How Investors Miss Big Profits

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Back in 1993, a curious thought crossed my mind while analyzing the federal regulations that were new at the time.

Mutual funds were permitted to report investment returns for one, three, five and 10 years ("alpha"), but how many investors actually kept their investments unchanged for those specific periods? If all investors did not hold on to their investments for those precise periods, then they had to be doing better or worse than was being reported.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. Simply stated, alpha represents the value that a portfolio manager adds to or subtracts from a fund's return. Investors' alpha is the value a retail investor adds to or subtracts from the alpha delivered by the portfolio manager. The return of the respective index is considered to be zero alpha, so any excess over the index is considered positive investor alpha.

I developed a calculation that would measure whether mutual fund investors were actually earning more or less than the reported alpha. In 1994, DALBAR issued the first Quantitative Analysis of Investor Behavior (QAIB), showing that investors had severely underperformed the average mutual fund alpha! This underperformance continues to this day.

Investors were actually missing much of the alpha that mutual funds had earned. Using the S&P 500 index to approximate the returns that equity mutual funds produced, investors were leaving between 10.97% and 4.32% on the table, as Table 1 shows.

This shocking finding of underperformance led to research to understand how and why millions of investors were missing so much of the alpha and, ultimately, what they could do to capture more of the profits that funds were earning.

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