Death, Taxes, and Short-Term Underperformance: Fixed Income Mutual Funds

In our original *Death, Taxes, and Short-Term Underperformance* studies, we examined the short-term underperformance of U.S. and non-U.S. equity mutual funds. Our research found that investors in U.S. and non-U.S. equity funds should expect periods of underperformance – both vs. 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. Given these findings for equity funds, we were curious to examine fixed income mutual funds to determine if they exhibited similar characteristics to their equity counterparts.

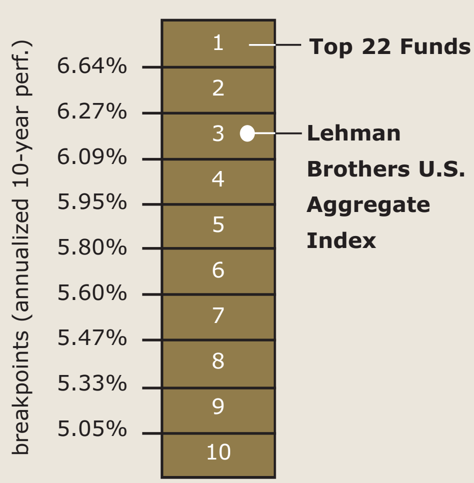
THE SAMPLE: 224 FIXED INCOME FUNDS

From the Morningstar database as of 12/31/06

- Actively managed U.S. fixed income funds
- Intermediate-term, long-term, and multisector bond funds
- 10 years of performance data available
- World bond funds excluded
- Multiple share classes excluded

THE DECILES: FIXED INCOME FUNDS RANKED BY 10-YEAR ANNUALIZED PERFORMANCE

1997 - 2006



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

To investigate, we initiated a query using methodology that paralleled our prior studies. Again using the Morningstar database, we focused on actively managed U.S. fixed income funds. Our analysis focused on funds that consisted mainly of intermediate-term, long-term, and multisector bond funds. Our sample included funds that had at least 10 years of performance data as of December 31, 2006, and funds within Morningstar's world bond category[1] were excluded. These criteria yielded a sample of 224 fixed income funds.

Using an approach identical to the methodology applied to our equity universe, our first step was to divide this sample into

[1] According to the Morningstar definition, funds within the world bond category invest 40% or more of their assets in foreign bonds.

deciles based on the funds' performance for the entire 10-year period. For example, decile 1 consisted of the 22 funds with the highest 10-year annualized returns, while the 22 funds with the next-highest returns formed decile 2, and so on. (Per statistical convention, deciles 4, 5, 6, and 7 contained 23 funds.) 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.

Underperformance vs. the benchmark

As the illustration on the first page shows, the top 22 fixed income funds in the sample posted an annualized gain of at least 6.64% over the 10-year period. All of these "decile 1" funds outperformed the Lehman Brothers U.S. Aggregate Index ("the Index"), which returned 6.24% during the decade.

While the top 22 funds outdistanced the Index for the 10-year period as a whole, most of them underperformed the Index substantially during various shorter periods within the decade. For instance, in their worst 1-year rolling periods, the top 22 fixed income funds underperformed the Index by margins ranging from 0.79% to 21.85%, as illustrated in the table below. On average, these funds trailed the Index by 8.37% in their worst 1-year rolling period. Underperformance versus the Lehman Brothers U.S. Aggregate Index was also noteworthy in most of the funds' worst *3-year rolling* period.

TOP 22 FUNDS: RELATIVE PERFORMANCE
VS. LEHMAN BROTHERS U.S. AGGREGATE INDEX
1997 - 2006 (ANNUALIZED ROLLING PERIODS)

	in worst 1-year rolling period	in worst 3-year rolling period
Range of top 22 funds	-0.79% to -21.85%	0.24% to -6.59%
Average of top 22 funds	-8.37%	-2.82%

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

Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. A hypothetical example is the 10-year time period from 12/31/96 through 12/31/06, this time period consists of 29 three-year segments on a rolling quarterly basis. The first segment is the three-year period 12/31/96 - 12/31/99, the next segment is the three-year period 3/31/96 - 3/31/99, and so on.

The table above reveals the level of short-term underperformance even top funds experienced. In the bond universe, where 10 basis points in annualized outperformance is notable, the average worst 1-year underperformance for the top funds was 8.37% – *or 837 basis points*. Considering that bond investors tend to be more averse to volatility than equity investors, significant relative underperformance can be difficult to endure.

