

## Death, Taxes, and Short-Term Underperformance

At the Brandes Institute, a division of Brandes Investment Partners, L.P., we recognize that underperformance in shorter periods, both versus the benchmark and relative to peers, can be frustrating for many investors. With this in mind, we think it's important to point out that underperformance in the short term may not have much bearing on a portfolio's long-term success.

In our opinion, it's not unusual for portfolios that outperform over longer periods to underperform in shorter periods. In fact, we believe that underperformance in shorter time spans – such as one quarter, one year, or even a few years – is to be expected, even for portfolios that perform well over the long term.

### *Checking the numbers*

To illustrate the limited relevance of short-term underperformance, we surveyed the Morningstar database, an archive of extensive data on thousands of mutual funds. We focused on mutual funds instead of separately managed accounts because performance histories for a wide range of funds are readily available, while return information for separate accounts is much less robust. Mutual funds and separate accounts do not share the same regulatory structures, fees, or expenses, but we believe mutual funds are an acceptable substitute for separate accounts for the purposes of examining short-term underperformance.

Our Morningstar query focused on actively managed U.S. funds with large-cap value, large-cap growth, or large-cap blend mandates, and 10 years of performance data available as of December 31, 2006. These criteria yielded a sample of 591 mutual funds.

Our first step was to divide this sample into deciles based on the funds' performance for the entire 10-year period. For example, decile 1 consisted of the 59

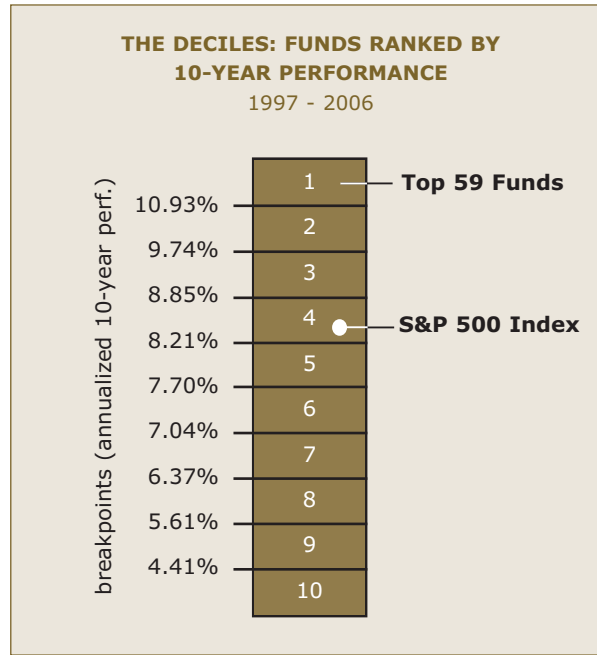
funds with the highest 10-year returns, while the funds with the next-highest returns formed decile 2, and so on. (Per statistical convention, decile 2 contained 60 funds.) All mutual fund performance figures assume the reinvestment of dividends and capital gains, include the impact of the funds' fees and expenses, and do not include the impact of taxes.

#### **THE SAMPLE: 591 MUTUAL FUNDS**

From the Morningstar database as of 12/31/06

- Actively managed U.S. funds
- Large cap value, growth, or blend mandates
- 10 years of performance data available
- Multiple share classes excluded
- Index funds and enhanced index funds excluded

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### *Underperformance versus the benchmark*

As the chart at left shows, the top 59 funds in the sample posted an annualized gain of at least 10.93% over the 10-year period.

All of these “decile 1” funds outperformed the S&P 500 Index, which returned 8.42% during the decade.

Source: Morningstar, The Brandes Institute; as of 12/31/06

While the top 59 funds outdistanced the S&P 500 Index for the 10-year period as a whole, all of them underperformed the Index substantially during shorter periods within the decade. For instance, in their worst 1-year rolling<sup>1</sup> periods, the top 59 funds underperformed the S&P 500 Index by margins ranging from 6.49% to 44.09%, as the table below shows. On average, these funds trailed the Index by 19.54% in their worst 1-year rolling period. Underperformance versus the S&P 500 Index was also significant in each fund’s worst 3-year rolling period.

