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Death, Taxes, and Short-Term Underperformance: Global Equity Funds 2011Update

In our original *Death, Taxes, and Short-Term Underperformance* studies, we examined the short-term underperformance of U.S., non-U.S., and global mutual funds. Our research found that investors in equity mutual funds should expect periods of underperformance – both versus the benchmark and relative to peers. Our studies also indicated that even longer periods of underperformance, up to three years, had relatively little impact on some of the better funds' ability to generate long-term success. In this handout we revisit and update our previous study on short-term underperformance of global equity mutual funds.

Using the Morningstar® database, we focused on actively managed global equity funds that followed value, growth, or blend mandates. Our sample included funds that had at least 10 years of performance data as of June 30, 2011, while excluding multiple share classes, index funds, and enhanced index funds. These criteria yielded a sample of 89 global equity funds, contrasted with our 76-fund universe from our previous paper.

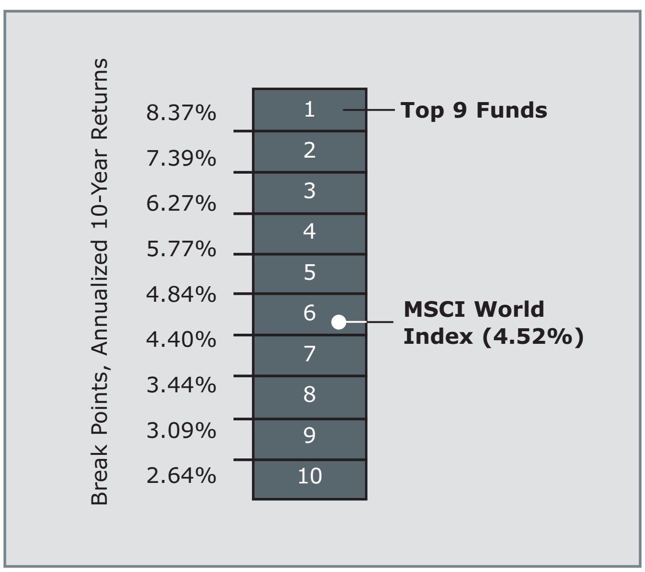
Applying the same methodology as used in our previous study; the sample was divided into deciles based on the funds' 10-year performance. The 9 funds with the highest 10-year returns were placed in decile 1, while the 9 funds with the next highest returns formed decile 2, and so on[1]. All mutual fund performance figures assume the reinvestment of interest and capital gains, include the impact of the funds' fees and expenses, and do not include the impact of taxes.

THE SAMPLE: 89 MUTUAL FUNDS

From the Morningstar® database as of 6/30/2011

- Global equity funds
- Value, growth, or blend mandates
- 10 years of performance data available
- Multiple share classes excluded
- Index funds and enhanced index funds excluded

Exhibit 1: The Deciles: Global Equity Funds Ranked by 10-Year Annualized Performance, 2001– 2011



Source: Morningstar®, MSCI, The Brandes Institute; 6/30/01 - 6/30/11. **Past performance is not a guarantee of future results.** Rolling periods represent a series of overlapping, smaller time periods within a single longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth.

[1] Per statistical convention, decile 5 contained 8 funds while all other deciles contained 9 funds.

UNDERPERFORMANCE VERSUS THE BENCHMARK

As Exhibit 1 shows, the top 9 mutual funds in the sample posted an annualized gain of at least 8.37% over the 10-year period. All of these "decile 1" funds outperformed the MSCI World Index ("the Index"), which returned 4.52% during the decade.

While the top funds outpaced the benchmark for the 10-year period as a whole, all of them underperformed the Index substantially during shorter periods. For instance, in their worst 1-year rolling periods, the top 9 mutual funds underperformed the Index by margins ranging from 3.40% to 23.97% and by 12.04% on average as illustrated in Exhibit 2. Underperformance versus the Index was also noteworthy in each fund's worst 3-year rolling period.

Exhibit 2: Decile 1 Funds Relative Annualized Performance vs. MSCI World Index, 2001 – 2011

	In Worst 1-Year Rolling Period	In Worst 3-Year Rolling Period
Range of Top 9 Funds	-3.40% to -23.97%	0.26% to -6.95%
Average of Top 9 Funds	-12.04%	-2.77%

Source: Morningstar®, MSCI, The Brandes Institute; 6/30/01 - 6/30/11. **Past performance is not a guarantee of future results.**

Exhibit 2 reveals the level of short-term underperformance experienced by top funds. In our view, this indicates that short-term underperformance for global equity funds might not be unusual, even for those funds that outperformed over the long term.

