FAM FUNDS
Managed by
FENIMORE ASSET MANAGEMENT

THE VALUE OF PATIENCE

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Executive Summary

May 2018 | Topics Covered Include:

Market Timing
Learn why investors attempt market timing, how the environment may encourage it, and if it is possible to do successfully.

Performance Chasing
The investment industry and human nature may foster performance chasing, and it can put a financial advisor in a difficult situation.

Compelling Data
A mutual fund titan outlines what happens when investors focus on maximizing returns.

Know the Course
A key to intelligent, long-term wealth creation

This paper examines two prominent, return-diminishing investment behaviors.

The assertions in this white paper are based on Fenimore Asset Management's opinion. Fenimore Asset Management is the investment advisor to FAM Funds.

Introduction

There are any number of reasons investors may find it difficult to achieve their financial goals. In some cases, unexpected and uncontrollable events can wreak havoc on a financial plan. But it is often an investor's own actions that lead to the failure to meet his or her objectives.

There is a branch of science called Behavioral Finance dedicated to exploring how an individual's propensities and predilections can short circuit rational investment decisions. Unfortunately, the investment environment — including academicians, practitioners, pundits, and the financial press — may be complicit in potentially steering the investor to return-diminishing behaviors such as Market Timing and Performance Chasing.

Fortunately, awareness can be the first step toward avoiding self-defeating behaviors. This paper looks at these two, all-too-common tendencies as well as a rational approach to combat them.

Market Timing

Simply put, market timing is selling stocks just before a person thinks the market will fall and, conversely, buying stocks just before one believes the market will rise. An investor seeking to time the market is trying to accomplish the dual goals of preserving capital and achieving outsized returns.

The financial press may, at times, validate market timing and may lead investors to believe that they *can and should* be doing it. The question frequently asked in the financial news, "Is this the time to buy (sell) stocks?" reverberates throughout the media.

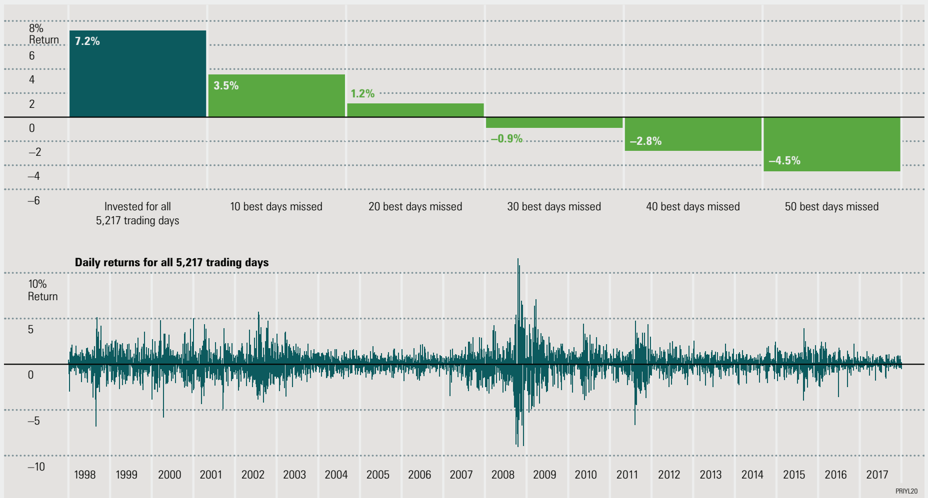
For example, *The Wall Street Journal* cites market strategists who advocate changes to stock holdings based on predictions of how financial markets will react to geopolitical events, economic data releases, or even past movements in the markets. Additionally, investment newsletters tell subscribers when to "get in" and "get out" of stocks, bonds, and other assets. Yet, financial markets are inherently unpredictable and there is overwhelming evidence that not only does market timing not work, it also can diminish long-term returns.

Is Successful Market Timing Possible?
A market timer must be clairvoyant with respect to two decisions: when to buy and when to sell. In a 1975 study, Nobel Laureate William Sharpe determined that investors had to be right on market calls 70% of the time to beat a buy-and-hold strategy. Follow-up studies put the required winning percentage even higher — difficult to do even if the individual believes that financial markets are predictable to a meaningful degree.