### TOP 59 FUNDS: OUTPERFORMANCE VS. S&P 500 INDEX

1997 - 2006 (ANNUALIZED ROLLING PERIODS)

	in worst 1-year rolling period	in worst 3-year rolling period
Range of top 59 funds	-6.49% to -44.09%	2.52% to -22.43%
Average of top 59 funds	-19.54%	-8.11%

Source: Morningstar, The Brandes Institute; as of 12/31/06

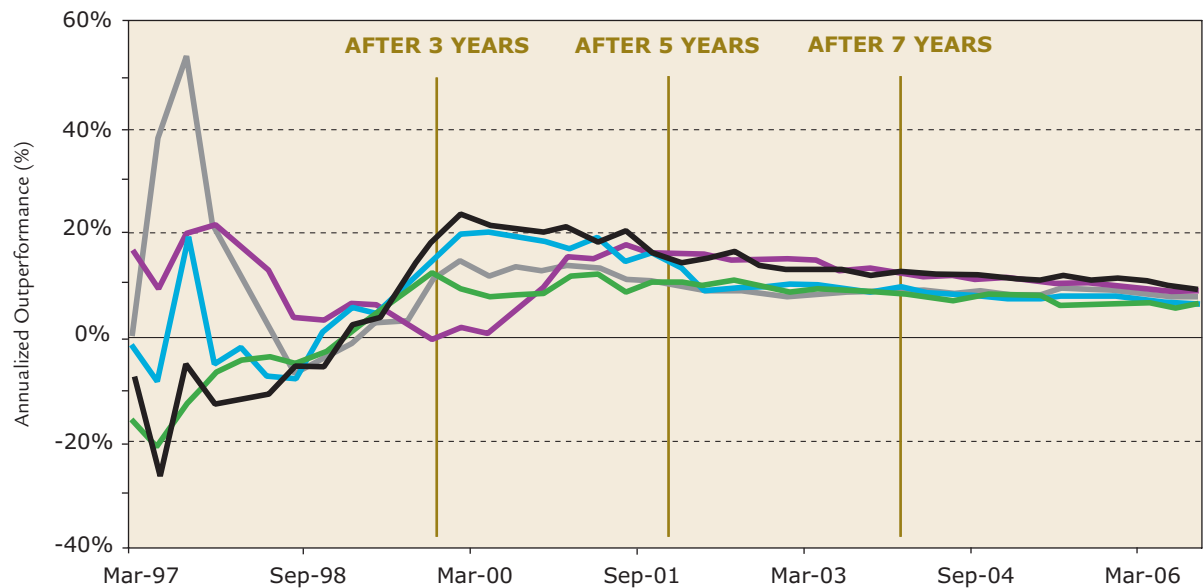
<sup>1</sup>Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. A hypothetical example is the 20-year time period from 12/31/82 through 12/31/02. This long-term period consists of 16 smaller five-year “rolling” segments. The first segment is the five-year period from 12/31/82 to 12/31/87. The next rolling segment is the five-year period from 12/31/83 to 12/31/88, and so on.

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In our opinion, this indicates that short-term underperformance versus the benchmark might not be unusual, even for investments that outperform over the long term. To further illustrate this point, we examined the outperformance of the five funds in decile 1 with the best 10-year performance on a quarter-to-quarter rolling basis across the decade.

As the chart below shows, these funds did not outperform the S&P 500 Index through the entire decade. Instead, each fund was underperforming the Index at various points during the period.

**TOP FIVE FUNDS: OUTPERFORMANCE VS. S&P 500 INDEX**  
1997 - 2006



Source: Morningstar, The Brandes Institute; as of 12/31/06

### *Underperformance relative to peers*

We believe the evidence above helps demonstrate that short-term underperformance versus the benchmark is not unusual – even for portfolios that perform strongly in the long run. But what about short-term underperformance relative to peers? Do portfolios that post favorable long-term results tend to lag their peers during shorter time spans?

To find out, we examined how the top 59 funds in our sample ranked against their peers in short-term periods. As mentioned above, these funds posted the highest returns during the

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decade under review, placing them in decile 1 based on 10-year performance. For shorter performance periods within the decade, however, the top 59 funds often appeared in lower deciles.

In terms of rolling quarterly performance, all 59 of the top 59 funds made at least one appearance in deciles 6, 7, 8, and 9 during the decade – and 53 of the 59 showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year rolling periods, the top 59 funds also experienced underperformance relative to their peers, as the table below shows. For example, 34 of these funds made at least one appearance at or below decile 8 based on 3-year rolling returns. And the 3-year rolling performance of 10 of the decade's top 59 funds ranked in the very last decile at least once during the decade.

