Adams Hall
Asset Management

How to Lose Money in a Top-Performing Fund

An article in the December 31 issue of the Wall Street Journal makes a point that many of us in the financial planning world have long suspected. It says that the CGM Focus fund was the top performing mutual fund, by far, over the past ten years, generating an annualized return of more than 18% a year since January 1, 2000.

Now here's the punchline: the average investor in this top-performing fund lost an average of 11% a year over the same ten year period.

How is it possible for investors to lose their shirts in a fund that posted outsized returns?

Most planning professionals know the fund's manager, Ken Heebner, as a swing-for-the-fences investor, somebody prone to huge runups and equally scary drops. A Chicago-based investment research firm called Morningstar--whose data is used by most financial advisors--calculated what is called the "dollar-weighted" return of the CGM Focus fund, which gives a picture of what investors in the fund actually experienced. If you had bought and held Ken Heebner's portfolio throughout the 2000s, you would indeed have received returns of 18% a year. But the fund was so up and down that investors were alternately panicked and selling out or optimistic and crowding back in.

The article says the most dramatic example came after the fund was up 80% in 2007. Investors flocked in, putting $2.6 billion into the CGM portfolio--just in time to catch its equally-dramatic 48% drop through the end of 2008.

There have been credible studies showing that the average investor underperforms the market, and this illustrates exactly how it happens. Right after an investment generates strong returns, people tend to jump on the bandwagon--and then they experience the subsequent return to reality. When an investment is struggling, people tend to abandon it, and miss out on its recovery. Missing the upside and catching the downside, consistently, is human nature, perfectly understandable behavior. But it inevitably leads to dismal investment results--as it did for the battered, unhappy, money-losing investors in the best-performing mutual fund of the 2000s.