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Bob Stowe, CFP  
Stowe Financial Planning, LLC

**QAIB 2006**  
**Advisor Edition**

**Staying On Track**

***Extract of Quantitative Analysis of Investor Behavior —2006*** ©

You will get an understanding of the "Guess Right Ratio" in this report. It shows that investors abandon their plan at the worst possible times —during down markets. By way of contrast, you will see what happened when investors stayed the course.

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## Guess Right Ratio

### What is the Guess Right Ratio?

The Guess Right Ratio indicates when the average equity investor correctly "guesses" the direction of the market. Net flows into mutual funds are used to determine if investors made short term gains by correctly anticipating the direction of the market. The average investor guesses right when there is either net inflow followed by a market rise or net outflow followed by a down turn.

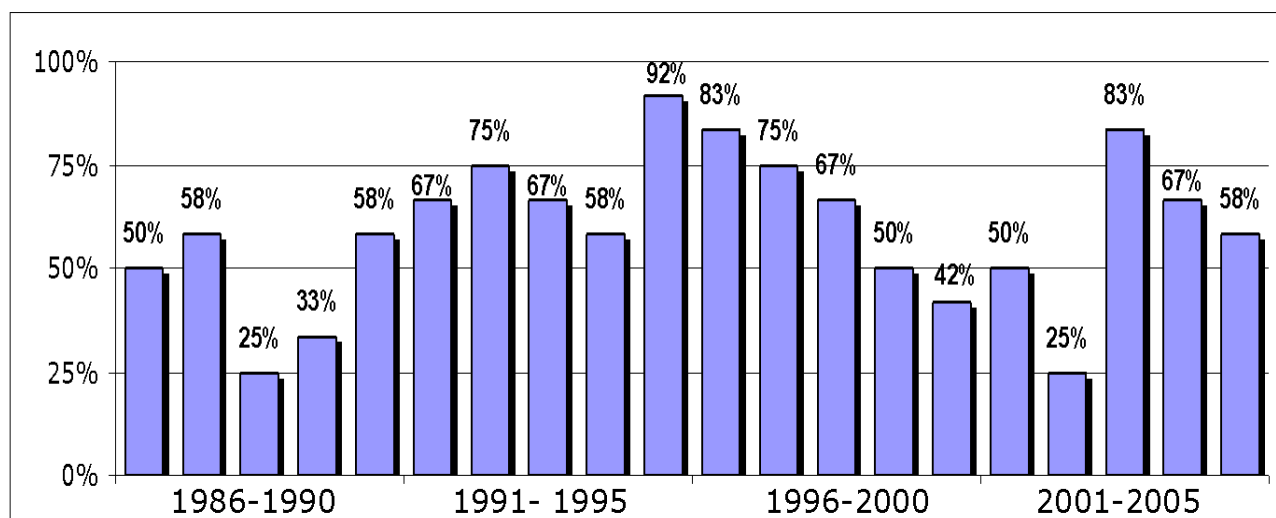
In general, profits are made when the Guess Right Ratio exceeds 50%, indicating that investors must be right at least half the time in order to gain more than is lost.

Note that this statistic is not dollar weighted so it cannot be used to measure returns.

### Investors Guess Wrong During Declines

The Guess Right Ratio is strongest during periods of rising markets (1986, 1995, 1996 and 2003) but investors make most mistakes after the down turns (1988, 1989, 2002). These mistakes occur because investors are driven by the fear that the market will not recover, but as broad indices show, the market does recover.

The overall Guess Right Ratio for the 20 year period is 58%.