### TOP 59 FUNDS: APPEARANCES IN LOWER DECILES

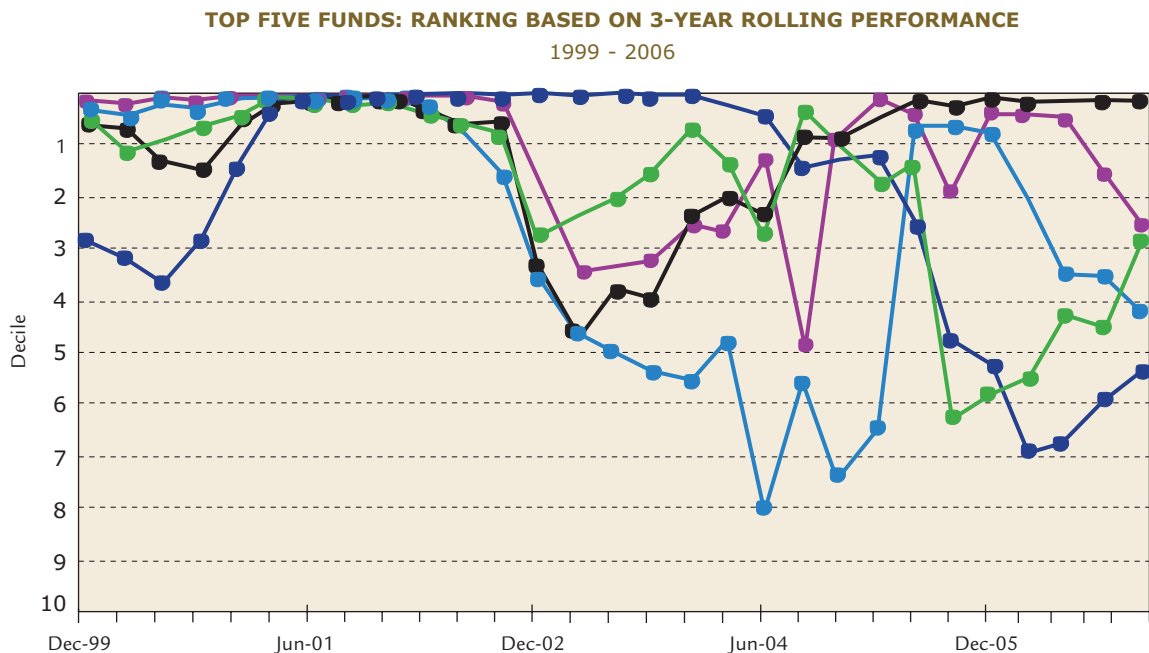
	# of top funds, with at least one appearance at or below:				
	decile 6	decile 7	decile 8	decile 9	decile 10
Based on rolling quarterly performance	59	59	59	59	53
Based on rolling 1-year performance	59	59	58	51	44
Based on rolling 3-year performance	51	45	34	24	10

Source: Morningstar, The Brandes Institute; as of 12/31/06

This suggests that short-term underperformance relative to peers is to be expected, even for portfolios that perform well over the long term. We also examined the 3-year rankings of the top five funds in our sample on a quarter-by-quarter basis, for each of the 3-year periods in the decade under review.

As the chart on next page shows, all of the top five funds – based on 10-year returns – had 3-year rolling performance rankings in decile 4 or lower at more than one point in the decade. Rankings for the rest of the top 59 funds (not shown) also tended to dip substantially for select rolling 3-year periods.

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Source: Morningstar, The Brandes Institute; as of 12/31/06

### *In Conclusion*

Short-term underperformance can be frustrating. At the Brandes Institute, however, we don't believe that it is necessarily a cause for alarm.

We think that underperformance in shorter periods – such as one quarter or one year, and perhaps even a few years – can be a normal part of the investment experience, even for portfolios that perform strongly over longer periods. In our opinion, investors who keep this in mind when evaluating short-term underperformance will be better positioned for long-term success.

### **Past performance is not a guarantee of future results.**

*The S&P 500 Index is an unmanaged index that consists of 500 stocks and is designed to form a representative sample of the United States stock market. This index is often used as a benchmark for U.S. equity portfolios and includes dividends and distributions, but does not reflect fees, brokerage commissions, or other expenses of investing. Please note that all indices are unmanaged and are not available for direct investment.*

*Morningstar, Inc. is an independent mutual fund research and rating service.*

*The foregoing reflects the thoughts and opinions of the Brandes Institute.*

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