

**Casey Mullooly:** Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly, and I'm joined by Tom and Brendan this week for episode 373. In this week's episode, we're going to discuss why investors underperform the funds they're invested in, a phenomenon that's come to be known as the behavior gap. There's a lot to get into this week, so we're going to just jump right into it and we hope you enjoy it.

**Casey Mullooly:** We're going to talk about another Morningstar article, a research article from them. This is two in a row for us now, so shout out to the folks at Morningstar. They continually churn out just really good research. I know we're huge fans of theirs here. So, keep doing what you're doing, guys. This article was titled Why Fund Returns Are Lower Than You Might Think, and it goes into what one of our other favorite finance writers, Carl Richards, has deemed the behavior gap. So the Morningstar study found that the average 10 year return for investors was 7.7%, but that's 1.7% less than the fund they were invested in. So the investors in the funds earned less than the funds themselves.

**Tom Mullooly:** Right. So the funds returned nine and a half percent, but the investors actually only got 7.7.

**Brendan Mullooly:** So they can look at the flows, meaning they can see when folks are buying, selling shares of these funds, and that's how they calculate this discrepancy between, hey, the fund did this and the average investor in the fund did that. And that's how we arrive at these numbers, or how Morningstar arrives at these numbers that we're citing.

**Casey Mullooly:** So this 1.7% gap is pretty much in line with where the average has been over the last five years. So, it's not a new phenomenon, this "behavior gap". So why does this gap exist?

**Tom Mullooly:** Remember February and March of 2020, when the market started going down, and it ultimately went down like 35% by March 23rd? Someone had to be selling. You get folks who get nervous and they just want to rip up the script. So they say, "I've got to get out of this stuff. I have to be in cash," or, "I don't want to have this much exposure anymore to internet stocks because they're all going down," even though we were all about to work from home. People panic and they change their, or they want to change their direction or their exposure to risk oriented investments. So they move out of a fund, and sometimes they go right back into a fund a little later on during the year and they say, "Wow, this fund was up 50% last year, but I only made 22%. Why?" Well, because you bailed out at the worst possible time.

**Brendan Mullooly:** Yeah. So, the short answer to that question is just timing.

**Tom Mullooly:** Are you saying I'm long winded?

**Brendan Mullooly:** Occasionally. I can be-

**Casey Mullooly:** Bren with the chirp.

**Brendan Mullooly:** ... I can be too, but the answer is just timing. Sometimes it's good, and a lot of times

it's not. I'd add the caveat too, that I think a lot of people in our line of work use this information to say how individual investors are doing this stuff, but I think that there are advisors who are doing it too because it's pretty difficult to get on the phone with a client who's panicking and actually calm them and help them stay the course during a period of time like March of 2020. It's a big reason why advisors exists and why we are paid to do a job. But it's not always successful. So sometimes advisors are doing these moves too, that are in hindsight, panic selling. That happens from advisors too, because they have to answer to their clients and they might be afraid that the clients are going to want to see them doing something. So rather than get on the horn and tell them why it would be a panic move and not do it, the advisors do that stuff too.

**Brendan Mullooly:** These stats do not discriminate. These aren't stats only from individual investors in their activities. These are just people who own mutual funds or the funds that are being tracked. That includes advisers, investors and everybody else out there too. So this is everybody making collective poor decisions on average with their money. That's what it is. That was long winded.

**Tom Mullooly:** His answer was longer than mine.

**Casey Mullooly:** Wow.

**Brendan Mullooly:** That's fine. That's fair.

**Casey Mullooly:** So do we think that this is just, this gap is just always going to exist? Because it sounds like it's pretty much just human behavior, driven people get worried about the market and sell at the bottom and then buy back in higher. I mean, that has been the case in the entirety of the stock market. So is there anything that investors or I guess advisors should be doing to try and help narrow this gap?

