

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

Investors in actively managed funds are usually cognizant of not only absolute performance, but performance relative to a benchmark and peers. Underperformance in shorter periods can be frustrating for many investors. At the Brandes Institute, a division of Brandes Investment Partners, L.P., 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.

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

In our original *Death, Taxes, and Short-Term Underperformance* study of international (non-U.S.) equity funds, with performance through 2006, our research found that investors in these 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.

After two and a half years characterized by volatile equity markets, we wanted to revisit the performance of non-U.S. equity funds – are extended periods of underperformance still to be expected for the mutual funds with the top long-term performance? We begin by revisiting the methodology, then share the updated results.

Checking the Numbers

To evaluate the 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 because performance histories for a wide range of funds are readily available. We believe mutual funds are an acceptable vehicle for the purposes of examining short-term underperformance.

THE SAMPLE: 170 MUTUAL FUNDS

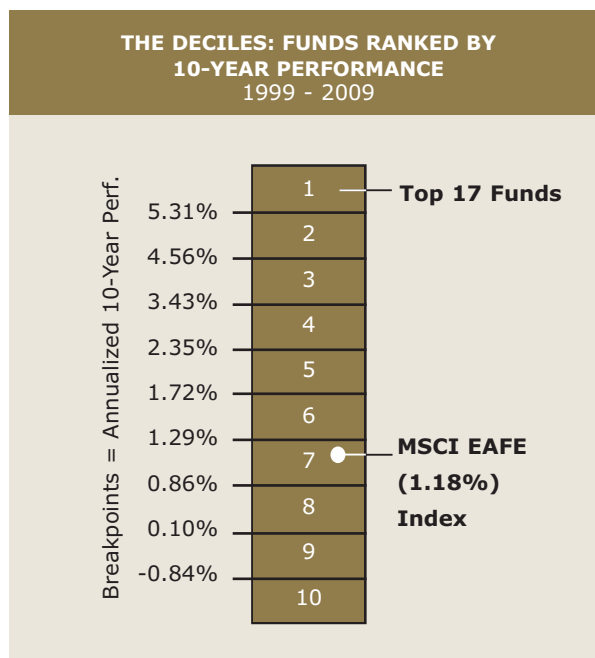
From the Morningstar database as of 6/30/09

- Actively managed international 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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Our Morningstar query focused on actively managed non-U.S. funds with large-cap value, large-cap growth, or large-cap blend mandates, and 10 years of performance data available as of June 30, 2009. These criteria yielded a sample of 170 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 17 funds with the highest 10-year returns, while the funds with the next-highest returns formed decile 2, and so on. 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.



Underperformance Versus the Benchmark

As the chart to the left shows, the top 17 funds in the sample posted an annualized gain of at least 5.31% over the 10-year period. All of these “decile 1” funds outperformed the MSCI EAFE Index, which advanced 1.18% during the decade.

Source: Morningstar, The Brandes Institute; as of 6/30/09
Past performance is not a guarantee of future results.

While the top 17 funds outdistanced the MSCI EAFE 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 periods¹, the top 17 funds underperformed the MSCI EAFE Index by margins ranging from 19.9% to 32.4%, as the table on the next page shows.

¹ 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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On average, these funds trailed the Index by 25.1% in their worst 1-year rolling period. Underperformance versus the MSCI EAFE Index was also significant in each fund's worst 3-year rolling period.

TOP 17 FUNDS: OUTPERFORMANCE VS. MSCI EAFE INDEX JUNE 1999 – JUNE 2009 (ANNUALIZED ROLLING PERIODS)

	In Worst 1-Year Rolling Period	In Worst 3-Year Rolling Period
Range of Top 17 Funds	-19.9% to -32.4%	-5.1% to -14.6%
Average of Top 17 Funds	-25.14%	-9.33%

Source: Morningstar, The Brandes Institute; as of 6/30/09
Past performance is not a guarantee of future results.

This short-term underperformance versus the benchmark is consistent with our previous research based on performance through 2006, and still applies to investments that outperform over the long term.

