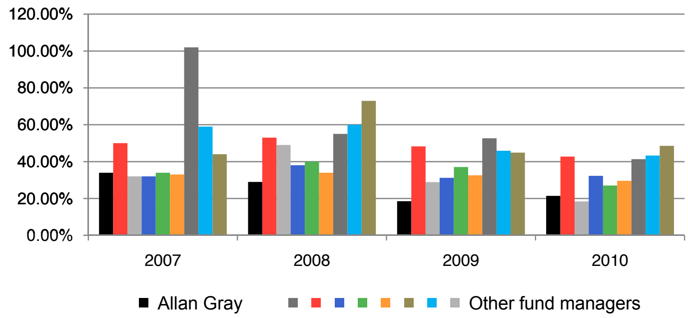
GrayIssue

To have and to hold...

22 November 2010
Issue no. 111

Regular readers of our commentaries will know that our goal is long-term wealth creation for our clients. Therefore, you won't be surprised that we worry about a gap between our unit trusts' returns and the returns achieved by the average investor in those funds. We have commented on the investor returns research of US firm Dalbar Inc. in previous issues – its latest numbers show that over the 20 years to the end of 2009, the average US investor earned 3.2% in US equity mutual funds, while the market returned 8.2% in that country. The same research shows that average mutual fund holding periods hover at less than five years. While a minority of investors are able to time their investments in funds so that they enhance their returns, on average, investors make poor decisions about when to buy and sell mutual funds and should therefore probably avoid switching.

Outflows as a percentage of average assets



Source: ASISA; as at end Q2 2010. Figures for 2010 are annualised.

Looking in the rear-view mirror

Back on home soil, the average fund manager sees outflows at a level of over a fifth of their assets every year (see graph). Some of these outflows are made up of investors taking their money out to spend it, but there is also a high incidence of switching.

Again, some investors improve returns by switching, but most switching behaviour in unit trusts destroys value, with the average investor pursuing past performance by switching between asset managers, funds and asset classes. Selling unit trusts which have temporarily dipped below their average performance, in order to buy those which are briefly punching above their weight can be part of a destructive sell-low, buy-high cycle. Investors should remember that it is very hard to get timing right consistently enough to beat the underlying funds. At the end of the day, for by far the majority of investors, the old cliché is true: *time* in the market is an easier way to win than *timing* the market.

How long is long enough in the market?

Because markets can be volatile over the short term, investors are perpetually encouraged to be clear on their objectives and to invest for the long term. But exactly how long is long term? Our investment objective at Allan Gray is to select shares that produce superior, long-term returns at lower-than-average risk of loss. To achieve this, we identify and invest in stocks that are out of favour and, as a result, are trading at prices significantly below our assessment of the company's intrinsic value. We tend to adopt a four-year investment horizon, which typically allows enough time for an undervalued asset to return to fair value as the market recognises its earlier, irrational pessimism.

Taking a four-year view when investing does not necessarily mean we will hold every share for four years. The price of a stock can change daily, even hourly. If it suddenly goes up substantially, and if in our assessment it is trading at fair value, we might sell immediately and use the proceeds to invest in our next best idea. Conversely, we may hold on to a share for much longer than four years.

One can apply similar logical principles to selecting funds. Your needs and time horizon should dictate which funds you choose. With the help of your financial adviser you need to carefully research your options so that you will not feel compelled to switch before you have been invested for long enough to get the maximum benefit from our investment approach.

Unit trusts are not good speculative investments

Switches between funds incur trading costs within the funds and these are borne by other investors. Switching involves selling your units and you may thus incur and crystallise capital gains tax. In addition, the funds you switch into may charge initial fees.

Well-managed unit trusts are good at spreading risk and making steady profits in the medium to long term. If you are doubting your choice and considering switching, remember that returns are influenced substantially by investor behaviour. The message remains to buy into quality and be patient.

Commentary by Jeanette Marais, director of distribution and client services, Allan Gray