

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

At the Brandes Institute, a division of Brandes Investment Partners, L.P., we recognize that underperformance in shorter periods, both versus the benchmark and relative to peers, can be frustrating for many investors. With this in mind, 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.

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

In our original *Death, Taxes, and Short-Term Underperformance* study of 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 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 illustrate the limited 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: 643 MUTUAL FUNDS

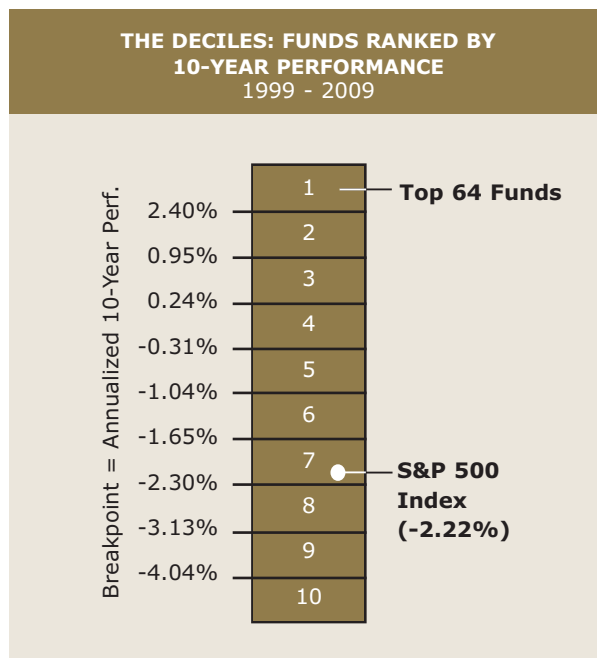
From the Morningstar database as of 6/30/09

- Actively managed U.S. 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 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 643 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 64 funds with the highest 10-year returns, while the funds with the next-highest returns formed decile 2, and so on. (Deciles 4, 5, and 6 contained 65 funds.) 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 at left shows, the top 64 funds in the sample posted an annualized gain of at least 2.40% over the 10-year period. All of these “decile 1” funds outperformed the S&P 500 Index, which declined 2.22% during the decade.

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

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While the top 64 funds outdistanced the S&P 500 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 64 funds underperformed the S&P 500 Index by margins ranging from 11.5% to 40.5%, as the table below shows. On average, these funds trailed the Index by 22.43% in their worst 1-year rolling period. Underperformance versus the S&P 500 Index was also significant in each fund's worst 3-year rolling period.

TOP 64 FUNDS: PERFORMANCE VS. S&P 500 INDEX
JUNE 1999 – JUNE 2009 (ANNUALIZED ROLLING PERIODS)

	In Worst 1-Year Rolling Period	In Worst 3-Year Rolling Period
Range of Top 64 Funds	-11.5% to -40.5%	1.5% to -17.8%
Average of Top 64 Funds	-22.43%	-8.30%

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 above helps demonstrate that short-term underperformance versus the benchmark is not unusual – even for portfolios that perform strongly in the long run. But 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?

To find out, we examined how the top 64 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 64 funds often appeared in lower deciles.

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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In terms of rolling quarterly performance, 63 of the top 64 funds made at least one appearance in deciles 6, 7, 8, and 9 during the decade – and 61 of the 64 showed up in decile 10 for at least one quarter. When it came to 1-year and 3-year rolling periods, the top 64 funds also experienced underperformance relative to their peers, as the table below shows. For example, 35 of these funds made at least one appearance at or below decile 8 based on 3-year rolling returns. And the 3-year rolling performance of 17 of the decade’s top 64 funds ranked in the very last decile at least once during the decade.

TOP 64 FUNDS: APPEARANCES IN LOWER DECILES
JUNE 1999 – JUNE 2009

	Of top 64 funds, # with at least one appearance at or below...				
	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
Based On Quarterly Performance	63	63	63	63	61
Based On Annualized 1-Year Performance	64	64	61	52	39
Based On Annualized 3-Year Performance	52	43	35	26	17

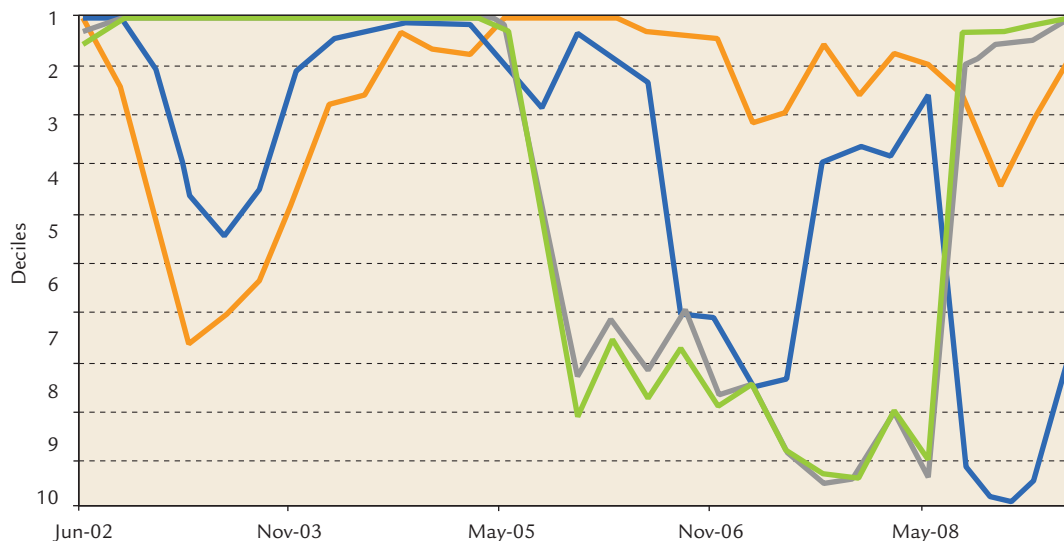
Source: Morningstar, The Brandes Institute; as of 06/30/09
Past performance is not a guarantee of future results.

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 on the next page shows, all 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 64 funds (not shown) also tended to dip substantially for select rolling 3-year periods.

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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 S&P 500 Index is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing. Please note that all indices are unmanaged and are not available for direct investment.

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