Underperformance Relative to Peers

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

For our research, we examined how the top 17 funds in our sample ranked against their peers in short-term periods. As mentioned above, these funds posted the highest returns during the decade under review, placing them in decile 1 based on 10-year performance. For shorter performance periods within the decade, however, the top 17 funds often appeared in lower deciles.

In terms of rolling quarterly performance, all 17 of the top funds showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year rolling periods, the top 17 funds also experienced underperformance relative to their peers, as the table on the next page shows. For example, nine of these funds made at least one appearance at or below decile 8 based on 3-year rolling returns. Finally, the 3-year rolling performance of 5 of the decade's top 17 funds ranked in the very last decile at least once during the decade.

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TOP 17 FUNDS: APPEARANCES IN LOWER DECILES
JUNE 1999 – JUNE 2009

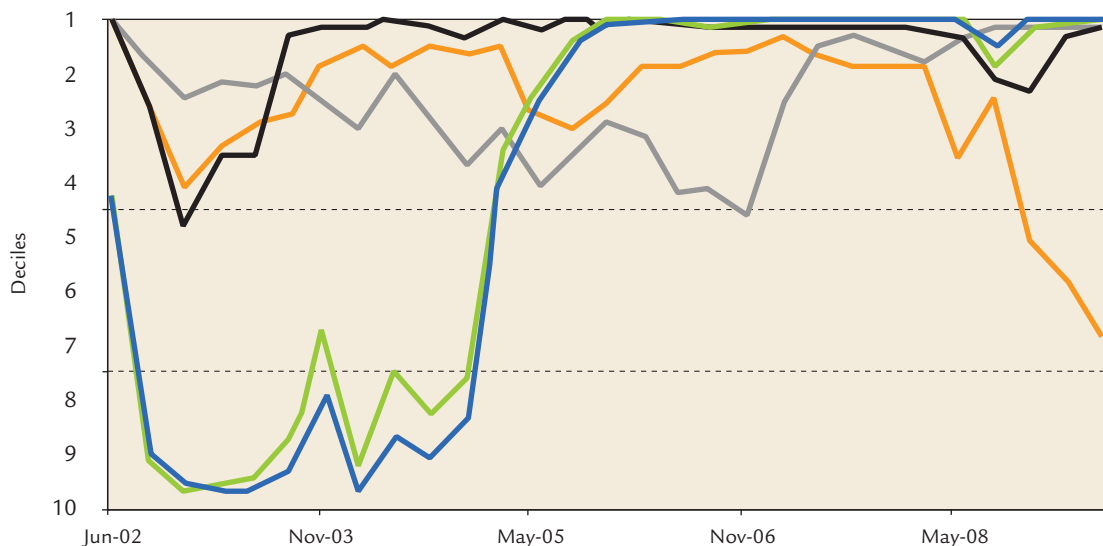
	Of top 17 funds, # with at least one appearance at or below...				
	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
Based On Quarterly Performance	17	17	17	17	17
Based On Annualized 1-Year Performance	17	16	15	15	11
Based On Annualized 3-Year Performance	14	12	9	7	5

Source: Morningstar, The Brandes Institute; as of 06/30/09
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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 below shows, four 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 17 funds (not shown) also tended to dip substantially for select rolling 3-year periods.

TOP FIVE FUNDS: RANKING BASED ON 3-YEAR ROLLING PERFORMANCE
JUNE 1999 – JUNE 2009



Source: Morningstar, The Brandes Institute; as of 06/30/09
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In Conclusion

While short-term underperformance may be frustrating, our findings suggest underperformance tends to be an endemic element of investing in actively managed mutual funds. In both this study and our previous research, even the funds with the best absolute and relative performance over a 10-year period tended to exhibit this phenomenon. In our opinion, investors who keep this in mind when evaluating short-term underperformance will be better positioned for long-term success.

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The MSCI EAFE (Europe, Australasia, Far East) Index is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed markets, excluding the United States and Canada. This index often is used as a benchmark for international equity portfolios and includes dividends and distributions net of withholding taxes, 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.

International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility.

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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