Sentimental Fools: Pity the Poor Mutual Fund Investor

Beware the 'dumb money' effects of investor sentiment on fund selection and investment returns

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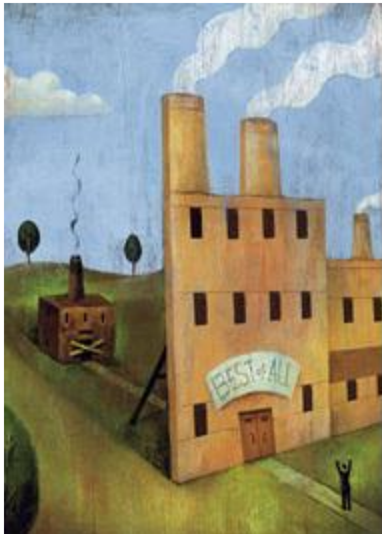

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By understanding sentimental pitfalls, advisors can help investors improve their performance.

Mutual fund investors exhibit remarkable skill when selecting mutual funds – remarkably awful, that is.

This track record is notable since many professional fund managers have difficulty achieving investment performance that differs consistently from the market. For the average investor, however, net flows into mutual funds reveal an uncanny ability to consistently select the worst fund categories at the worst possible times. Investors feel most comfortable investing in overvalued sectors at the tail end of bull markets, and flee to safety when stock prices are their lowest.

First identified by researchers Andrea Frazzini and Owen Lamont, now respectively at NYU and Harvard, the poor timing ability of fund investors has come to be referred to as the “dumb money” effect.

Emotion, limited attention, misguided perceptions and inexperience lead investors to sentiment-driven investment. This tendency to invest more in funds with high positive sentiment (for example tech stocks in the 1990s), and to pull out of funds with high negative sentiment (for example liquidating stock funds in 2008 and moving to bond funds), has led fund investors to lose on average about 1.5% annually, according to a 2007 analysis by Geoffrey Friesen of the University of Nebraska and Travis Sapp of Iowa State.

Understanding investor sentiment provides insight into why most fund investors underperform the market. It also explains how an advisor can help an investor improve their performance by avoiding sentimental pitfalls.

Frazzini and Lamont identified stocks that received excess inflow and outflow from mutual fund investors between 1980 and 2003. If investors were dumping large amounts of money into tech stock funds in 1999, they tracked the impact that these flows had on the percentage of stock held by retail mutual fund investors. If a large amount of money flowed into the stock via retail mutual fund investment, they shorted the stock.

They went long on stocks that saw large outflows of mutual fund investor cash. In essence, they wagered that both positive and negative mutual fund investor sentiment were wrong.

Betting against investor sentiment resulted in a riskless excess return of 10% per year if held for a three-year period. A sophisticated investor could simply observe the stocks favored by less sophisticated small investors and profit from their misdirection.

Fund Follies

A number of mutual fund researchers have noted that the average fund investor has not performed as well as the average fund. Friesen and Sapp compared time-weighted to dollar-weighted fund return and found that the biggest performance gap occurred within the more speculative fund categories prone to investor sentiment. Aggressive growth funds saw a performance gap of 3% per year, while income-oriented fund categories had the smallest gap.

The largest performance gap was highest within the funds that achieved the greatest risk-adjusted performance. This may be because fund families are most likely to advertise smaller funds that have outperformed in order to attract new investor cash, and these subsequently underperform.

While chasing positive return was harmful, outflows from mutual funds were even more destructive. Buying the wrong funds cost investors 6 basis points per month, but selling at the wrong time reduced fund investor returns by 15 basis points.

Recent performance is the force that drives dumb money losses from sentiment investing. This isn't surprising since mutual fund advertisements and fund prospectuses tend to focus on illustrating how well the mutual fund has performed in the past. Most investors shop for mutual funds the way they would for a cantaloupe. Instead of sniffing and tapping the fund fruit, they try to find cues of quality such as fund family name recognition, a famous fund manager, a fund objective that sounds appealing and past performance.

Past performance is the easiest characteristic to compare and most compelling since it is ultimately what an investor is looking for in a fund. A grocery shopper sniffs the cantaloupe to determine how it is going to taste and a fund investor looks to past performance as an indicator of better future performance. The difference is that the fund investor never seems to recognize that the nice-smelling mutual fund tastes worse when they get home and take a bite.

Yale researcher James Choi and his co-authors David Laibson and Brigitte Madrian of Harvard investigated how an average investor uses information on a mutual fund prospectus using identical S&P 500 index funds with different fund initiation dates. In addition to the prospectus, they gave respondents in different groups a "cheat sheet" that summarized differences in fund fees, and another that spelled out how the objective of all funds was to mimic the S&P 500. Samples of both employees and Wharton MBA students (with average SAT score at the 98th percentile) consistently focused on the obviously irrelevant fund performance rather than on fund fees even when presented with information that should have helped them make better choices.

Return Chasers

Brad Barber of UC Davis and Terrance Odean of Berkeley blame return chasing on the limited attention span of individual investors. According to their investor attention hypothesis, most of us have limited time to devote to researching mutual funds. We can either invest a huge amount of time and effort into learning how to evaluate and select funds, or we can simply invest in ones that capture our attention. The fact that mutual fund investors are attracted by the shiny funds does not serve them well in a market where sentiment can drive the value of securities too high or too low.

Marketing mutual funds to investors who overemphasize recent returns means that fund families need to make sure that they have individual funds in sectors with high recent performance. Since mutual funds can only invest within a universe of investments whose return is by definition average, this presents a challenge.