The cost of being wrong is significant because long-term returns have historically been driven by a relative handful of days in the market. As indicated in the Morningstar chart on the next page, "The Cost of Market Timing," if an investor misses those days, their performance is radically altered. For instance, if someone remained invested in the S&P 500 Index for 19 years ending in 2017, their annualized return was 7.2%. Astonishingly, missing just the 10 best performance days (out of 5,217 trading days) would cause the return to fall to 3.5%, while dropping the 20 best days results in a return of only 1.2%. Finally, an investor who missed the top 50 days would have garnered a -4.5% return! This type of analysis yields strikingly similar results over many time periods.

The Cost of Market Timing

Risk of missing the best days in the market 1998–2017



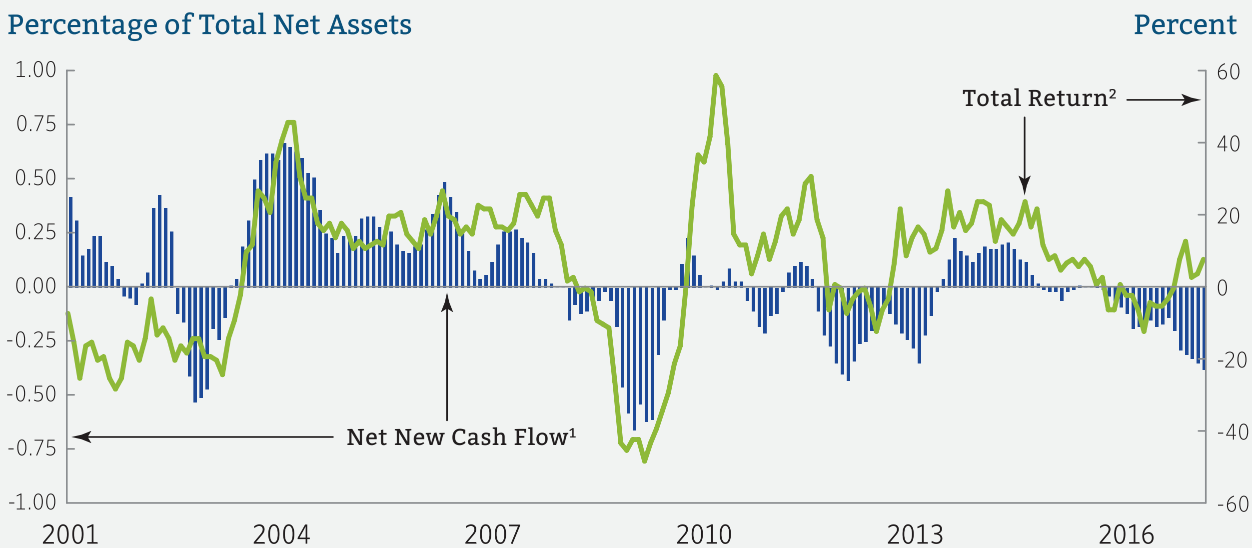
Past performance does not indicate future results.

This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

Despite the long odds of being right and the high costs of being wrong, the graph below details money flowing in and out of equity mutual funds and demonstrates that investors are still tempted to try to time the market.

The Investment Company Institute's study overlaps net new cash flow into equity mutual funds and the corresponding returns on equities. This study confirms that investors, in aggregate, pour money into equities at market peaks and are significantly invested as markets fall — they sell stocks at low points and are less exposed to stocks just as they rebound.

Net New Cash Flow to Equity Mutual Funds Typically is Related to World Equity Returns *(Monthly, 2001–2016)*



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[1] *Net new cash flow is the percentage of previous month-end equity mutual fund assets, plotted as a six-month moving average.*

[2] *The total return on equities is measured as the year-over-year percentage change in the MSCI All Country World Daily Gross Total Return Index.*

Sources: *Investment Company Institute, Morgan Stanley Capital International, and Bloomberg*

Investment Company Institute. 2017. 2017 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry. Washington, DC: Investment Company Institute. Available at www.icifactbook.org.

The investing mantra — buy low and sell high — is turned on its head.

More Evidence

Financial research firm DALBAR has been studying investor behavior for years. In their "Quantitative Analysis of Investor Behavior 2017" they tally just how costly market timing has been. DALBAR found that the average equity investor's compounded annual return over the 30-year period ending December 2016 was 4.0% — more than 6% lower than the 10.2% return on the S&P 500 Index. Between December 2011 and December 2016, the average investor underperformed the market by 4.9%, experiencing an annualized return of 9.8% versus 14.7% for the S&P 500. Much of this difference was due to ill-fated attempts to time the market.[1]

Performance Chasing

Human nature leads investors to strive for maximum returns and our industry further conditions them to always seek more, often in comparison to others. Investors feel compelled to chase performance — to sell funds (fire managers) that are underperforming and buy those funds (hire managers) that are outperforming. After all, how can one be maximizing returns if someone else is doing better? For financial advisors the temptation to chase performance may be amplified when a client asks the seemingly fair question, "Why are we keeping this underperforming fund?"

