

## Know your stomach or get off the ride



By Dan Richards

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*Volatility costs you money and sleep. A broad-based portfolio will serve most investors well.*

Investors hate volatility, the ups and downs in our investments. (To be more precise, we hate the downs - the ups we don't mind so much.) And we pay a big price for that volatility - not just stress and lost sleep at night, but volatility induces behaviour that costs many of us serious money.

Lots have been written about the twin emotions of fear and greed that cause investors to buy at the top (when greed prevails) and sell at the bottom (when fear takes over) - quite simply, most investors don't have the stomach to ride market ups and downs with equanimity.

That's one reason investors benefit from working with a financial adviser. Good advisers serve as an emotional anchor, keeping the highs from being too high and the lows from being too low.

But good advice isn't enough. You also need a portfolio you can live with.

At a recent conference, Don Phillips of Morningstar Inc. presented an analysis of how U.S. mutual fund investors did in the 10 years ended in 2007, comparing this to the performance of the funds themselves. In calculating the investor return, Morningstar factored in when investors bought and sold, and the returns during the periods they held funds.

For balanced funds, typically conservative funds that hold stocks, bonds and cash, the annual investor return was 7.88 per cent. Because of when they bought and sold, investors narrowly outperformed the return they would have received if they'd bought at the beginning of the 10 years and held on - that strategy would have generated 7.80 per cent a year.

Compare that to funds invested in specific sectors such as technology, health care and energy. The average return on these funds was 9.53 per cent - they did much better than the stodgy balanced funds. And the investors in those sector funds? The investor return was 6.75 per cent. Investors did much better in balanced funds than in sector funds, not because the balanced funds performed better (they actually did much worse) but because most investors couldn't stomach the ride in sector funds.

In theory, narrow sector funds can boost returns and fit the higher risk portion of a portfolio, but getting the timing right on these funds is incredibly difficult.

Morningstar took this analysis one step further.

For each asset class (for example, value stock funds, bond funds, emerging market funds), they divided the participants into two categories - those whose volatility was above average and those whose volatility was below average. They looked at the performance of the high-volatility and low-volatility entries and compared this to the investor experience. The returns of high-volatility and low-volatility funds were almost identical - about 6.25 per cent. Investor returns in those funds were very different, however. The actual investor return in the low-volatility funds was just under 6 per cent, almost matching the return on the funds themselves.

By contrast, the investor return in the high-volatility entries was 4.32 per cent - over the 10-year period measured, higher volatility cost investors in those funds almost a third of their potential return.

The reason that volatility extracts such a big price on investor returns is quite simple - fear, greed and lack of patience lead to counterproductive behaviour. When faced with volatility, most investors typically buy and sell at exactly the wrong times.

There are some important lessons here for investors, financial advisers and mutual fund companies.

First, fund companies that focus on narrow sector funds don't typically do investors any favours - it's clear that most investors are best served by broader-based entries.

Second, it's not just returns that count, the volatility accompanying those returns is important. Performance has to come first - after all, that's what managers are paid for - but even for offerings in higher-volatility categories such as emerging markets, fund companies should

strive to have their funds operate with as little volatility as possible.

Advisers need to be aware of the risk of putting their clients into volatile investments such as narrow sector funds, even when clients ask for them.

And if advisers have a choice between recommending two alternatives with similar performance histories, clients will almost always be better off with the less-volatile choice.

### The real cost of volatility

	10 yr investor return	10 yr fund return
Equity sector funds (e.g. tech, health, energy)	6.75 per cent	9.53 per cent
Balanced funds	7.88 per cent	7.80 per cent
Lower volatility funds	5.97 per cent	6.21 per cent
Higher volatility funds	4.32 per cent	6.28 per cent

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