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GETTING GOING

Maybe Investors Aren't Stupid After All: Oft-Cited Study Is Revised

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This is a financial mystery story that cuts to the heart of three of today's biggest issues.

Was replacing traditional company pensions with 401(k) plans a huge mistake? Do small investors need financial advisers? Is it wise to privatize Social Security?

In each case, possibly the most critical issue is the competence of ordinary investors. Are they stupid, as many on Wall Street claim?

If you believe an influential study by Boston financial-services research firm Dalbar, there's no doubt about the answer. First published in 1994, Dalbar's ongoing study has found that mutual-fund investors earn returns far lower than the market averages.

For instance, Dalbar reported last year that stock-fund investors earned just 2.6% a year over the 19 years ended 2002, versus the Standard & Poors's 500-stock index's 12% gain. To generate this number, Dalbar looked not only at market returns, but also at the flow of money in and out of all stock funds. The firm's conclusion: Fund investors are terrible market timers, buying high and selling low.

Dalbar's astonishing findings have been repeated again and again in books, articles and

Wall Street research. Brokers and financial planners gleefully publicize the study's results. After all, if investors can be persuaded of their own incompetence, they are more likely to hire an investment adviser.

But are fund investors really so clueless? I have long had my doubts.

To its credit, Dalbar helped me out, taking the time to spell out precisely how it calculates each month's return for fund investors. The bottom line: There is a bias in the study's methodology.

With the formula that Dalbar uses, stock-fund investors don't earn the full monthly return on any money that they invest during that month. As a result, investors appear to lag far behind the S&P 500 when the market rises and investors are simultaneously shoveling money into stock funds. This, of course, is what happened for much of the 19-year period studied.

When I spoke to Dalbar President Louis Harvey, he agreed that the methodology has a bias. After our conversation, he directed his staff to create a new benchmark, which assumes that investors poured money into stock funds in equal monthly amounts during the past two decades.

The result? Instead of the 9.6-percentage-point annual gap between investors' paltry gain and the S&P 500, it seems investors' underperformance is considerably smaller. Using its new benchmark, Dalbar now figures that investors' ill-timed purchases and sales may have cost them only 3.4 points a year over the 19-year stretch.

But our mystery story isn't over. The next twist: It seems investors' poor market timing may not be entirely their fault. Which brings me to another set of numbers, this time from the University of Michigan's Lu Zheng and the University of California at Berkeley's Terrance Odean.

Like Dalbar, the two professors looked at how stock-fund investors fared over the 19 years through 2002. But they took a more direct approach, considering both the size and the performance of each fund.

The professors started by weighting each fund's monthly results by the fund's assets at the beginning of the month, so that big funds like Fidelity Magellan and Vanguard 500 Index carried more weight. These dollar-weighted monthly results were then strung together, generating an annual stock-fund return of 9.9% for the 19 years, versus 12.2% for the S&P 500.

This lackluster performance is no great surprise, and it certainly doesn't mean investors are inept at picking funds. The fact is, stock funds -- burdened by annual fund expenses and trading costs -- have a long and sorry history of lagging the S&P 500.

Instead, the big surprise came when our two professors calculated a second set of returns. This time, they didn't just give more weight to bigger funds when calculating each month's result. They also gave more weight to those months in which investors had more money invested. For instance, because investors had far more at stake in 2002 than in 1984, the results earned in 2002 were given greater weight.

Suddenly, as with Dalbar's original study, investors' performance appears to be downright dreadful. Over the 19 years, stock-fund investors earned a mere 5.1% a year. That's far below the 9.9% you get when you give equal weight to each month, which indicates fund shareholders were most heavily invested during some of the worst-performing months. Investors, it seems, are indeed atrocious market timers.

But that conclusion "isn't fair," says Prof. Zheng, who argues the results are heavily influenced by the time period studied. To prove this, the two professors looked at the 16 years through year-end 1999.

If we use the professors' first calculation method, where we dollar-weight fund returns within each month but we don't dollar-weight over time, stock-fund investors earned 15.4% a year during this 16-year period, versus 18.1% for the S&P 500. But if we use the second method, where we give greater weight to those months in which fund shareholders had more invested, performance jumps to 17.1% a year. In other words, fund shareholders -- instead of looking like clods -- appear to be fairly savvy.

But in reality, the results have nothing to do with investor brilliance or the lack thereof. Prof. Zheng notes that, over the past two decades, companies replaced traditional company pension plans with 401(k) plans and many investors dumped individual stocks in favor of mutual funds.

Those two developments have caused stock-fund assets to grow far faster than the market, skewing the results. Investors had heaps of money in stock funds ahead of the late 1990s rally, which made them look smart, but also heaps invested ahead of the current decade's brutal bear market, which made them look dumb. A mystery story? Maybe it's the dog that didn't bark.

ABOUT THE AUTHOR

Jonathan Clements has written The Wall Street Journal's Getting Going personal-finance column since October 1994. Born in London, Jonathan is a graduate of Emmanuel College, Cambridge University, where he edited the student newspaper. He was a writer and researcher for Euromoney magazine in London before moving to the New York area in 1986. Prior to joining the Journal in January 1990, he covered mutual funds for Forbes magazine.

Jonathan is the author of "You've Lost It, Now What? How to Beat the Bear Market and Still Retire on Time," published in 2003. His earlier books include "25 Myths You've Got to Avoid -- If You Want to Manage Your Money Right" and "Funding Your Future: The Only Guide to Mutual Funds You'll Ever Need." He has two children and lives in Metuchen, N.J.