

Death, Taxes, and Short-Term Underperformance: Non-U.S. Mutual Funds

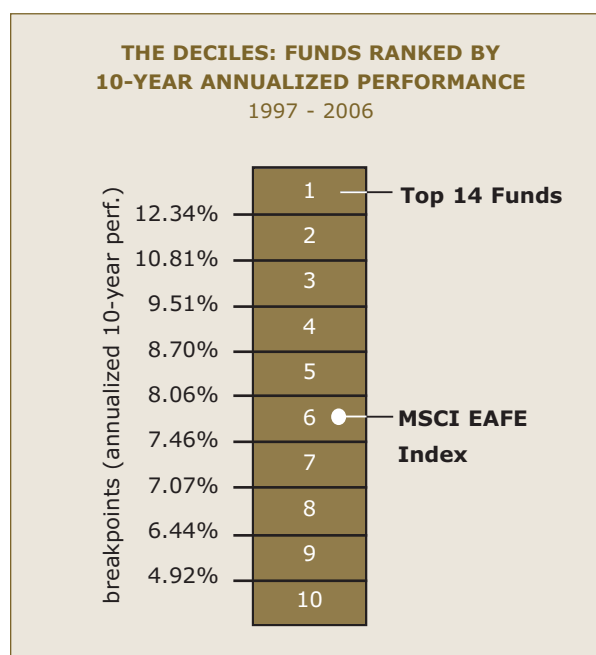
While perhaps not as certain as death or taxes, short-term underperformance for mutual fund managers – even those with exceptional long-term results – is commonplace. To draw this conclusion, we analyzed actively managed international stock funds (those mostly or completely invested in non-U.S. stocks) in the Morningstar database. We studied 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 147 mutual funds.

Our first step was to divide this sample into deciles based on the funds' annualized performance for the entire 10-year period. For example, decile 1 consisted of the 14 funds with the highest 10-year annualized returns, while the funds with the next-highest returns formed decile 2, and so on. (Per statistical convention, deciles 2, 3, 4, 5, 7, 8, and 9 contained 15 funds.)

THE SAMPLE: 147 MUTUAL FUNDS

From the Morningstar database as of 12/31/06

- Actively managed international stock 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



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

As the chart at left shows, the top 14 funds in the sample posted an annualized gain of at least 12.34% over the 10-year period. All of these “decile 1” funds outperformed the MSCI EAFE Index (“the Index”), which returned 7.71% during the decade. 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.

While the top 14 funds outdistanced the MSCI EAFE Index for the 10-year period as a whole, most of them underperformed the Index substantially during various

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shorter periods within the decade. For instance, in their worst 1-year rolling periods, the top 14 funds underperformed the Index by margins ranging from 3.46% to 34.92%, as the table below shows. On average, these funds trailed the Index by 12.71% in their worst 1-year rolling period. Underperformance versus the Index was also noteworthy in most of the funds' worst 3-year rolling period.

TOP 14 FUNDS: RELATIVE PERFORMANCE VS. MSCI EAFE INDEX
1997 - 2006 (ANNUALIZED ROLLING PERIODS)

	in worst 1-year rolling period	in worst 3-year rolling period
Range of top 14 funds	-3.46% to -34.92%	1.47% to -8.85%
Average of top 14 funds	-12.71%	-2.93%

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

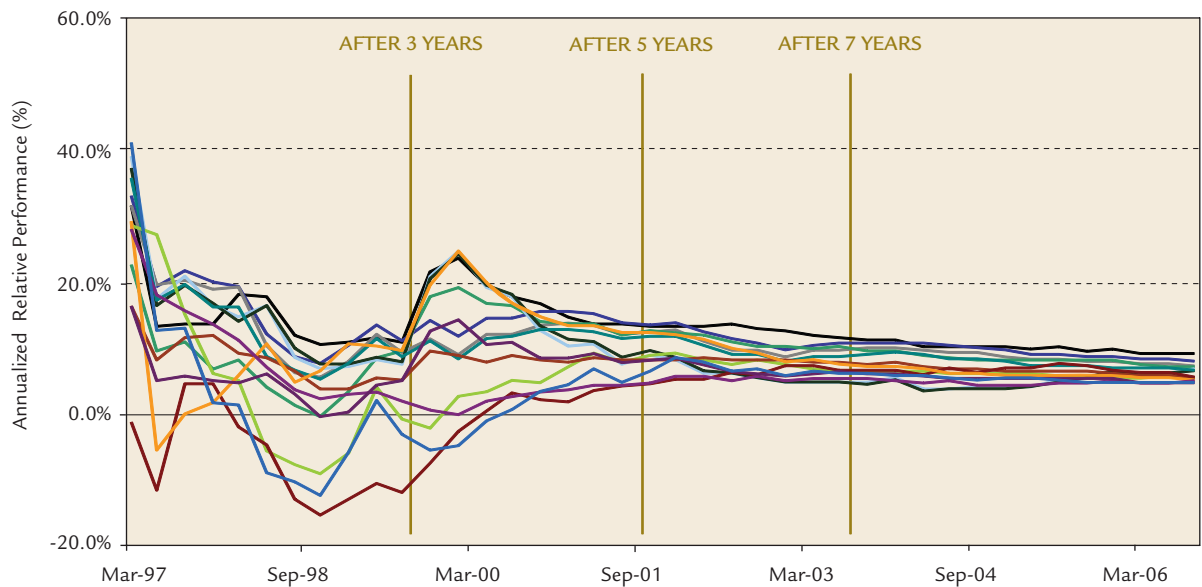
Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. A hypothetical example is the 10-year time period from 12/31/96 through 12/31/06, this time period consists of 29 three-year segments on a rolling quarterly basis. The first segment 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 our opinion, this indicates that short-term underperformance versus the Index might not have been unusual, even for the funds that outperformed over the long term. To further illustrate this point, we examined the relative performance of the top 14 funds on a quarter-to-quarter basis across the decade.

