Richard Carter

HOW CAN YOU IMPROVE YOUR INVESTMENT RETURNS?

EXECUTIVE SUMMARY: Richard Carter highlights the gap that exists between the return you get as an investor and the actual returns generated by Allan Gray's funds. He explains the cause of this and suggests some ways to improve the returns you get out of your investment.

The difference between the returns you get from your investment and the actual fund returns

The returns of the fund are the returns generated by the portfolio managers over a period of time. The returns you actually get as an investor depend on your participation in the fund:

- How much and when you invest
- How long you remain invested
- When you disinvest

For example, if you invested R1 000 in the Allan Gray Equity Fund in the very first week that the Fund was launched (10 years ago) and kept it there, your return would be the same as the 'since inception' returns reported in our literature. If, however, you had invested R500 at the start of the Fund and a further R500 at the beginning of this year, your return would have been much less than the Fund returns over the same period.

The example below illustrates the potential difference between fund returns and investor returns:

Context

The Allan Gray Equity Fund produced a return of 35.21% for the three-year period shown in the table below:

	Fund performance
2005	50.03%
2006	43.47%
2007	14.83%
3-year return	35.21%

Scenario

Now assume that three different investors (Investor A, Investor B and Investor C) invested the same amount in total, and were invested in the Allan Gray Equity Fund over the same three years, but made their investments at different times according to the table below. The table shows that each investor's returns vary significantly both from each other and from the Fund return.

	Investor A	Investor B	Investor C
Total investment	R30 000	R30 000	R30 000
When they invest and when they take their money out	At the start of: 2005 invested R10 000 2006 invested R10 000 2007 invested R10 000	At the start of: 2005 invested R30 000	At the start of: 2005 invested R30 000 2007 withdrew R30 000
Investor return	**30.92%**	**35.21%**	**39.6%**

Investor B would have received the same return as the Fund (35.21%), having adopted a 'buy and hold' approach to his/her investment for the entire three years. Investor C could have achieved a better return than the Fund by taking his/her initial R30 000 out of the investment (excluding growth on the investment in the previous two years) at the start of 2007. This, on the face of it, looks appealing – but evidence shows that timing not only fund performance but also market performance is very difficult to do.

We measure our success by the wealth we build for our investors, not just our fund returns

Because investor returns are a function of the decisions they take as well as those our investment team take, we have only done half our job by ensuring that our funds deliver outperformance. We also need to consider the difference between fund returns and investor returns as a measure of how successful we have been at encouraging investors to remain invested for long enough to benefit from our investment approach. A fund may perform well but if it has no investors in it or if they are in the fund for too short a time to benefit from our approach, little wealth is created.

Your investing behaviour can increase or reduce the gap between your returns and fund returns

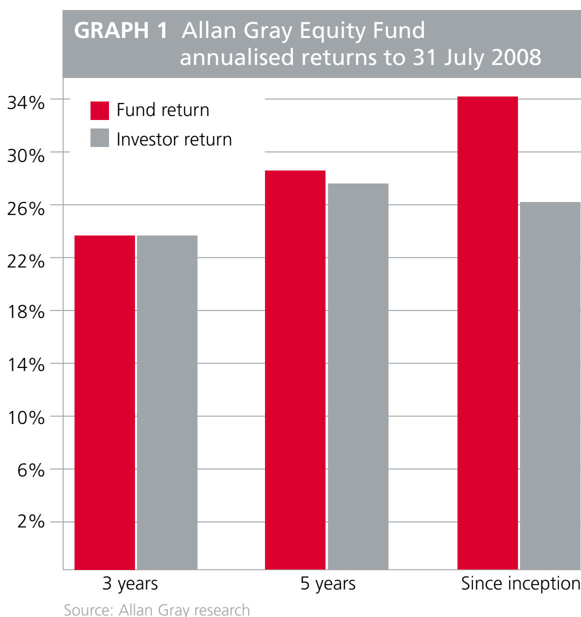
Aside from educating investors and communicating the benefits of a long-term, buy and hold approach to investing, we have little control over when investors invest or for how long they hold their investments. In fact we think that it is essential that we do not have control and that our clients have the freedom to disinvest at any time and without penalty. The degree to which your investing behaviour is aligned with our long-term philosophy will define how big or how small the gap is between the Fund's returns and your own returns.

Are we creating wealth for investors over the long term?