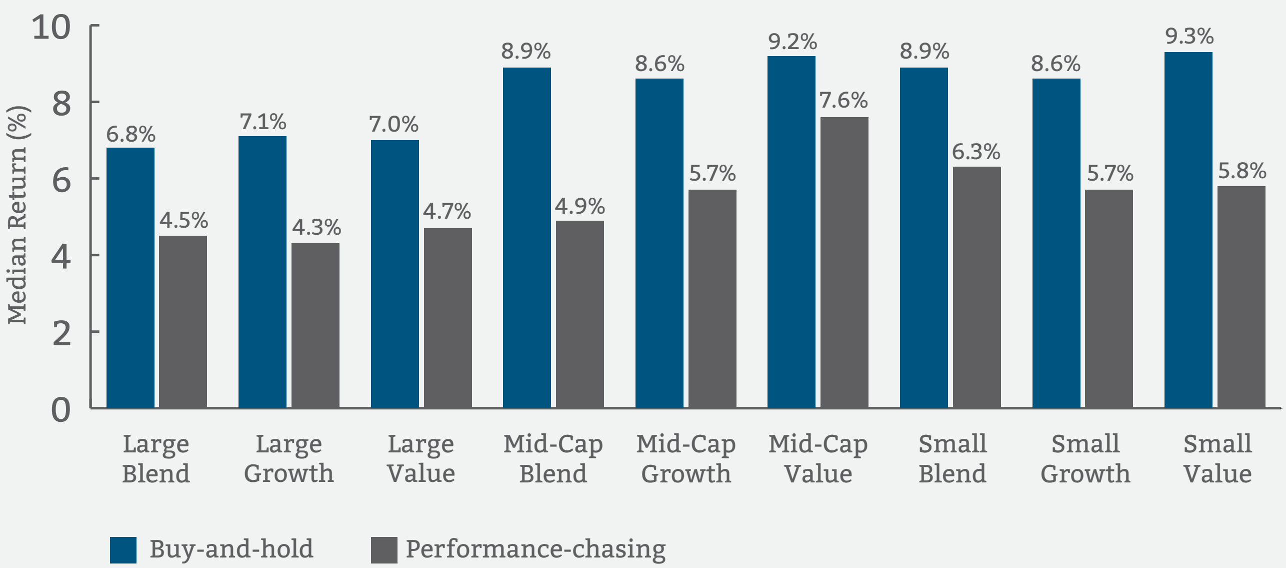
In a July 2014 Vanguard research study titled "Quantifying the impact of chasing fund performance," the mutual fund firm found that performance chasing often diminishes returns. The study used actively-managed, U.S. equity mutual funds available in Morningstar's database that had been in existence for at least three of the 10 years ending 12/31/2013 (3,568 funds). With respect to this universe of funds, Vanguard took Morningstar's nine style categories based on blend, growth, and value subsets of large-, mid-, and small-cap funds, and looked at hypothetical results for each based on buy-and-hold and performance-chasing approaches.

The buy-and-hold strategy was simple: invest in any fund, sell only if the fund was discontinued, and replace a discontinued fund with one of the median-performing equity funds within the style box.

The performance-chasing strategy invested in any fund that had above median 3-year returns for the period 2004 to 2013. Funds that achieved below median returns for a rolling 3-year period were sold and replaced with a fund that achieved an average annual return within the top 20 performing funds over the prior 3-year period.

The results, detailed in the charts below, were conclusive: performance chasing may, in practice, be a hindrance to capital appreciation and wealth building. Furthermore, the Sharpe Ratio (referenced in Figure 2) in each study indicates that performance chasers experienced more volatility en route to their subpar returns.

Figure 1. Buy-and-hold was superior to a performance-chasing strategy across the board: 2004-2013

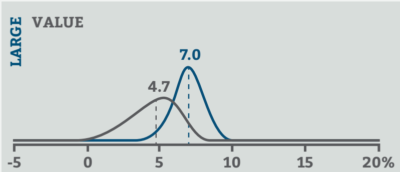


Past performance does not indicate future results.

