Death, Taxes, and Short-Term Underperformance: Global Equity 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. mutual funds. Our research found that investors in U.S. and non-U.S. 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. Given these findings for U.S. and non-U.S. equity funds, we were curious to examine global equity mutual funds to determine if they exhibited similar characteristics.

THE SAMPLE: 76 MUTUAL FUNDS

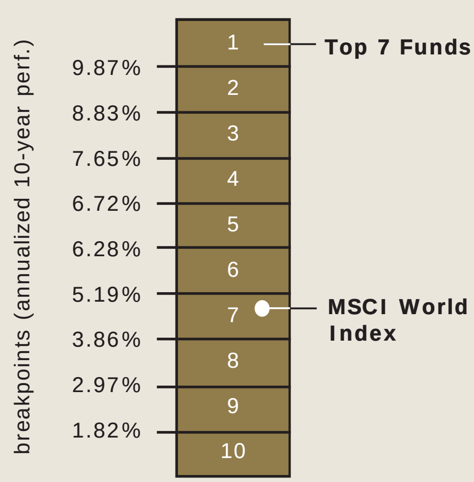
From the Morningstar database as of 6/30/08

- Actively managed 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

To investigate, we initiated a query using methodology that paralleled our prior studies. Again using the Morningstar database, we focused on actively managed global equity funds. Our analysis focused on 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, 2008, while excluding multiple share classes, index funds and enhanced index funds. These criteria yielded a sample of 76 global equity funds.

EXHIBIT 1: THE DECILES: GLOBAL EQUITY FUNDS RANKED BY 10-YEAR ANNUALIZED PERFORMANCE

JUNE 1998 - JUNE 2008



Source: Morningstar, The Brandes Institute; as of 6/30/08

Using an approach identical to the methodology applied to our previous equity universes, 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 7 funds with the highest 10-year returns, while the 8 funds with the next-highest returns formed decile 2, and so on.[1] 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.

[1]Per statistical convention, deciles 1, 4, 8, and 10 contained 7 funds while deciles 2, 3, 5, 6, 7, and 9 contained 8 funds.

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Underperformance versus the benchmark

As Exhibit 1 shows, the top 7 mutual funds in the sample posted an annualized gain of at least 9.87% over the 10-year period. All of these "decile 1" funds outperformed the MSCI World Index ("the Index"), which returned 4.65% during the decade.

While the top 7 funds outdistanced the benchmark 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 periods, the top 7 mutual funds underperformed the Index by margins ranging from 4.11% to 18.25%, as illustrated in Exhibit 2. Relative performance versus the MSCI World Index was also noteworthy in each fund's worst 3-year rolling period.

EXHIBIT 2: TOP 7 FUNDS: RELATIVE PERFORMANCE VS. MSCI WORLD
JUNE 1998 - JUNE 2008 (ANNUALIZED ROLLING PERIODS)

	in worst 1-year rolling period	in worst 3-year rolling period
Range of top 7 funds	-4.11% to -18.25%	2.97% to -4.89%
Average of top 7 funds	-10.82%	-0.98%

Source: Morningstar, The Brandes Institute; as of 6/30/08

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 3/31/97-3/31/00, and so on.

Exhibit 2 reveals the level of short-term underperformance even top funds experienced. The average worst one-year underperformance for the top funds was 10.82% – *or 1082 basis points*. Although global equity investors can expect to bear some additional risk, significant relative underperformance can be difficult to endure.

In our opinion, this indicates that short-term underperformance for global equity funds 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 seven funds in decile 1 on a quarter-by-quarter basis across the decade.

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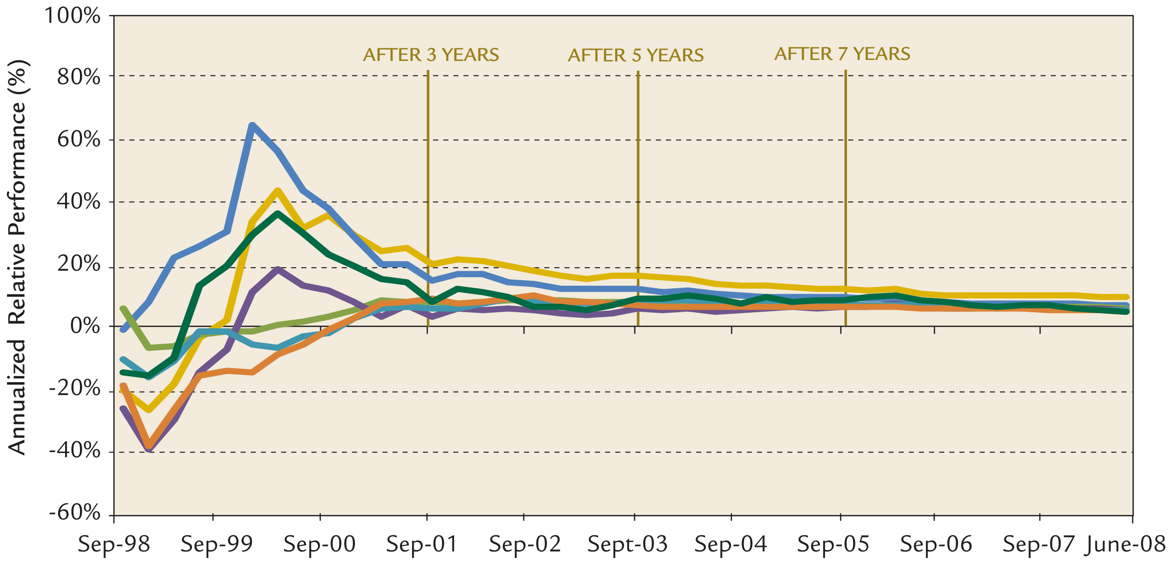
As Exhibit 3 shows, not all of the top seven funds outperformed the Index on a quarterly basis through the entire decade. Indeed, six of the top seven funds were underperforming the Index at the beginning of the period.