**Tom Mullooly:** A lot to unpack there. The smart aleck answer to your first question is you can't have this gap every day because the stock market is closed on Saturday and Sunday. So it won't be every day of the week, but for as long as the market's open, you're going to get a difference of opinion. There's someone, a chart gal that I follow on Twitter, Helene Meisler. I don't know if you guys do as well. But every Saturday morning, she has a poll, just tell us if the next 100 points in the S&P are going to be up or down. And it is amazing to see, no matter what happened the week before, it's going to be somewhere between 45% and 55% up or down, market is split on what direction the next 50 points are going to be in the S&P. That is what makes a market.

**Brendan Mullooly:** I want to remind us of her pinned tweet on Twitter is also because I think it's pretty relevant to the discussion here.

**Tom Mullooly:** Very relevant.

**Brendan Mullooly:** Nothing like price to change sentiment. Meaning just everybody's opinion on asset classes, things that they own changes based on what they've done recently. So that definitely factors into these decisions to buy or sell at what later may seem like a smart or not so smart decision. So, the more that you can avoid those short term recently biased decisions may be aligning yourself, so you

don't have to become a forced seller. Meaning if you enjoy your portfolio, all the things that you own, don't put yourself in a position to have to sell it in March of 2020 because you needed some cash, because you were just basically at the end of the day over leveraged because you had some other kind of emergency that you hadn't set aside money for, so it had to come from a stock portfolio. Meaning even if you knew it was a bad decision, that you had to sell when things were down.

**Brendan Mullooly:** So I mean, all of those things that factor into our planning process here are to hopefully avoid not having that decision within our control, because when it's just you and emotion and getting caught up in recent events, I think you stand a better chance at maybe walking back from the ledge and not becoming a unflattering Morningstar statistic about investors. But if you're in a forced position and you need the cash, then it is what it is.

**Casey Mullooly:** So it really comes down to just having a plan and not flying by the seat of your pants out there and just reacting based off of what the market is doing.

**Brendan Mullooly:** Reacting, yeah.

**Casey Mullooly:** Reacting being the key word there.

**Tom Mullooly:** Meb Faber, listened to him recently on a podcast with the folks from Morningstar.

**Casey Mullooly:** Oh, nice.

**Tom Mullooly:** And he had mentioned that, is it the AAll poll that comes out on a weekly basis? And it's actually a very good contrarian indicator when-

**Casey Mullooly:** Is that the sentiment?

**Tom Mullooly:** Right. So when it shows more people are bullish, it's probably meaning that we're going to go through some kind of pullback or draw down. He pointed out that the highest reading ever on that index was in December of 1999, where the NASDAQ was at 5000. It was about to go back to 1300 in less than a year, down 80%. People could not have been more bullish. And this is not just individual investors. These are people who do what we do. They were the most bullish ever in December of 1999. Couldn't have been more wrong. So this has become a very good contrarian indicator for us when we see these sort of things.

**Brendan Mullooly:** We all know this inherently. We understand that it's not smart to sell into a downturn. In fact, we should be thinking about buying, and the opposite holds true as well with euphoria on the other end. Don't pile in. Maybe if anything, think about how you might be able to walk things back a bit. But we can read that a million times and nobody wants to do it still. So I don't know. I don't know what the solution is because I think it's just human nature to act that way. But you've got to find a way to remind yourself in the moment when you're on those ends of the spectrum, that some self-doubt there, if you're very sure about something, just-

**Casey Mullooly:** It's not going to be this way forever.

**Brendan Mullooly:** Yeah.

**Casey Mullooly:** That's part of the ... I think investors get suckered into that, like with the sentiment index back in '99, when it's gone up so much lately that of course this is going to continue in the future. And guess what? Things change.

**Tom Mullooly:** Yeah. In the short-term, they changed very quickly and they changed abruptly in a negative way, but were they really wrong? It depends on your timeframe. I can tell you-

**Brendan Mullooly:** Not wrong, just early by a decade.

**Tom Mullooly:** Thank you. Yes.

**Casey Mullooly:** I wasn't going to say it.

**Brendan Mullooly:** I think there's a statute of limitations to being early, and I think it's like a year. If you're more than a year early, then it doesn't matter.

