What Fund Investors Really Need To Know

OUR EXCLUSIVE STUDY OF MUTUAL FUND RETURNS SHOWS WHICH ONES REALLY MADE MONEY FOR INVESTORS AND WHICH ONES TOOK SHAREHOLDERS FOR A COSTLY RIDE

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With the bursting of the internet bubble still ringing in our ears, fund investors may be puzzled when market pundits insist that the aftermath of this boom and bust is not as bad as it seems. After all, say the experts, the Dow is up 30% from its level at the beginning of 1998. Even the notorious Nasdaq is up 15.9% since Jan. 1, 1998. And the average mutual fund is up 26.2% for the period. Then why does it seem as if you've lost so much money?

Well, you're not imagining things, and you're not alone. The truth is that for fund investors, total returns give only a partial picture. They tell you how much the stocks in a fund's portfolio gained or lost--but they don't tell you how the fund's investors fared. That's because their results are a function not just of a fund's behavior but also of their own. Say a fund posts super returns in Year One and investors respond by dumping in lots of new money. If the fund tumbles in the following year, they will lose a lot more dollars than they made in Year One.

Now for the first time in any major publication, this article provides a comprehensive answer to the crucial question of how much money funds really made or lost for their investors (including individual results for nearly 700 of the largest portfolios). The results will astound you. Yes, fund investors as a group came out ahead during the four-year period we studied (the boom-bust years 1998 through 2001). But to a remarkable degree, investors underperformed their funds' reported returns--sometimes by as much as 75 percentage points a year. The sheer magnitude of the difference we discovered between the total returns earned by funds and the results captured by the average shareholder is "shocking and tragic," says Charles Trzcinka, an Indiana University finance professor who helped conduct the study.

HOW WE RAN THE NUMBERS

With the help of three leading experts--Trzcinka; Lawrence Siegel, director of investment policy research at the Ford Foundation; and Timothy Aurthur, a Ford Foundation researcher--MONEY analyzed the returns of more than 6,900 U.S. stock funds for 1998, 1999, 2000 and 2001, using data provided by Lipper Inc.

By adjusting each fund's reported total return to take into account the money that investors shoveled in and yanked out over the period, we've calculated what we call its shareholder return. That number (which statisticians call the internal rate of return or dollar-weighted return) reflects not only how the investment behaved but also how its investors behaved. It is both a window into the fund's performance and a mirror held up to the public's hunger to chase hot returns at all costs. We took our analysis one step further. By multiplying a fund's net assets by its returns each month, it's possible to see how much money its total population of shareholders earned.

To take just one example, Firsthand Technology Value earned an impressive 16% annualized total return from the beginning of 1998 through the end of 2001. But we calculate that its typical investor lost 31.6% annually over the period. Overall, shareholders lost $1.9 billion (see the chart below). "You can't help but feel bad about losing money for your shareholders," says Phil Mosakowski, head of fund marketing at Firsthand. "But the unfortunate thing is that a lot of people lost a lot of money because they took oversize bets in technology at the wrong time."

All told, investors in U.S. mutual funds did make money from 1998 through 2001--a total we peg at $280.2 billion. Investors in core large-cap funds (like Fidelity Magellan and T. Rowe Price Growth & Income) fared best--earning $58.4 billion. Technology funds did the most damage, vaporizing $30.5 billion of shareholders' money. But the suffering went beyond tech. At the Janus funds, the average portfolio returned 5% annually from 1998 through 2001, but the typical fund investor at Janus lost an annual average of 11.1%. That translates to $7.3 billion in wealth wiped out. (To be fair, Janus had earned billions for its investors earlier in the 1990s.)

Stunningly, while the average fund generated a 5.7% annualized total return over the four years, the average fund investor earned just 1%. In every category except two (equity income and utilities), investors earned less than their funds did. While the period we studied was unusually volatile, researchers have documented these trends in calmer times as well. "It's terrible how much money was destroyed," laments Lawrence Siegel of the Ford Foundation. "If investors earned the rates of return that the funds report, we'd all be rich. And why aren't we all rich? Because people keep shooting themselves in the foot by chasing hot funds that just can't sustain their performance."

UNHAPPY RETURNS

Mutual funds are not lying about their performance, by the way. The returns they report are entirely accurate, calculated according to the strict rules mandated by federal regulators. The problem is that total return tracks the change in value of a dollar as if it had been invested at the beginning of the measurement period and then frozen in the fund until the end of the period--with not another penny added or subtracted. But no one invests a single lump sum in a fund and then leaves it utterly alone for exactly 365 days or for precisely three, five or 10 years--the time periods typically used to measure a fund's performance. Yet total return is calculated as if that's how we all invest.