### Commentary

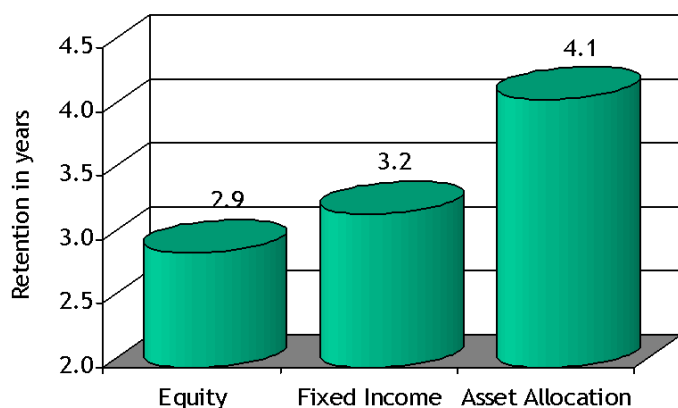
It is easier to make the right decision when markets are rising and the fear of loss is on the back burner. The really smart decision, that most investors get wrong, is to invest when the market is down.

**"If you don't know when to get out, it is better to stay in."**



## Retention Rates Equity, Fixed Income and Asset Allocation

### Average Retention Over 20 Years



### Asset Allocation Investors Show Discipline

Asset allocation funds handle decisions for investors and this study finds that investors actually hold them for longer.

The 20 year analysis shows that asset allocation funds are held for substantially longer periods than either equity or fixed income funds.

### Retention Improved During 2005

Retention based on 2005 fund flows is projected to increase from 3.2 to 3.6 years for fixed income funds and from 5.3 to 5.6 years for asset allocation funds. Estimated retention for equity funds remained steady at 4.3 years.

Retention is projected based on the length of time to fully liquidate the average investor's account at the redemption rate for the period in question.

### Commentary

Investors are holding on to their mutual funds for longer and this is a very good indication that previous imprudent behavior is being corrected.

If maintained, the effect of this change will likely be higher investor returns.

**"Check your fund every year to avoid a panic."**

| Average Retention measured over:  | 1 Year | 3 Years | 5 Years | 10 Years | 20 Years |
|-----------------------------------|--------|---------|---------|----------|----------|
| Average Equity Fund Investor      | 4.3    | 4.0     | 3.3     | 3.2      | 2.9      |
| Average Fixed Income Investor     | 3.6    | 3.1     | 3.0     | 3.1      | 3.2      |
| Average Asset Allocation Investor | 5.6    | 5.3     | 4.7     | 4.6      | 4.1      |