**Tom Mullooly:** Then you were wrong.

**Brendan Mullooly:** You were wrong,

**Tom Mullooly:** You were wrong. But I'll also add on top of that, that there have been many days, I've lost count of the days where I have gotten into the office at 7:30. You know the market is going to go down, you know it's going to be down a lot, and it might be the 10th day in a row or the 30th day in a row where it's gone down and it's just eating away at you, that you feel like you should be doing something. And some days you do, and you learn to regret it pretty quickly. As you've said Brendan many times, you could be right for a couple of days, but ultimately you're going to be wrong. I know that. When I got into this business, the Dow Jones was at 1600. It's 35,000.

**Brendan Mullooly:** There's times when it's going in that direction described, and you need to question your existence as an investor, I suppose. I think you've got to remember the reason you're doing it all to begin with. And it is because over a long enough time horizon, if you're bullish, you're going to be right. So I think if you just can't take it anymore and you feel the need to sell, I think you at least have to be okay with if you're going to act on that, that you're probably going to be right for the very short term and feel like an idiot at some point in the future. TBD how long that takes, but I think that's the whole, like Case said, having a plan and knowing the purpose of the money and when and what it's going to be used for to what degree. These are all important things that you can at least act appropriately if you have to do something, have in air quotes there. Don't put yourself in the position to have to do something, hopefully.

**Casey Mullooly:** I think it's hard because, I mean, we might be in one of these periods now where

investors get lulled to sleep where the market's not moving a lot or it's just churning upwards like we've seen over the last couple months, and then boom, March 2020 happens and it's like, oh my God. Like you said, we have to do something. So, yeah. I think-

**Brendan Mullooly:** Think happens 2017 into the end of 2018 too, where in 2017, the market just marched higher. Not many pullbacks to write home about. And then 2018, we had some volatility.

**Tom Mullooly:** In 2017, like 12 months in a row, we had a higher high in the market. That never happens.

**Brendan Mullooly:** It's pretty comparable to this year.

**Casey Mullooly:** Yeah, we just did a podcast about eight for eight. Not to be harsh, but investing is hard. The easy move is to make the knee jerk reactions that you guys are talking about and sell at the bottom and create this one and a half percent gap. That's the easy thing to do. The hard part is to have the fortitude to have, whether that be an advisor to back you up and support you in those decisions or to systematize it and take the emotion out. I think it's impossible to strip all of the emotion out of investing. That's just not going to happen. But sticking-

**Tom Mullooly:** It would be great if it was.

**Casey Mullooly:** It would be great. Billion dollar idea. But it's hard sticking to the plan, but that's where we typically see the most success.

**Tom Mullooly:** Just my personal opinion, I can't believe that the gap between what a fund or what a yard stick returns and what the actual individual's returns are, I can't believe the gap is only 1.7%. It should be bigger.

**Brendan Mullooly:** You can look. There are some individual funds out there that are just absolute horror shows, where the fund could have been one of the best performers, but the timing of the inflows, most people just had an awful time in it, despite the manager doing a terrific job.

**Casey Mullooly:** Yeah. From the piece of research from Morningstar, alternative funds and "narrowly focused funds with higher volatility" are mostly to blame for the gap being this big. So, we're not seeing the big gaps in SPY or some of these more plain vanilla type stuff.

**Brendan Mullooly:** They sort of throw a blanket over a category and talk about managed futures after '08, '09, because they did so well, they're doing rend following and owning things like commodities. And that was all the rage because they were successful through the financial crisis. And they've been terrible since in terms of performance. So people piled in obviously in '09, '10, '11, '12, and then got sick of it and piled out after that. So, yeah.

**Tom Mullooly:** Now some of these funds are closing because they just don't have the assets anymore.

**Brendan Mullooly:** Right. So, chasing the hot dot is not usually a good investment strategy.

**Casey Mullooly:** Yeah. So some of the recommendations that the Morningstar article suggested to narrow the gap include dollar cost averaging and doing periodic rebalances, so just scheduling out your moves, whether that be once a quarter, once a once a year. Just having some sort of plan in place and sticking to that through all market cycles.