To see how absurd this assumption is, consider Kinetics Internet. From the start of 1998 through the end of 2001, this fund earned a fabulous 42.4% annualized total return. If you had invested $10,000 on Jan. 1, 1998, you would have amassed $41,084 by Dec. 31, 2001--if, that is, you had never touched the money in the meantime.

And how realistic is that? Throughout the boom years of 1998 and 1999, as the most deafening hype in financial history roared around you, you would have refused to add a dime to Kinetics Internet, even though it specialized in the very stocks the hypesters were promoting. And in 2000 and 2001, as the miracle market for dotcoms turned into an unending curse, you would have clung relentlessly to the fund, never redeeming a share. Only then would you have earned the return that the fund reported.

Now let's look at what investors really did. Kinetics Internet began 1998 with a mere $100,000 in assets. After returning a spectacular 78.9% in six months, the fund finally broke the $1 million mark at midyear. Kinetics finished 1998 with a return of 196.1%, one of the highest in history. Even so, its assets rose to just $22 million by year-end, so only a minuscule number of investors got all of that phenomenal return. Then in 1999 the fund earned 216.5%--and the tidal wave began. More than $75 million gushed into Kinetics in January; another $380 million cascaded in during April. By the end of 1999, those inflows had helped to swell the fund's assets to $1.15 billion.

In early 2000, of course, the dotcom bubble burst and Kinetics Internet crashed. While the vast majority of the fund's investors had missed its early glory days, nearly all of them got caught in the gruesome collapse. Thus as a group Kinetics Internet investors lost 15.8% annually from 1998 through 2001, trailing the fund's stated total return by an astonishing 58.2 percentage points per year. "I'm not sure Kinetics as a whole did everything possible to dampen expectations," says the firm's chief investment officer Peter Doyle. "It's an issue I grapple with daily."

THE HORRORS OF HOT MONEY

Who's to blame for this kind of catastrophe? If you come to a party at 11:59 p.m. and there's nothing left in the punchbowl but a few drops of bitter goo, is it the caterer's fault? Or is it at least partly yours for being late to the party? All too many of us wait for a fund to go on a huge run-up before we buy it. Unfortunately, the investors who chase hot returns end up obliterating the very thing they are pursuing: The immense amounts of cash they pour into their favorite funds prevent the managers from being selective and patient. Stock picking suffers; returns collapse. And, by definition, the people who pile into hot funds are buying high--when we all know the first half of the oldest investing rule is to buy low.

This behavior doesn't just hurt those who engage in it. We all suffer. As stocks rise and performance-chasing investors pour money into stock funds, portfolio managers must put all that new cash to work--by buying more of the stocks that have already risen. That drives stock prices higher still, goading investors into sinking even more money into the same funds, which must then load up on more of the same stocks. For a while, this closed circle can seem like a kind of perpetual-motion machine, as it did in 1998, 1999 and 2000, when an annual average of $218.1 billion poured into equity mutual funds--and stock prices soared into the ionosphere. But once the oxygen of cash got cut off, the machine sputtered to a halt; in 2001, stock funds took in only $24.9 billion in new money, worsening the market plunge that had begun in early 2000.

Fund managers insist that it's unfair to measure their results by how well shareholders fared. Explains Peter Kris, spokesman for the Van Wagoner funds: "There are two things we can't control: the markets, and when people invest their money." Van Wagoner "has never taken out a single advertisement," says Kris. And yet investors poured $460 million into Van Wagoner Emerging Growth in 1999, when it was hot--and yanked $265 million back out in 2000, once it went cold.

A MANAGER CAN JUST SAY "NO"

"People have always come in at the wrong time and left at the wrong time," says Jim Oelschlager, who runs the Oak funds in Akron. "That's unfortunate, but I don't know how you change human psychology. The truth is, I don't think you can. You can't save people from themselves."

That's not quite true. Fund managers can save some people from themselves simply by shutting the front door. Van Wagoner, for instance, closed two of its top funds in November 1999, sparing thousands of investors the agony of buying at the top. Not surprisingly, many of the funds that created the greatest amounts of wealth from 1998 through 2001--like Fidelity Contrafund—closed to new investors for at least part of the period, refusing to take on more money than they could reasonably handle. (Tragically, Fidelity did not follow suit at its Aggressive Growth fund, where investors lost a staggering $7.1 billion over the period.) Other funds, like Sequoia, had already been closed to new investors for years. The average shareholder at these three funds earned returns better or only a whisker lower than those of the portfolios themselves.

But most money managers, understandably perhaps, are reluctant to close their funds. "Two years ago," says Oelschlager, "we were taking in $100 million a day. You have to take it, you can't reject it.... I don't know anybody who would." Over the years, dozens of managers have told me the same thing. Not all are fee-grubbers; many simply feel obligated not to turn customers away. But the fact remains: The more money a fund manager takes in, the higher his management fees go. Thus hoping that a fund company will reject new money is like expecting an alcoholic to tell a bartender, "I've had enough."

