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## Pogo Meets Plato

Pogo Possum, the creation of cartoonist Walt Kelly, said "We have met the enemy, and they is us." Nowhere is that more correct than in investing, where our thoughts and emotions must be overcome to succeed. People tend to think of investing as a kind of three-dimensional chess, in which successful investors do exhaustive research to find the best investments. Of course, investment firms who have good recent performance encourage this portrayal with advertisements attributing the performance to their brilliance and hard work. This stereotype is solidified by the media's tendency to have financial news mimic the sports report, with winners, losers and an analysis of momentum.

***"Knowing about markets  
is knowing about  
people's weaknesses."  
-- Michael Lewis, Liar's Poker***

Unfortunately, investment performance is almost irrelevant to investor success. We are able to make this somewhat astounding statement after reviewing the updated results from an ongoing study of investor performance by a mutual fund research group, Dalbar, Inc. The study covers 1984 through 2000, a period when the Dow Jones Industrial Average increased from about 1,200 to a high of over 11,700. During that period, growth and income mutual funds had an average annual return of 14.45 percent, while the average money fund return was 5.89 percent. So far, nothing very surprising -- stocks beat more conservative investments in the long run, and owning stocks during a long bull market is very rewarding. But Dalbar estimates that the average equity mutual fund investor during the same period achieved an actual annual return of only 5.32 percent. In the biggest bull market in U.S. history, despite enduring the risks of the stock market, the average equity mutual fund investor would have done better to just leave the money in a money fund.

How can this be? The problem is that our brains are wired to make us naturally poor investors. People get more and more excited about investing as the market goes up, even though that means that the price relative to underlying value is getting less attractive. We get more and more depressed about investing as the market goes down, even though that means values are getting better. So, people buy high and sell low, chasing performance and piling into an asset class or investment type just as it is about to fade.

Plato wrote more than 2,300 years ago of the difference between illusions and reality, imagining prisoners chained in a dark cave lit by a fire behind them. The only things they can see are shadows projected on the cave wall in front of them. The shadows are the only "reality" they know. One prisoner breaks loose, sees the fire and realizes that the shadows are just reflections. He crawls out of the cave, sees the outside world and realizes that everything he has seen before

that moment has been an illusion, a pale copy of reality. He runs back in the cave to tell the others, but they do not believe him and want to kill him for his trouble.

***“We are confronted with insurmountable opportunities.”***

**--Pogo**

Performance, as it is advertised and understood by investors, is equivalent to the shadows on the cave wall. Assume you were unlucky but persistent, investing in something that performed two percent per year worse than the average growth and income mutual fund during all 17 years of the Dalbar study. (We estimate about 85 percent of the surviving funds beat this number.) You lost the performance sweepstakes, but you outperformed the average equity fund investor by more than seven percent per year. “Winning” may boost long term returns by a percent or two, but this pales in comparison to the 9 percent per year headwind (the difference between the average fund and actual investor performance) created by human behavior.

Tell this to most investors, however, and the reaction is likely to be similar to the remaining prisoners in Plato's cave -- they don't want to hear about it. Why do investors obsess about comparative mutual fund trailing performance figures, but brokerage firm clients don't seem to insist upon performance reporting for their specific accounts? We believe it is because they don't want to know, and the brokerage firms have no incentive to tell them.

Pleasing fantasies will always seem more satisfying than reality. The marketing engines of Wall Street have figured this out and perpetually generate new illusions. In a mass version of low self-esteem, investors seem perpetually willing to believe that smart people on some mountaintop are making everyone rich -- and now those smart people are available to you if only you buy the new “product.” In the early 1990's, the new products focused on emerging markets and “Europe 1992.” In the late 1990's, the new products focused on technology and the Internet. Now, the new products are alternative investments and hedge funds. To the unfortunates that persist in being distracted by the shiny objects flashed at them by creators of investment product, past performance is always terrific, hopes are high for the future, but nothing good ever seems to happen today.

Aging tends to strip away illusions about your life and what you plan to accomplish. Unfortunately, it also takes you closer to the reality of your retirement, where illusions, however pleasant they may be, will do you little good. If you want to break free of the chains of marketing illusions in your investments, give us a call.