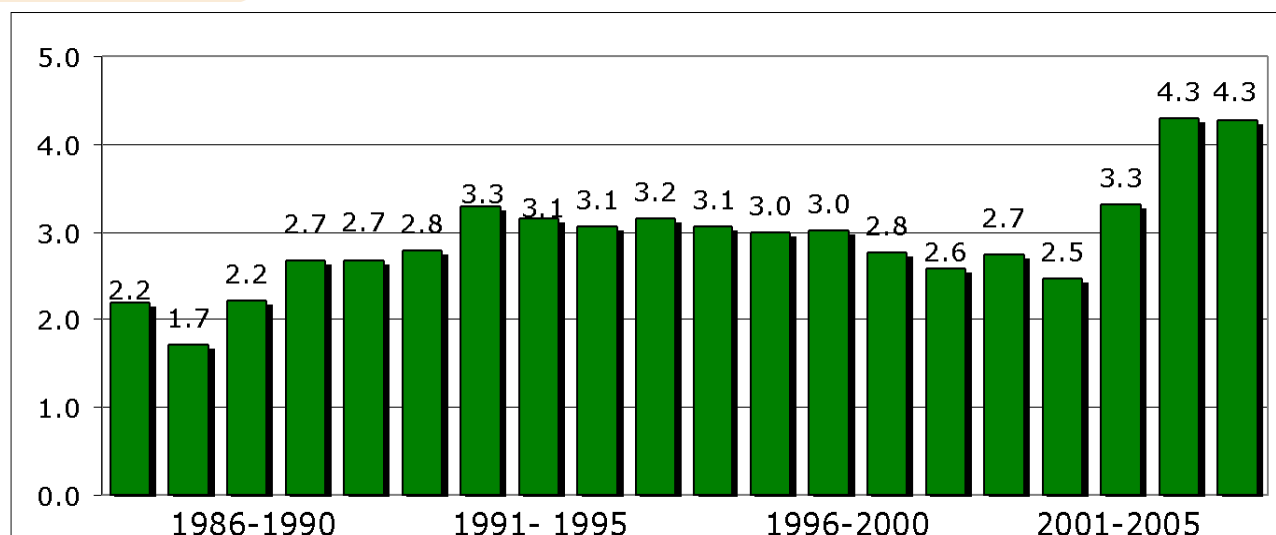
## Equity Investors Retention Rates

### Increased Retention Pay Big Dividends in 2005

The equity fund retention rates held steady in 2005 at 4.3 years. Retention remained at the highest level since 1984. This contributed greatly to investors actually earning more than the S&P 500. This was not due to outstanding fund performance but to investor behavior. Investors wisely continued to plow money into their funds regardless of the market up turns and down swings.

The desirable investment behavior in 2005 marks the third year of increased retention. It is too early to speculate whether this improved behavior will continue, but it is encouraging to compare recent actions to the 1987 crash and 2001 when retention reached record low levels.

### Equity Investors Retention (Years)



### Commentary

Retention is critical to investment success for the obvious reason that you cannot benefit from the market if you are not in the market. While it is highly profitable to avoid market down turns, very few investors do this successfully. Unless you can predict when down turns will occur and for how long, the strategy of getting out to avoid a loss does not work.

Consider that the market moved up 60% of the time and down only 40% for each month of the last 20 years.

**"Remaining invested is betting with the odds."**



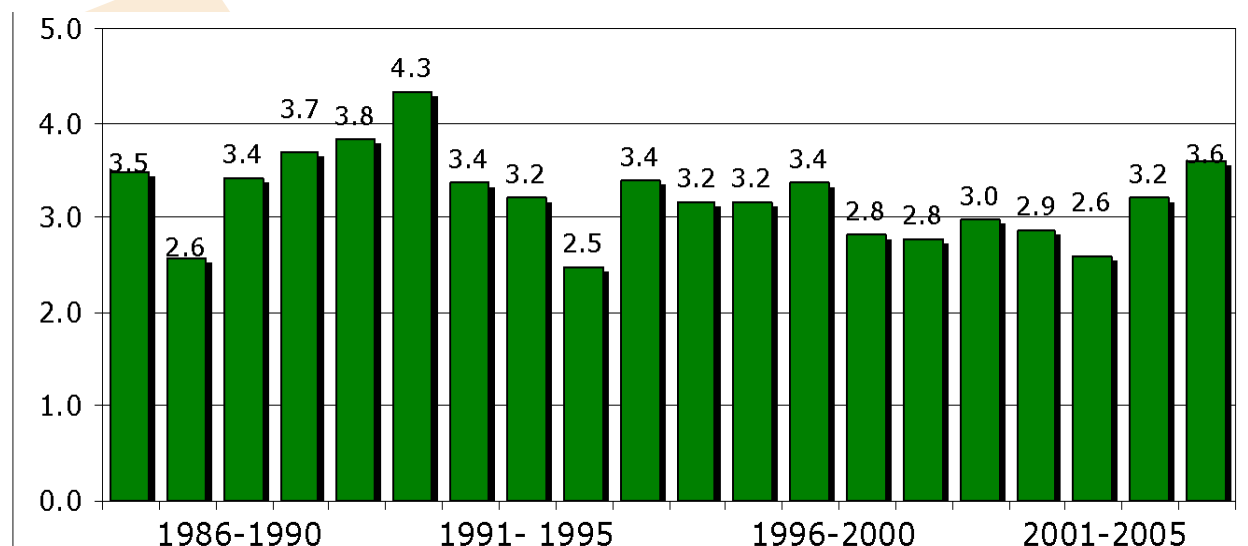
## Fixed Income Investors Retention Rates

### Bond Investors Held as Long Term Rates Held

The expected increase in long term rates that drove investors out of bond funds in 2003 never materialized. These fixed income investors decided to hold on to their funds and pushed retention rates back over the three year level.