Managers can also influence investors by the way they communicate with the public. In 1999 and early 2000, hotshots like Kevin Landis of Firsthand were bullish regulars on CNBC and cnnfn, helping lure even more investors into their funds. At year-end 1999, Firsthand's letter to shareholders sounded few notes of caution. It even boasted about the funds' "record asset level gains for the year," which suggests that the firm cared not just about maximizing investment returns but also about maximizing the size of its funds.

(Firsthand did close one fund, Technology Innovators, in December 1999.) From 1998 through 2001, Firsthand took in more than $140 million in management fees, even as its investors were losing a cumulative total of more than $3.3 billion. Firsthand spokesman Steven Witt says that for the young firm, "increasing assets at that time meant that we would survive and be able to add research tools and staff. That was and still is very big news for any start-up."

Closing isn't the only way a fund can encourage responsible investing. Many funds with sales charges, or loads, show up on the winners list, suggesting that at least some brokers earn their keep by urging clients to hang tough. In particular, the American Funds, run by Capital Research and Management of Los Angeles, are sold by small-town stockbrokers who preach the old-fashioned gospel of buy-and-hold investing. No-load Vanguard, with its relentless emphasis on "staying the course," also earns generally high marks for building shareholder wealth. Finally, funds that levy redemption fees (like Federated Kaufmann) score well; by taking a slice of your proceeds if you sell too soon, these fees encourage you to stick around.

HOW YOU CAN HELP YOURSELF

Now let's talk about how you can be a better owner. Start by abandoning all hope of ever getting into a fund at the bottom and out at the top. The only people who've ever done it succeeded by sheer dumb luck. Instead, put no more money into a fund than you can afford to lose, then strap yourself in. Add a fixed amount every month by dollar-cost averaging; if you doubt your own perseverance, write a contract committing yourself to at least five years of ownership and have a friend or family member witness it for you.

Finally, be honest. In the wake of this crash, the media and the public have blamed the venture capitalists and investment bankers who foisted shoddy stocks onto retail investors, Wall Street analysts who acted like cheerleaders, company executives who shamelessly pumped up their shares in public while selling them in private and accountants who rubber-stamped whatever numbers anyone put in front of them.

But in our outrage we have forgotten to blame the most obvious perpetrators of all.

By hyping "superstar funds" just when they were at their hottest, the financial media sent millions of investors pile-driving into these portfolios at the worst possible time. And investors eagerly, almost desperately, went along for the ride--even though many knew full well that chasing hot returns is the surest way to get burned. By willfully ignoring that eternal truth, the investing public inflicted more damage on itself than all the more obvious villains did combined. Here's hoping that as we digest the sad numbers in the tables below, we will all learn our lesson--and that we steadfastly remember it in the years to come.

BEST AND WORST BIG FUNDS

Of the 100 largest stock funds, here are the top and bottom 10, ranked by how investors performed relative to the funds.

ANNUALIZED RETURN 1998-2001

FUND NAME	PORTFOLIO	SHAREHOLDER	DIFFERENCE
BEST			
Fidelity Adv. Growth Opp. T	-2.8%	0.9%	3.7%
Fidelity Destiny I	-3.4	-1.7	1.7
American Century Select Inv.	5.5	6.9	1.4
Fidelity Growth & Income	5.9	7.3	1.4
Fidelity Equity-Income II	6.4	7.5	1.2
Fidelity Contrafund	7.6	8.7	1.1
AIM Weingarten A	-1.5	-0.5	0.9
W&R Adv. Core Invest. A	7.6	8.5	0.9
AIM Constellation A	4.1	5.0	0.9
GE S&S Program Mutual	7.9	8.6	0.7
WORST			
Fidelity Aggressive Growth	2.8%	-24.1%	-26.9
Vanguard Capital Opportunity	29.2	5.2	-23.9
Invesco Dynamics Inv.	7.0	-14.4	-21.4
Janus Mercury	13.9	-7.4	-21.3
Fidelity Select Electronics	21.7	7.6	-14.0
Van Kampen Emerging Growth A	13.2	-0.7	-13.9
Alliance Premier Growth B	3.4	-9.2	-12.5
SEI Inst. Mgd. Large Cap Growth A	2.5	-8.3	-10.8
Fidelity Growth Company	12.4	1.9	-10.5
Fidelity OTC	7.7	-2.7	-10.4

Notes: "Difference" shows the gap, in percentage points, between a fund's total return and what shareholders actually earned. Sources: Calculations by Charles Trzcinka, Lawrence Siegel and Timothy Aurthur; MONEY research.