be an indication of future results." This statement should be permanently etched on the minds of every investor. When recent performance is strong, investors think it will last forever. However, after long periods of underperformance, people tend to abandon investments only to miss out on potential opportunity. This chart shows 10-year rolling periods where returns were less than 6%. The 10-year period ending December 2008 was the worst 10-year stretch for the S&P 500 since 1926.

The good news is that good performance often follows bad performance. After disappointing stretches in the market, investors tend to sell their equity investments, pushing prices lower. Low prices often lead to higher returns, also shown in the following chart.

Good Performance Often Follows Bad			
10-year Period	Average Annual Return of S&P 500	Next 10-year Average Return	Next 20-year Average Return
1926 - 1935	5.86%	8.42%	12.48%
1928 - 1937	0.02%	9.62%	12.98%
1929 - 1938	-0.89%	7.26%	13.48%
1930 - 1939	-0.05%	9.17%	14.15%
1931 - 1940	1.80%	13.38%	14.76%
1937 - 1946	4.41%	18.43%	13.72%
1965 - 1974	1.24%	14.76%	14.58%
1966 - 1975	3.27%	14.33%	14.59%
1968 - 1977	3.59%	15.26%	16.65%
1969 - 1978	3.16%	16.33%	17.75%
1970 - 1979	5.86%	17.55%	17.87%
1998 - 2007	5.91%	TBD	TBD
1999 - 2008	-1.38%	TBD	TBD
<b>Average</b>		<b>13.14%</b>	<b>14.82%</b>

Source Ibbotson: The performance data quoted above are historical, for illustrative purposes only and do not represent the performance of any specific investment. The S&P 500 is an unmanaged index and is not available for direct investment. Past performance is not a guarantee of future results. Current performance may be higher or lower than the performance data quoted.

**Recommended Action:** Don't base an investment decision on a period that was so unusual. Instead, consider why good performance often follows bad, and hold quality investments for the long term. So "investing for the long term" means investing for at least 10 years, recognizing that 10 years might not always be long enough.

## 5. Failing to Account for Income

The primary investment goal for most people is to have enough money to live comfortably in retirement. To meet that goal, you should own investments that generate enough income to cover your bills and any extra activities you want to pursue. You'll likely own fixed-income investments and equities, both of which can pay income. Equities tend to pay a lower rate of income but offer the potential to grow that income over time through dividend increases. Remember that dividends can be increased, decreased or totally eliminated at any point with or without notice. Investors who understand this should realize performance comes from two sources: growth and income.

Focusing more on a portfolio's income stream over the long term rather than on short-term price fluctuations can be a powerful psychological advantage. The principle is understood by dairy farmers: You don't sell the milk cow if the price of beef falls abruptly. You own a milk cow for the milk it provides.

**Recommended Action:** Ask your financial advisor if your current investments are properly invested to provide enough income during your retirement.

## 6. Having Unrealistic Expectations

While the stock market has generated total returns (including dividends) of about 10% per year since 1926, the market return has been between 8% and 12% only five times during that same period. The wide price swings in the stock market can be difficult to stomach. Equities can be uncomfortable to own when the news is bad and the market is down. However, owning quality equities as part of a diversified portfolio can provide the potential for growth.

**Recommended Action:** Have realistic expectations for your investments and the returns they should be able to offer over the long term. Talk with your financial advisor about your expectations and the performance you should reasonably expect.

## 7. Failing to Take Risk into Account

People tend to buy riskier investments after the market has risen and safer investments after the market has dropped. This approach is really "buying high and selling low," which can significantly reduce long-term investment returns.

Riskier investments will likely experience wider price swings. The opposite is true for more conservative investments. Some investors are disappointed when certain investments rise less than the market, yet sometimes that's what they're designed to do. It's likely those same investments will fall less in a broad market decline. However, many people are disappointed again simply because the investment went down in value. They don't realize the investment actually fell less than the market as a whole.

**Recommended Action:** Don't compare your investments to benchmarks, such as the Dow Jones Industrial Average or S&P 500. Some investments are designed to match the market's return, others to earn more or less. Instead, ensure whether your investments are appropriate to help you achieve your long-term financial goals. And remember, the outlook for even quality investments can change. Review your portfolio with your financial advisor and talk about rebalancing, which can reduce risk and help keep you on track.

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## A Final Word about Diversification

Spreading your money among many different types of investments is a time-tested principle that's not designed to avoid losses, but can work to reduce wide swings in the value of your overall portfolio. However, this latest crisis was so severe, and so global, that nearly all asset classes (with the exception of government bonds) declined significantly at almost the same time.

That doesn't mean we should abandon diversification. Investors should focus on strategies that work the majority of the time, not on those that might have worked if we were able to anticipate the latest crisis – which most agree was a rare event.

Diversification does not guarantee a profit or protect against loss.