One solution is to create high performing funds through the process of incubation. About a quarter of all new mutual funds are initiated privately by a fund family. A farmer watching over a batch of eggs knows that chance variation will result in a few particularly healthy chicks. Likewise, chance variation in performance of securities held within incubated funds leads some to outperform during the incubation process. The underperformers are then discarded and the incubated funds are introduced to investors and their high returns featured to attract investor attention.

Richard Evans of the University of Virginia finds that new incubated funds outperformed other non-incubated funds by 3.5% before being sold to the public. Incubated funds garner much more investor attention than non-incubated funds and receive much higher investor inflows. However, once these funds leave the incubation stage they subsequently don’t perform any better than non-incubated funds. And since incubated funds are also included in mutual fund return databases, their artificially high performance in the incubation stage increases the dollar-weighted investor performance gap of 0.84% annually.

Selective promotion of established high performing funds is also an effective method of attracting investors. Prem Jain of Georgetown University and Joanna Wu of the University of Rochester examine which individual funds are more likely to be advertised by fund families. Unsurprisingly, funds that have recently outperformed the market are far more likely to be advertised than funds with average performance.

However, these funds tend to underperform the average fund after they have attracted the new investor cash. And the now disappointed investors begin to look for ways to shift their investments into another winning fund, contributing to a vicious cycle of dollar-weighted performance gap.

The subsequent underperformance of high-flying funds can also be attributed to investor sentiment. Periodic excess performance within sectors favored by emotional investors can lead to high firm valuations. This over-optimism contributes to the underperformance of growth stocks, and in particular stocks that are small and whose value is highly speculative. More money flowing into overvalued sectors leads to disappointing long-run performance for fund investors when the party ends and values fall back to reality.

Seeking Safeguards

A simple way to break the cycle of mutual fund underperformance is to develop an investment policy in which an investor maintains a diversified portfolio that reallocates periodically as market values change. This

naturally works against investor sentiment by increasing investment in bonds when stock prices are rising and reducing one's bond allocation when stock prices have fallen.

Azi Ben-Rephael of Indiana University and his co-authors estimate monthly shifts between bond and stock mutual funds and find that investors consistently do the opposite—they shift to bond funds when equity values drop and back toward stock funds when equities rise in value. I use the monthly calculated shift in equity funds during the two significant equity bear markets of 2001-2002 and 2007-2009. In both cases, mutual fund investors move sharply toward bonds after stock prices have fallen. Investors appear to be unwilling to follow a disciplined long-run investment strategy by maintaining their portfolio risk exposure in a down market.

Since poorly timed mutual fund sales are more harmful than poorly timed purchases, these flights to safety can have a significant impact on long-run portfolio performance. An advisor can act as a voice of reason when client are tempted to give up on their stock investments. Two recent studies conducted at Texas Tech University show how an advisor can help an investor stay the course.

The first study surveys investors just after the most recent great recession. Respondents were asked whether they shifted their portfolio toward cash in the previous year. Those who had an advisor were significantly less likely to shift assets to cash, but individuals who had both an advisor and a written financial plan were twice as likely to maintain their portfolio allocation during the recession. If a client sits down with an adviser and develops a plan that focuses on long-run goals rather than short-run performance, it can be easier to convince him or her to be patient during periods where they may be tempted to cash out.

Including an investment policy statement inevitably leads to a discussion of the importance of rebalancing during good times and bad, allowing a client to anticipate portfolio volatility and follow a smart money strategy.

The second study uses a database of daily tweets been advisors and their clients constructed by the social media aggregator Arkovi. These tweets represent real time advisor/client contact and illustrate the potential of social media in helping manage client market anxiety. We identify conversations that include the mention of an S&P 500 corporation. When the price of an S&P stock increases, so does the frequency of advisor/client tweets. Tweet frequency also increases when prices fall. When prices fall below 3% in a day, however, tweet frequency spikes as investors look for advice. Investor anxiety appears to increase significantly when prices fall enough to force them to pay attention. This is the time when anxious clients want feedback from their advisor. Immediate communication gives the advisor an opportunity to calm an investor down when he or she is most likely to make an investment mistake.

Advisors and Client 'De-Biasing'

Reducing the impact of sentiment-driven trading mistakes may be a significant source of value provided by advisors. However, advisors compensated based on transactions have an incentive not to talk a client out of shifting assets among mutual funds. A study by Santosh Anagol of Wharton found that "de-biasing" a client—for example, explaining the need to resist the urge to shift equity investments into bond funds during a recession—is difficult for both buyer and seller. While an advisor who has an incentive to maximize long-run

assets will argue against a sentiment trade, receiving additional compensation from each new asset sale removes the temptation to disagree with a client's misguided preferences.

Friesen and Sapp found that sentiment-driven underperformance on load funds was twice as large (1.92% per year) as the performance gap on no-load funds (0.96%). Incubated funds are also significantly more likely to be load funds. This is consistent with other studies that suggest that the mutual fund universe can be split between funds that are sold through the broker channel and funds that are bought through a direct channel. It is far easier to sell a privately incubated fund with significant recent excess performance, than it is to sell a fund with average performance. This is so even if neither fund is actually more likely to outperform in the future.

It would be tempting to conclude that bad investor timing is primarily the result of inexperienced investors making bad choices, but a recent study by Ilia Dichev of Emory University and Gwen Yu of Harvard found that dollar-weighted returns on hedge funds are between 3% and 7% lower than time weighted returns. This is more than twice the dumb money difference observed in mutual fund investments. Since hedge fund investors are primarily institutions and extremely wealthy individuals, apparently even the professionals can get caught up in the excitement of investing in hot funds.

Whether novice or professional, it is easy for an investor to fall into the trap of chasing returns of attention-grabbing funds. The good news is that investors who avoid relying on their emotion are much more likely to succeed in the long run. And an investment advisor can help a client tune out the noise.