EXHIBIT 3: TOP SEVEN FUNDS: RELATIVE PERFORMANCE VS. MSCI WORLD INDEX
1998 - 2008



Source: Morningstar, The Brandes Institute; as of 6/30/08

Underperformance relative to peers

We believe this evidence helps demonstrate that short-term underperformance versus the benchmark has not been unusual. 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 seven global equity funds in our sample performed against their peers in short-term periods. As mentioned above, these seven 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 performance, all seven of the top seven funds made at least one appearance in deciles 6, 7, 8, and 9 during the decade – and six of the seven showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year rolling periods, the top seven funds also experienced underperformance relative to their peers, as the table below shows. For example, six of these funds made at least one appearance in deciles 8 and 9, while two funds appeared in decile 10, based on 1-year annualized returns.

EXHIBIT 4: TOP 7 FUNDS: APPEARANCES IN LOWER DECILES
1998 - 2008

	# of top 7 funds, with at least one appearance at or below				
	decile 6	decile 7	decile 8	decile 9	decile 10
Based on quarterly performance	7	7	7	7	6
Based on annualized 1-year performance	7	7	6	6	2
Based on annualized 3-year performance	4	3	2	1	0

Source: Morningstar, The Brandes Institute; as of 6/30/08

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 seven funds in our sample on a quarter-by-quarter basis for each of the 3-year periods in the decade under review. As Exhibit 5 shows, of these seven funds – which represent the top-performing global equity funds in our sample – four funds had 3-year annualized performance in decile 5 or lower at more than one point in the decade, while an additional fund performed in decile 5 in only one 3-year period.

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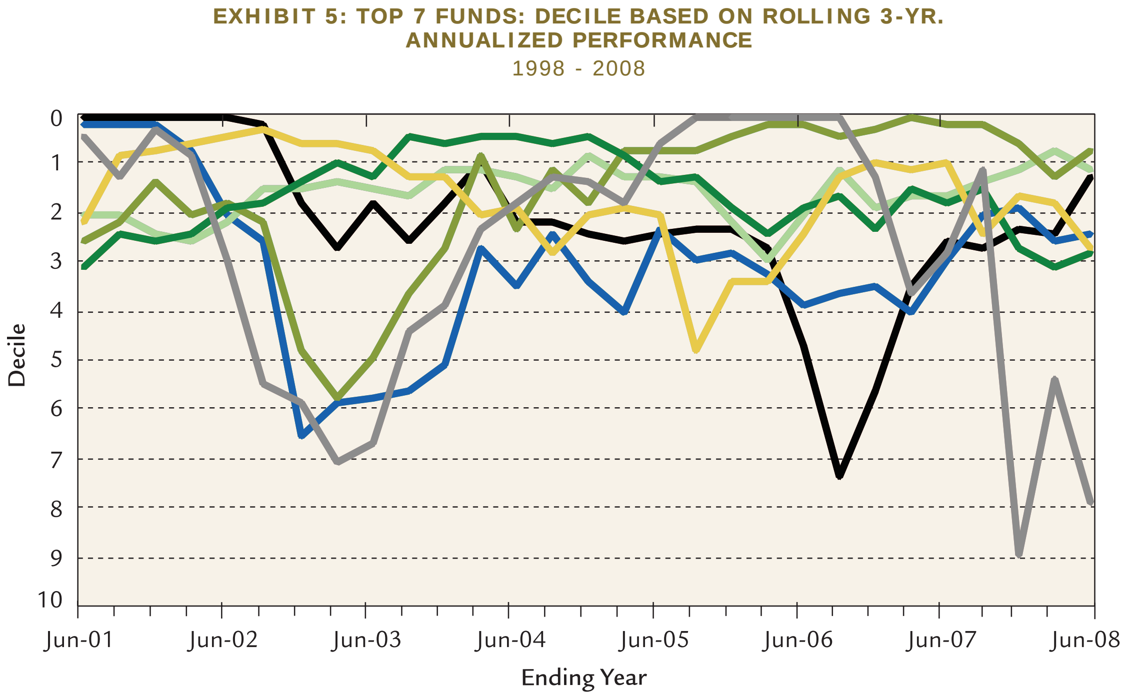

Source: Morningstar, The Brandes Institute; as of 6/30/08

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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.

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.

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Past performance is not a guarantee of future results.

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Basis points – a basis point equals .01%.

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Index Guide:

MSCI World Index: The MSCI World Index is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure equity market performance of the developed markets throughout the world, including the United States. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

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