**Tom Mullooly:** That's the hardest thing. Early on in my career, I tried to get folks to do dollar cost averaging, where they would actually ... Think about this now. You're going to cringe. I would actually ask people to write checks and mail it into us once a month so we could put it into a mutual fund.

**Casey Mullooly:** That's what you had to do.

**Tom Mullooly:** This was the only way to do it.

**Casey Mullooly:** Yeah.

**Tom Mullooly:** Now we can set it up so that money comes in electronically from the bank. The client sets it up once and we forget about it. And then it goes in at the same period, every recurring time that this happens. It's automated. So you don't have to think about it. Because what would happen in the past, in the '80s, is that people would do dollar cost averaging, and then about six months into it, I would get a phone call. We'd get into a discussion with the client. And he'd be like, "Hey, this thing really isn't working out," or, "The fund went down. So, I don't want to do it this month." It's like, this is kind of how it works.

**Casey Mullooly:** Well, you could also make the argument, looking at you Bren, that dollar cost averaging is market timing, in a sense.

**Brendan Mullooly:** I mean, everything is market timing because you're making a decision about when to put your dollars to work into something. I would say that dollar cost averaging is preferable to other forms of timing because it's basically admitting that we don't know what's going to happen in the short term. I don't know if the price is going to be good today, better next month, vice versa. So, I'm going to do equal over a period of time and just stick to it. It's a system. Which I think is preferable to saying, "Hey, I'll know when the time is good to buy and sell." I think the more you can remove those buy, sell decisions and timing decisions, the better you're going to do over the long term. I think short term, obviously, if you nail the timing, you're going to look better than the person who averages. But I think over the long term, I think your odds of success are better if you just have a system and stick to it.

**Casey Mullooly:** So, the benefit of dollar cost averaging in a down trend in the market is that you're buying shares of funds at lower prices. And then when the market's going up, you are just slowly getting in on that. So it speaks to what you said before about the Dow being at, was it 1600?

**Tom Mullooly:** Yeah.

**Casey Mullooly:** And now it's at 30 ... It's like, okay, over time, this is going to continue to go up. We're not sure in the near term exactly which direction it's going to go, but over 10, 20, 30 years.

**Brendan Mullooly:** I think the important distinction is when you're averaging into a reasonable diversified portfolio that we can expect based on history to rise over a long period of time, that is dollar cost averaging. Dollar cost averaging, because you'll get the opposite. If you don't specify what you're averaging into, like what I just described, then you'll get the people who say, "Well, I'm just throwing good money after bad," when they're averaging into some individual stock that keeps going down month after month. We don't know if that stock's going to exist in the future. If you look at the history of most companies, they go in and out of business. So yeah, your odds are bad. If we're talking about averaging into an individual position, I don't know, and I don't think that I would say that that's a good idea. So I think to make that distinction too is important. What's the expectation over the long term? We're averaging into diversified investment. Yeah, sounds good. Sounds reasonable. But averaging into an individual stock that just keeps going down, I don't know that that's a great idea.

**Casey Mullooly:** Like we talked about on the last podcast, we talked about the whole active versus passive thing. It's like, if you're owning these "passive funds", but you're actively trading them in your account, then what are you even doing?

**Brendan Mullooly:** What's the difference?

**Casey Mullooly:** Exactly.

**Brendan Mullooly:** You've moved the timing decision from professional mutual fund manager to yourself is what you've done. So if you feel good about that, then more power to you, but I don't know.

**Casey Mullooly:** So this behavior gap, the gap that exists due to poor market timing decisions, sounds like it's always just going to exist and we just have to be cognizant of it and try and do our best to not make those poor decisions and to have a plan and a system in place to not fall into that market timing trap. So, shout out again to our friends over at Morningstar. Thank you guys so much for putting out this research for advisors and individual investors. We will definitely link it up in the show notes, so go over there and check it out for yourself.

**Casey Mullooly:** This was episode 373. We want to thank you as always for listening, and be on the lookout for episode 374.

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