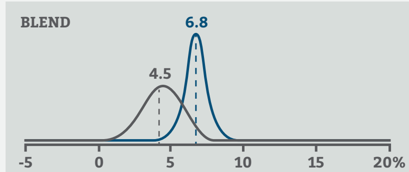
Source: *Vanguard*

[1]*DALBAR's Quantitative Analysis of Investor Behavior 2017*

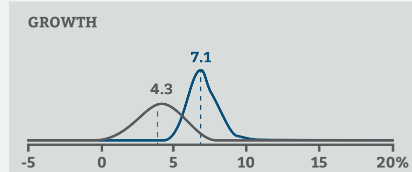
Figure 2. Detailed results of buy-and-hold versus performance-chasing strategies: 2004-2013



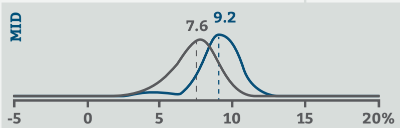
	Return	Sharpe
Buy-and-hold	7.0%	0.37
Performance-chasing	4.7%	0.25
Difference	2.3%	0.12



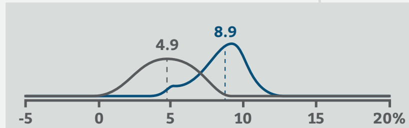
	Return	Sharpe
Buy-and-hold	6.8%	0.36
Performance-chasing	4.5%	0.25
Difference	2.3%	0.11



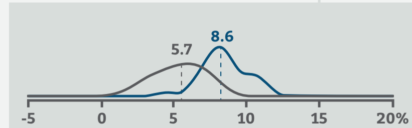
	Return	Sharpe
Buy-and-hold	7.1%	0.36
Performance-chasing	4.3%	0.24
Difference	2.9%	0.12



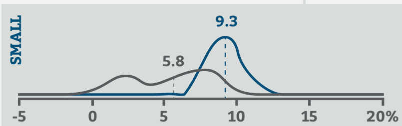
	Return	Sharpe
Buy-and-hold	9.2%	0.44
Performance-chasing	7.6%	0.38
Difference	1.5%	0.06



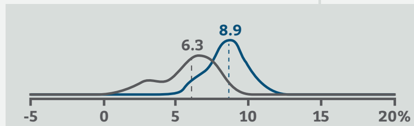
	Return	Sharpe
Buy-and-hold	8.9%	0.43
Performance-chasing	4.9%	0.27
Difference	4.0%	0.16



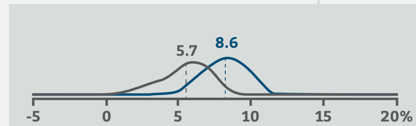
	Return	Sharpe
Buy-and-hold	8.6%	0.41
Performance-chasing	5.7%	0.30
Difference	2.9%	0.11



	Return	Sharpe
Buy-and-hold	9.3%	0.44
Performance-chasing	5.8%	0.29
Difference	3.5%	0.15



	Return	Sharpe
Buy-and-hold	8.9%	0.43
Performance-chasing	6.3%	0.32
Difference	2.6%	0.11



	Return	Sharpe
Buy-and-hold	8.6%	0.40
Performance-chasing	5.7%	0.29
Difference	2.9%	0.11

Past performance does not indicate future results.

Notes: *All returns and Sharpe ratios shown are median annualized; for "Difference," numbers may not compute because of rounding. Area under the curves represents frequency of returns realized under either strategy, similar in effect to a histogram. Dotted lines represent median return of the distribution. Investors prefer distributions with higher median returns and less dispersion, or volatility, around the median.*

Sources: *Vanguard calculations, using data from Morningstar, Inc.'s nine equity style boxes.*

Buy-and-hold investing takes a great deal of discipline and patience, both of which are in short supply against the backdrop of today's chattering class of investment commentators. While performance-chasing investing sounds plausible, it relies on the shaky premise that "past results are indicative of future performance."

Conclusion

How should investors steel themselves against behavioral and external factors that may lead them to attempt to time the market or chase performance? As advisors well know, the key is to have a comprehensive, understandable, long-term investment plan that can serve as a foundation — it is hard to stay the course if you do not know the course. Ultimately, long-term wealth building requires the discipline to avoid self-defeating behaviors.

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