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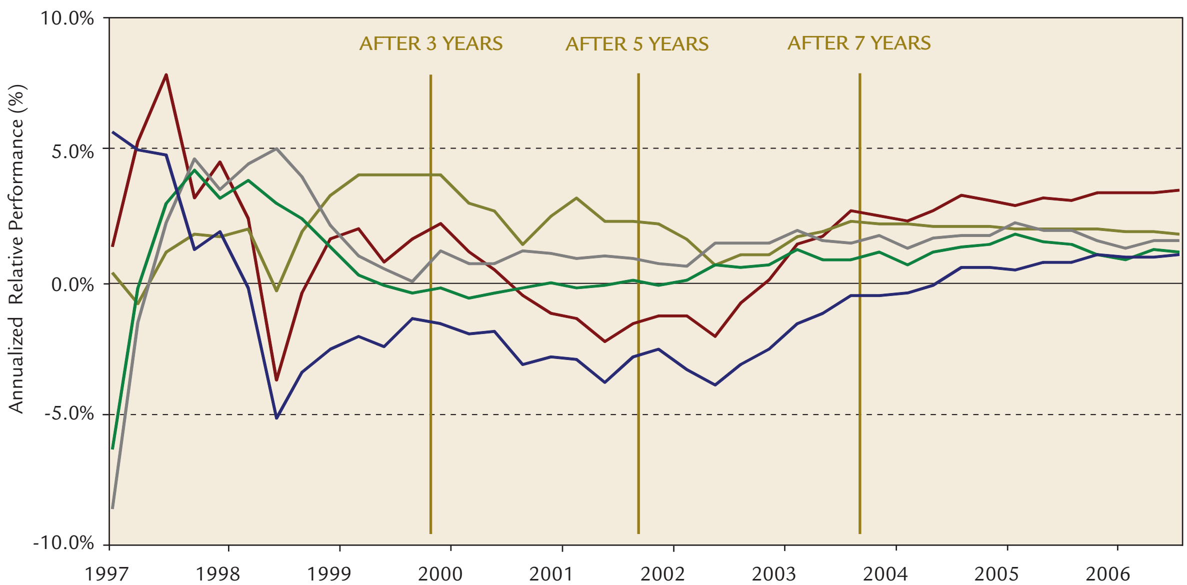
In our opinion, this indicates that short-term underperformance for fixed income funds vs. the index might not have been unusual, even for those funds that outperformed over the long term. To further illustrate this point, we examined the relative performance of the top five funds[2] in decile 1 on a quarter-by-quarter basis across the decade.

As shown below, not all of the top five funds outperformed the Index on a quarterly basis through the entire decade. Instead, each fund underperformed the Index at various points during the period. In fact, three of the top five funds trailed the Index near the decade's midway point, before pulling ahead in subsequent years. Return histories for the rest of the top 22 funds (not shown) revealed similar propensities for short-term underperformance.

TOP FIVE FUNDS: RELATIVE PERFORMANCE VS. LEHMAN BROTHERS U.S. AGGREGATE INDEX
1997 - 2006 (ANNUALIZED)



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

[2] Please note that the top five funds based exclusively on 10-year annualized performance were fund offerings from the same investment management firm. Due to the highly correlated nature of these funds, the top five performing funds used in this study were comprised of the top-performing fund from this firm, and the subsequent top four funds from different investment managers based on 10-year annualized performance. We believe this illustrates a more accurate representation of fixed income funds from differing firms rather than illustrating the performance history of five funds from one investment manager.

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Underperformance relative to peers

We believe the illustration on the prior page helps demonstrate that short-term underperformance vs. the benchmark has not been unusual – even for fixed income funds that performed well in the long run. But what about short-term underperformance relative to peers? Did funds that posted favorable long-term results tend to lag their peers during shorter time spans?

To find out, we examined how the top 22 fixed income funds in our sample performed against their peers in short-term periods. As mentioned above, these 22 funds posted the highest returns during the decade under review, placing them in decile 1 based on 10-year annualized performance. For shorter performance periods within the decade, however, these decile 1 funds often appeared in lower deciles.

In terms of quarterly performance, all 22 of the top 22 funds made at least one appearance in deciles 6, 7, 8, and 9 during the decade – and 20 of the 22 showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year periods, the top 22 funds also experienced underperformance relative to their peers, as the table below shows. For example, more than half of these funds made at least one appearance at or below decile 8 based on 3-year annualized returns. And the 3-year performance of nine of the decade's top 22 funds ranked in the very last decile at least once during the decade.