It is tempting for confident investors to switch between different funds in the belief that they can 'time' performance and generate better returns than staying in their current fund. While there are undoubtedly examples of this, they are few and far between and experience has shown that 'timing' fund performance is extraordinarily difficult to do, perhaps even more so than 'timing' markets – something even investment professionals find challenging.

Part of this experience is shown in **Graph 1** below, and in **Graph 2** on page 13, where you can see the Fund returns compared with the average investor returns for the Allan Gray Equity Fund and Allan Gray Balanced Fund over various time periods.

GRAPH 1 Allan Gray Equity Fund annualised returns to 31 July 2008



Source: Allan Gray research

The statistical calculation behind fund returns (time-weighted returns) and investor returns (money-weighted returns)

The difference between an investor's returns and the actual fund returns is the difference between what is referred to as 'time-weighted returns' and 'money-weighted returns'.

Fund returns (time-weighted returns)

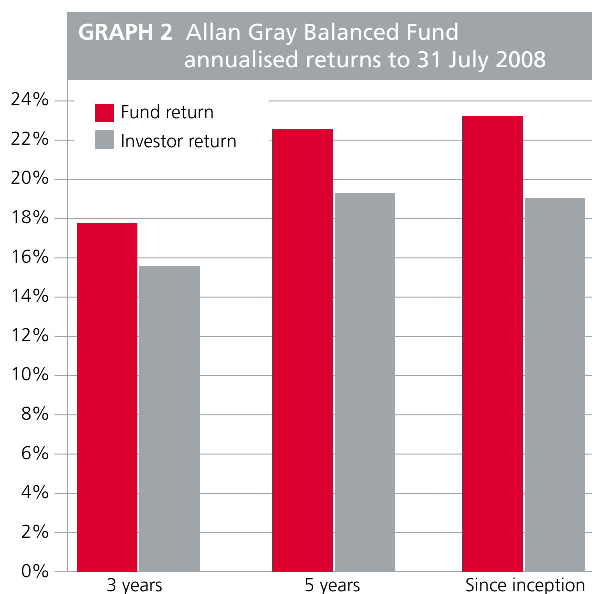
When calculating 'time-weighted returns', the size and timing of cash flows in and out of the fund do not really matter. This calculation applies the same weighting to the returns over every period and provides the single rate of investment return which is equal to the actual fund returns over time.

We report time-weighted returns in our documentation.

Investor returns (money-weighted returns)

'Money-weighted returns' are a much more accurate measure of actual investor returns. They take into account when the investment is made, how long that investment is held and when the returns are generated. This calculation takes the size and timing of these 'cash flows' into account.

Each investor may have a different return depending on their own pattern of investments. For the purposes of this article we are looking at the average investor returns for all investors invested in the funds.



Source: Allan Gray research

It is encouraging that the average investor in the Allan Gray Equity Fund has done more or less as well as the Fund over the last five years. Indeed, in the five-year period to the end of July 2008 investors in the Allan Gray Equity Fund received 0.96% per year less than the return the Fund generated. However, the average investor in the Fund holds the Fund for only around three years, which in our view is not long enough to benefit consistently from the Fund's performance. Evidence of this is the large gap in the 'since inception' returns, showing that investors have missed out on a significant amount of performance generated by the Fund.

"Investors … will keep the rewards of our investment approach only if they stay invested for long enough."

Over the same five-year period, investors in the Allan Gray Balanced Fund missed out on a 3.3% performance per year. This is significant and we are concerned that in spite of achieving a benchmark-beating performance, we are not creating the same level of long-term wealth for the average Balanced Fund investor. This is particularly disappointing for us when we consider that when investors choose the Allan Gray Balanced Fund, they are delegating not only the underlying share or security selection, but also the asset allocation decision (or how much is invested in equities, bonds, cash and offshore). Investors who believe in our ability to make these decisions on their behalf will keep the rewards of our investment approach only if they stay invested for long enough.

The pattern is similar for all our funds. Over most periods, investor returns have underperformed the Fund returns by a few percentage points. This may not sound like a lot but, over a five-year period, a few percentage points each year can make a significant difference.

More volatile markets increase investor fears and the price to pay for irrational switching may be high

The difference between fund returns and investor returns is likely to increase during times when the market is very high, decreasing or very volatile. These extreme conditions unsettle investors and increase the number of emotive short-term investment decisions. In the example above, the figures being used were from a bull market or period of rising returns. Whether investors would stay the course in the context of the current volatility, market extremes and anticipated 'normalisation' of market returns remains to be seen.

American mutual fund investor experience is similar to ours

We have looked at two American research studies and found that in both instances, mutual fund investor experience is similar.