The persistently low long term interest rates have protected bond investors from significant loss of principal that would occur if there was an increase in rates.

### Fixed Income Investors Retention (Years)



### Commentary

Fixed income fund investors have historically made fewer errors than their equity counterparts. This trend was dramatically reversed in 2004 and 2005 when equity investors remained invested, driving retention to record levels.

While long term rates have remained low, this is not sustainable and rates are likely to rise to historical norms.

**"Bond funds are the cushion for a bumpy stock market."**



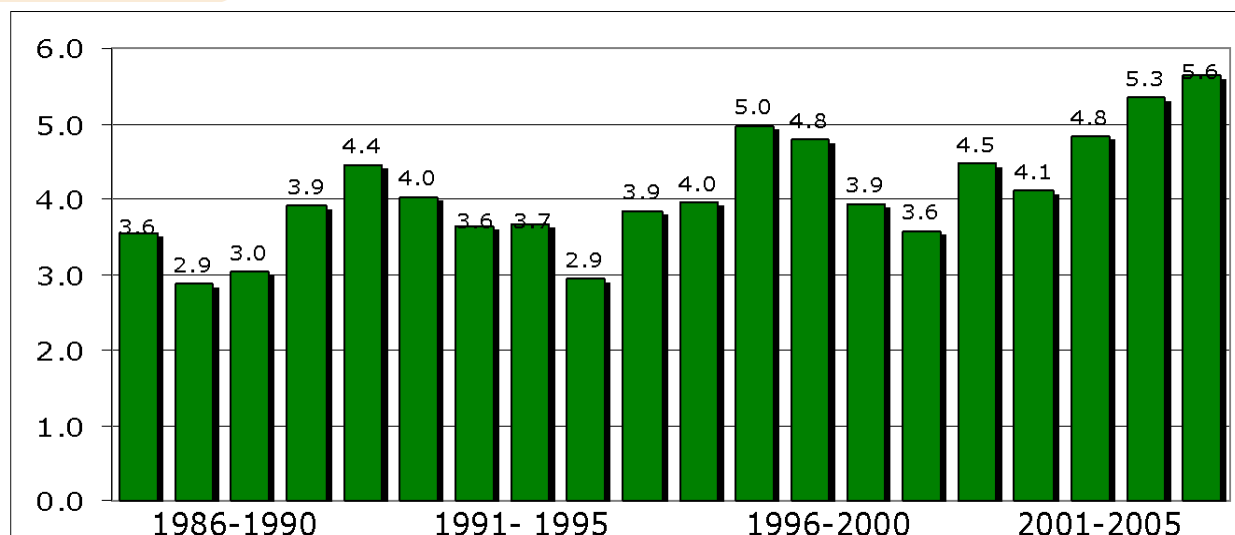
## Asset Allocation Investors Retention Rates

### Asset Allocation Funds Encourage Good Behavior

Longer retention rates are expected since asset allocation funds handle the rebalancing for investors. Retention rates for these funds give evidence that this does work. The retention rates for asset allocation investors are substantially longer than either equity or fixed income counterparts.

At a projected retention rate of 5.6 years, asset allocation are successful in limiting the investor losses that occur because of fear based selling. Even in the face of most severe market declines in history (2000 - 2002), retention in these funds remained above 3.6 years. This retention limited investors realized losses and took advantage of the market recovery.

### Asset Allocation Investors Retention (Years)



### Commentary

Asset allocation funds have created a comfort zone for investors that protects them from their own errors.

While traditional performance measures show asset allocation funds severely underperforming equities, the improved investor behavior that they produce has prevented significant losses for investors.