As the chart on the next page shows, not all of the top 14 funds outperformed the MSCI EAFE Index on a quarterly basis through the entire decade. Instead, select funds underperformed the Index at various time periods during the decade. Return histories for the rest of the funds in our study (not shown) revealed similar propensities for short-term underperformance.

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TOP 14 FUNDS: RELATIVE PERFORMANCE VS. MSCI EAFE INDEX
1997 - 2006 (ANNUALIZED)



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

Underperformance relative to peers

Although the top 14 funds (those in decile 1) in our study posted the best annualized returns versus their peers over the 10-year period, they often appeared in lower deciles during shorter performance periods within the decade.

In terms of quarterly performance, all 14 of the decile 1 funds made at least one appearance in deciles 6, 7, and 8 during the decade – and 13 of the 14 showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year rolling periods, the top 14 funds also experienced underperformance relative to their peers, as the table on page 4 shows. For example, seven of these funds made at least one appearance at or below decile 8 based on 3-year annualized returns. And the 3-year annualized performance of four of the decade's top 14 funds ranked in the very last decile at least once during the decade.

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TOP 14 FUNDS: APPEARANCES IN LOWER DECILES

1997 - 2006

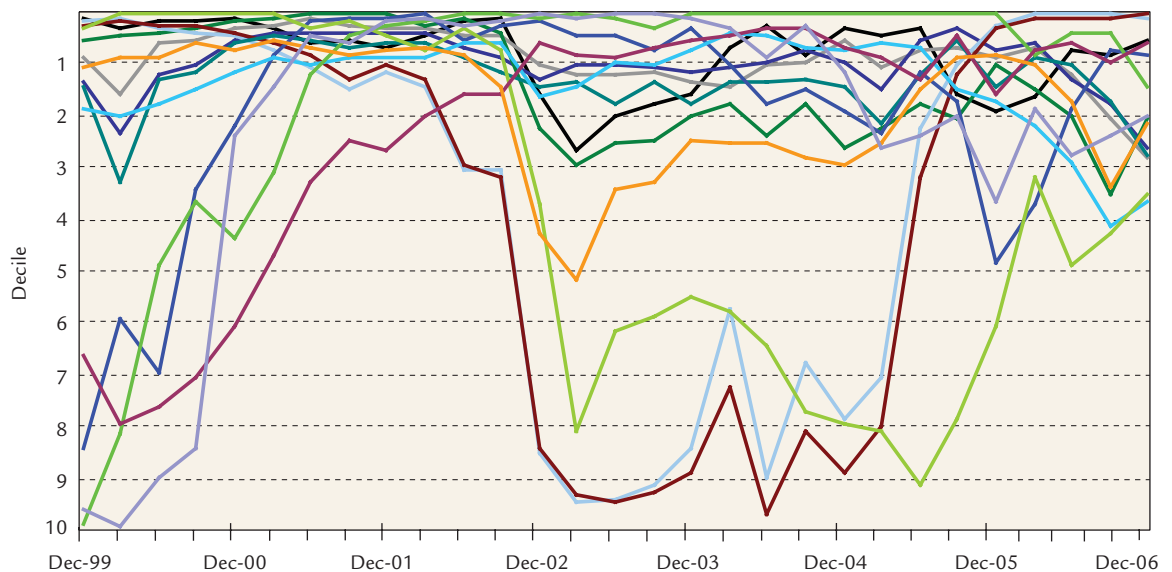
	# of top funds, with at least one appearance at or below...				
	decile 6	decile 7	decile 8	decile 9	decile 10
Based on quarterly performance	14	14	14	13	13
Based on annualized 1-year performance	14	13	13	10	9
Based on annualized 3-year performance	8	7	7	6	4

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 14 funds in decile 1 on a quarter-by-quarter basis, for each of the 3-year periods in the decade under review. As the chart below shows, many of these 14 funds – which represent the top decile of our sample based on 10-year annualized returns – had 3-year annualized performance that tended to dip into lower deciles at more than one point during the decade.

TOP 14 FUNDS: DECILE BASED ON ROLLING 3-YEAR 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.

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In Conclusion

An investor who wishes to achieve long-term relative outperformance faces two main challenges: 1) selecting a fund capable of generating this performance, and 2) enduring the seemingly inevitable period(s) of short-term underperformance.

Our research examined the second challenge – given a set of top-decile funds, what is the likelihood and degree of underperformance an investor might experience?

Our findings suggest that short-term underperformance – for periods ranging from one quarter to up to three years – can be a normal and frequent occurrence, even for top-performing funds. An investor focused solely on relative short-term performance may be likely to abandon a top-performing (based on long-term returns) mutual fund.

At the Brandes Institute, we believe investors who recognize this potentially frequent occurrence, and apply a disciplined investment strategy that weighs funds over longer time periods, may be better positioned for long-term success.

Past performance is not a guarantee of future results.

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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Index guide

MSCI EAFE: The MSCI EAFE Index is an unmanaged index consisting of equities from Europe, Australasia, and the Far East. The index is often used as a benchmark for international equity portfolios and includes dividends and distributions net of corresponding withholding taxes, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing. Indices are unmanaged and are not available for direct investment.

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