1. Morningstar research shows the difference between fund returns and investor returns

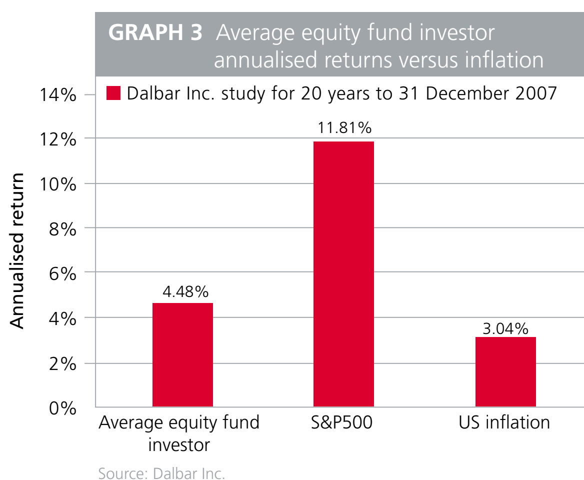
In 2006, Morningstar, a Chicago-based securities research firm, started to report mutual fund (unit trust) returns in a new way. The 'Morningstar Investor Return' gives a statistical measure of the price investors have paid for failing to be disciplined and patient by measuring the difference between fund returns and investor returns.

Morningstar research (as quoted in an article titled 'Investor return versus total return', 10 February 2006) indicates that for most mutual fund categories, fund returns and investor returns were fairly close together over the three-year and five-year periods to the end of September 2006. But the gap widened substantially over the trailing 10-year period. This may be likely because the 10-year period encompassed the late 90s bull run as well as the bear market, and both extremes tended to stimulate poor decision-making. In every diversified stock category and most sector categories, funds' 10-year investor returns lagged their total returns. The divergence was, in several

cases, quite striking. For example, technology sector funds over the period on average generated total returns of 6.4% but investors lost an average of 4.2% on an annualised basis over the period. It was a similar story for growth funds which generally posted 10-year investor returns that fell far short of their total returns. The same was true for communications and health-care funds.

2. The average equity fund investor seeking to out-perform the S&P index did not achieve this goal

In a different research study by financial services research company Dalbar Inc. it was found that, on average, equity fund investors undermined their ability to create wealth through chasing past performance, switching funds and trying to time the market. As you can see in **Graph 3** below, this behaviour manifested itself in very poor returns relative to the S&P index, barely outperforming inflation.



Source: Dalbar Inc.

We are committed to help you achieve the highest possible return on your investment

If you do not benefit from our long-term investment performance, we believe we will have failed in our mission to create long-term wealth for our investors. We are committed to helping our investors achieve the same performance as our funds. Below are some of the specific ways that we can do this:

1. Continue to educate and inform our investors about our approach

Our investment approach is long-term in nature. If you believe in this approach and want to benefit from it, it is important that you understand it, buy into it and remain disciplined in spite of short-term fluctuations. We will continue to emphasise the importance of taking a long-term view to investing.

2. We will not market or 'sell' funds based on short-term performance

The danger of chasing past performance is well documented. It leads to investors undermining their own investment returns through frequent switching and taking a very short-term view. Aggressive fund-specific performance advertising hypes the fear among investors of 'missing out', causes investors to switch funds more frequently and undermines the returns they get from their investment.

3. Publish an investor return for your accounts

We plan to publish your investor return per account (also known as an 'internal rate of return') on the secure area of our website. It will enable you to analyse the actual return you are getting from your investment accounts over various periods. This can be quite different from the fund return of your chosen funds, but you are able to influence this by your investment behaviour.

4. Continue to offer a simple and manageable range of funds

We realise that investing is complicated enough. We have tried to simplify this for you by maintaining a small range of funds that we aim to make as easy to understand as possible. This range includes enough choice to meet investor needs without unnecessary complexity. We will not launch funds for the sake of doing so – and therefore hope to lessen the confusion that investors may experience in the face of 'marketing hype' about new and 'better' funds.

There may be times when it is appropriate for you to disinvest or switch funds, but this depends on your personal circumstances and portfolio. Some investors are sufficiently knowledgeable, confident and disciplined to make these kind of decisions on their own. However, if you require guidance in considering your investment plan holistically, an independent adviser may be able to help you to meet your objectives and grow your wealth. They provide expertise and are able to reassure you during times of market volatility, helping you maintain the level of investment discipline you need to meet your goals.