**"Asset allocation funds don't perform better, they make investors perform better."**



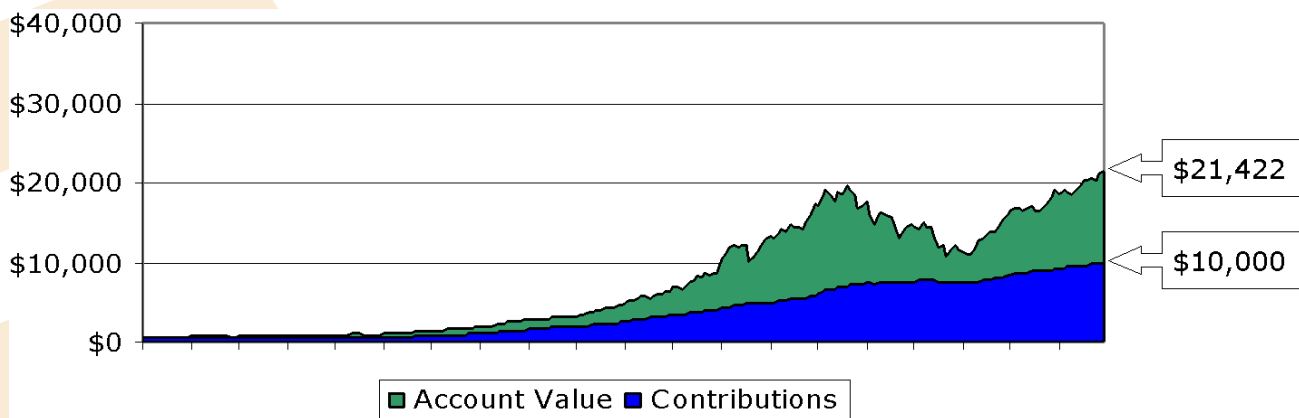
# Hypothetical \$10,000 Investments

## Comparison of Average Investor Behavior to Systematic Investing

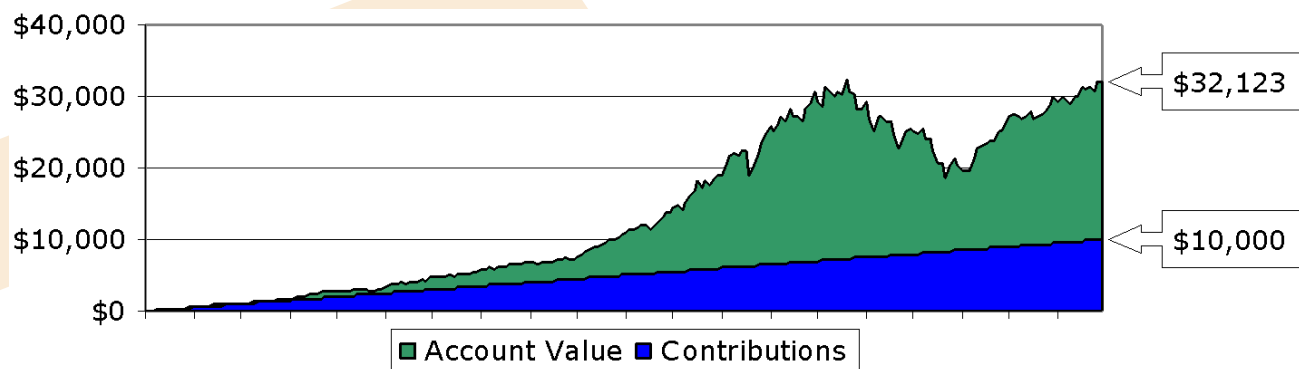
The first illustration depicts the growth of an average equity mutual fund investment when \$10,000 in contributions are made in the same pattern as the average investor. The results are an ending value of \$21,422.

The second illustration depicts the growth of a systematic investor using dollar cost averaging to make \$10,000 in contributions. The systematic investor ending value is \$32,123; representing an advantage of \$10,701 or 50% over the 20 year period.

### Average Investor - \$10,000 over 20 Years



### Systematic Investor - \$10,000 over 20 Years



### Commentary

The 70% advantage of systematic investing shows the importance of consistency in wealth building. The benefit of dollar cost averaging illustrated here can be dramatically improved by starting immediately and increasing contributions over time.

**"Start early, keep contributing and don't panic."**

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