TOP 22 FUNDS: APPEARANCES IN LOWER DECILES
1997 - 2006

	# of top 22 funds, with at least one appearance at or below...				
	decile 6	decile 7	decile 8	decile 9	decile 10
Based on quarterly performance	22	22	22	22	20
Based on annualized 1-year performance	22	22	21	19	18
Based on annualized 3-year performance	17	16	13	12	9

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

These findings suggest that short-term underperformance relative to peers is to be expected, even for funds that may perform well over the long term. We also examined the 3-year annualized performance of the top five funds[2] 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 the next page shows, these five funds – which represent the top-performing fixed income funds in our sample based on 10-year annualized returns – all had 3-year annualized performance in decile 6 or lower at more than one point in the decade. Annualized performance for the rest of the top 22 funds (not shown) also tended to dip substantially for select 3-year periods.

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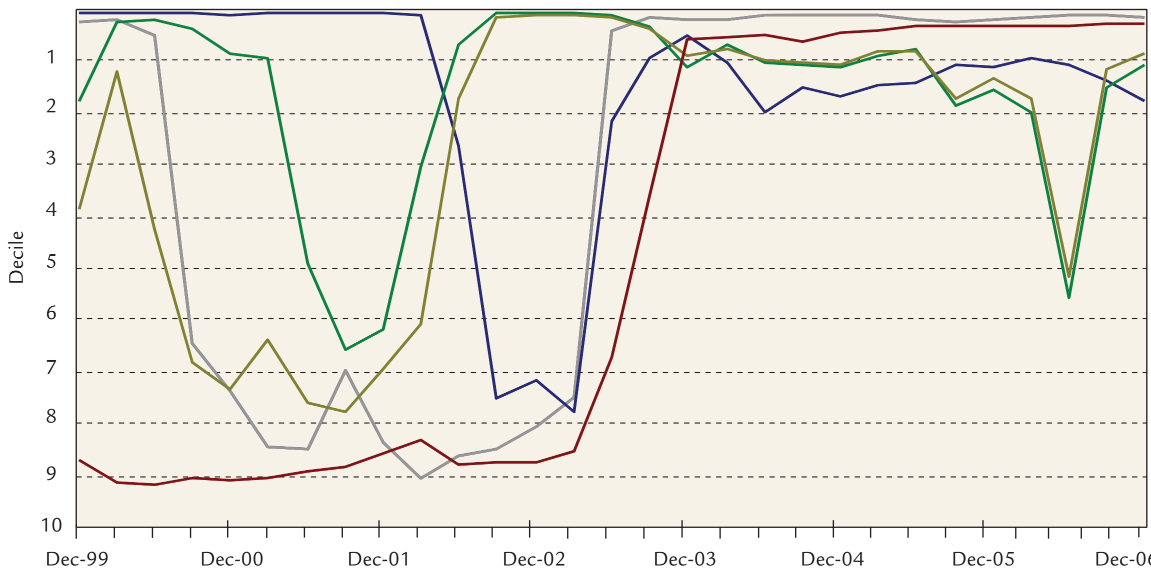
TOP FIVE FUNDS: DECILE BASED ON ROLLING 3-YR. ANNUALIZED PERFORMANCE

1997 - 2006



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

Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. A hypothetical example is the 10-year time period from 12/31/96 through 12/31/06, this time period consists of 29 three-year segments on a rolling quarterly basis. The first segment is the three-year period 12/31/96 - 12/31/99, the next segment is the three-year period 3/31/96 - 3/31/99, and so on.

In Conclusion

Short-term underperformance can be frustrating. At the Brandes Institute, however, we believe that it may not necessarily be a cause for alarm, and may even be an inherent consequence of the investment process that is behind a successful longer-term record.

As a result, 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 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.

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Index Guide:
Lehman Brothers U.S. Aggregate Index: The Lehman Brothers U.S. Aggregate Index is an unmanaged index consisting of more than 5,000 taxable U.S. government, investment-grade corporate and mortgage backed securities. Securities must be dollar-denominated, public issues with at least $150 million par amount outstanding. Securities must be rated investment grade (Baa3 or better) by Moody's. If Moody's rating is not available, a comparable rating from Standard & Poor's or Fitch is used. Indices are unmanaged and are not available for direct investment.

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