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# Impatient Investors Get Caught in the ‘Return Gap’

Investors on average lose 1 to 2 percentage points a year because of behavioral inefficiencies, writes this professor

*By Derek Horstmeyer*

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Because investors tend to pull their money at the exact wrong time, they often don’t experience a mutual fund’s stated return in full. ILLUSTRATION: ROBERT NEUBECKER FOR THE WALL STREET JOURNAL

Most investors think of themselves as rational and immune from the behavioral elements that periodically roil markets. Human factors, however, do continue to affect our personal portfolio decisions—usually to the detriment of our long-run returns

returns.

One way to measure the damage is what is known as the "return gap," or "investor gap." This gap captures the difference between the average return for a fund and what the average investor actually experiences in returns within that fund. Why might these two numbers not match up exactly? A mutual fund's stated return will reflect the average return of its stock or bond holdings over a period of time. But because investors on average pull their money at the exact wrong time (panicking when the market has already hit a bottom and putting in more when at the top), they often don't experience this stated return in full.

Thus, what investors on average are actually experiencing in the fund is better captured by an asset-weighted return for the fund (an internal rate of return that factors in fund inflows and outflows).

## Selling out

Indeed, even though the average S&P 500 indexed mutual fund delivered 26% returns in 2009, many investors saw lower returns because they had sold out at the bottom after experiencing the full weight of the 35% drop in the markets in 2008. So, while the average stated return for mutual funds over this two-year period was somewhere near minus 4.5% (minus 35% plus 26% divided by 2), many investors had an average annual return much closer to minus 17.5% (minus 35% plus 0% divided by 2). This would yield a return gap equal to 13 percentage points.

In what types of funds do investors suffer the biggest return gaps? A look at a variety of U.S.-based stock funds from 2008 to 2018 shows mutual funds that particularly target value stocks produced the biggest annual return gap for

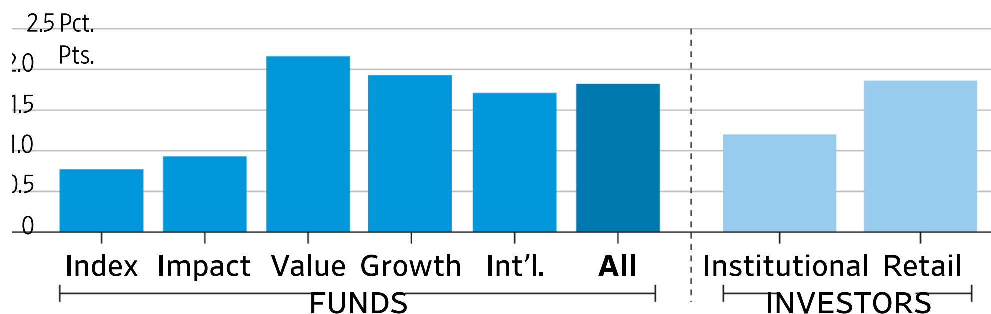
investors, 2.16 percentage points, followed closely by funds that target growth stocks, with 1.93 percentage points.

## Avoiding timing

By contrast, investors in S&P 500 index funds and those in impact/sustainable funds—or funds with an ethical bent—have the lowest return gaps (0.77 and 0.93 percentage point, respectively). This might be surprising, since passive investing and ethical investing seem to be polar opposites (one pretty much ignores the content of the investments; the other is completely predicated on it). But the common link, according to Jina Penn-Tracy, a financial adviser focused on sustainable investing at wealth manager Centered Wealth—who noticed this phenomenon with her clients, and is producing a series of white papers on the topic—is that both types of investors resist the urge to try to time the market, which damages so many portfolios.

**Lost Money**

The 10-year 'return gap' for investors (percentage points a year) in mutual fund types




Source: Derek Horstmeyer, George Mason University

Fund flows for S&P 500 index funds have been less volatile at critical times as well, compared with other types of funds. While S&P 500 index funds as a group saw an inflow of $4.2 billion in 2008 (a 1.3% jump as a percentage of assets under management at the start of the year), investors in value funds pulled $15.1 billion (a 2.6% decrease as a percentage of assets) and investors in growth funds pulled $45.4 billion (a 4.5% decrease).

While we've shown that investment-style preference can be an important factor in determining return gaps, there is also a difference between individual and institutional investors. A comparison of the return gaps for U.S. stock mutual funds exclusively for institutional investors with the gaps for all other U.S.-based stock mutual funds shows that funds for the institutional investors had an annualized return gap that was 0.65 percentage point smaller than the gap for retail investors over a 10-year period.

The institutional investors saved more than half a percentage point a year compared with individuals—because the big money is less likely to get caught up in the exuberance of market cycles and can ride out market storms.

With some behavioral restraint, investors can close the 'return gap,' argues the author. PHOTO: ISTOCKPHOTO/GETTY IMAGES

With market volatility, as measured by the VIX, recently at a three-year high, it is important to resist the urge to panic when things turn south. The trick to this may lie in the behavior of index and/or impact investors—either

through being passive or through sticking with a moral/ethical attachment to holdings. This behavioral restraint could save you 1 to 2 percentage points a year by closing the return gap.

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