UNDERPERFORMANCE RELATIVE TO PEERS

What about short-term underperformance relative to peers? Do funds that post favorable long-term results tend to lag their peers during shorter time spans?

To find out, we examined how the top 9 global equity funds in our sample ranked against their peers in short-term periods. As mentioned previously, these 9 funds posted the highest returns during the decade under review, placing them in decile 1. However, for shorter performance periods within the decade, decile 1 funds often appeared in lower deciles.

In terms of quarterly, 1-year, and 3-year rolling returns, all of the top funds made at least one appearance in the bottom deciles during the decade. Within longer rolling periods, we observe that the top funds slowly move away from the lowest deciles. For example, in the 3-year rolling period analysis, 5 of the top 9 funds made at least one appearance in decile 9.

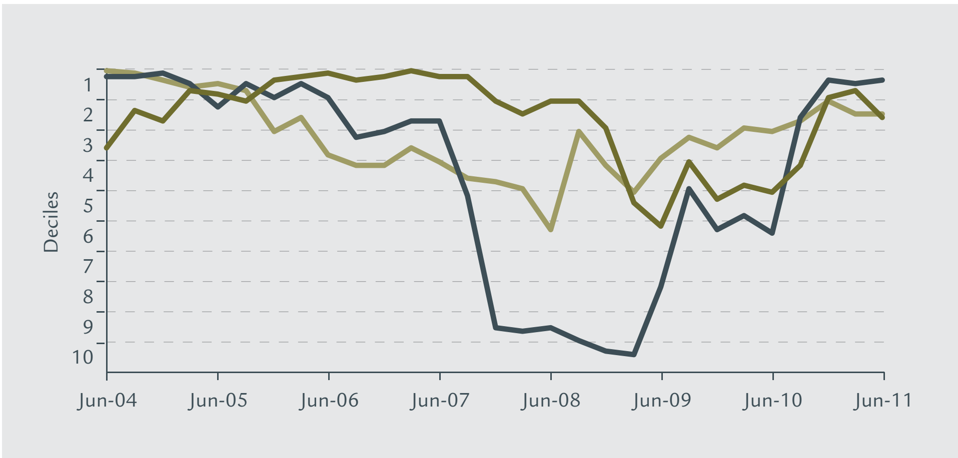
Exhibit 3: Decile 1 Funds: Appearances in Lower Deciles, 2001 – 2011

	# Of Top Funds With at Least One Appearance At or Below Decile:				
	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
Quartely	9	9	9	9	9
1 - Year Roling	9	9	9	9	7
3 - Year Rolling	9	6	6	5	1

Source: Morningstar®, The Brandes Institute; 6/30/01 - 6/30/11. **Past performance is not a guarantee of future results.**

These findings suggest that short-term underperformance relative to peers is to be expected, even for funds that perform well over the long term. Exhibit 4 examines a different angle of the 3-year rolling performance shown in the preceding table. We focused on the ranking progression of the top 3 funds through the decade. We observe that even one of these gold-, silver-, or bronze-medal funds reached the notorious 10th decile once during the full period, and each was at or below the middle deciles at some point through the decade.

Exhibit 4: Top 3 Funds Ranking Based on Rolling 3-Year Annualized Returns, 2001-2011



Source: Morningstar®, The Brandes Institute; 6/30/01 - 06/30/11. **Past performance is not a guarantee of future results.**

IN CONCLUSION

Short-term underperformance can be frustrating. However, we believe that it may not necessarily be a cause for alarm, and may even be an inherent byproduct of the investment process that is behind a successful longer-term record. Investors may find it difficult to endure periods of underperformance but patient long-term investors have the potential to be rewarded.

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

Mutual Fund investing involves risk. Principal loss is possible. Foreign investments involve additional risks, including currency fluctuations, political instability, differences in financial reporting standards and less stringent regulation of securities markets.

The MSCI World Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of May 27, 2010 the MSCI World Index consisted of 24 developed market country indices. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

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

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