Lower Portfolio Risk to Boost Return

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UPDATE: The words I wrote in this post from August 27, 2010 are as sound today as they were back then. The basic principles of good investing just never change. This is how we operate at [Richard C. Young & Co., Ltd](#).

Do you know the difference between total return and investor return? Most investors are familiar with the concept of total return. The total return of a fund is simply the sum of the capital and income return of a fund over a certain holding period. The total return of a fund of course assumes a buy-and-hold strategy.

Investor return (a Morningstar term) is a measure of the experience of the average investor in a fund. Investor return does not assume a buy-and-hold approach. Instead it accounts for all cash flows into and out of the fund in an attempt to measure how the average investor in the fund performed over time.

Investor return is not a replacement for total return, but an important complement. Total return indicates how a fund manager performed over a certain time period, but investor return shows how the average investor in a fund performed.

Hot funds with strong recent performance often show total returns that are higher than investor return, as do volatile funds. One of the reasons investor return in volatile funds can lag total return is that investors pile into funds when they are in an uptrend, but bail out after performance turns south. You end up with a situation where there are more assets in a fund when returns are poor than when they are strong. That lowers investor return.

The formerly overhyped Legg Mason Value Trust Fund offers a telling illustration of this concept. For those of you who are not familiar with it, this is Bill Miller's fund. Prior to a recent streak of poor performance that began in 2006, Mr. Miller's fund was touted by the financial press as being the only mutual fund to outperform the S&P 500 for 15 consecutive years. Let's first look at the total return of the fund. For the 15-year period ending July 31, 2010, the Legg Mason Value Trust Fund earned a compound annual total return of 6.87%, compared to a return of 6.48% for the S&P 500. That's not bad; even after some atrocious relative performance in 2006, 2007, and 2008, Mr. Miller managed to outperform the index by a few basis points. But how did the average investor in his fund do? The 15-year investor return for the Legg Mason Value Trust Fund was only 4.40%—a significant difference of 2.47% per year.

Compare the experience of the Legg Mason fund to a balanced fund such as Vanguard Wellesley Income. Over the last 15 years, the compound annual total return of the conservative Wellesley

Income Fund was 8.1%, and the investor return was 7.73%, a difference of only 0.57%. Wellesley's investor return was closer to the total return because investors in the fund didn't bail out when markets were down. Wellesley's low volatility provided investors with comfort and confidence to hold their shares. In my forty-plus years in the investment business, I have found that during down markets, investors are less likely to bail out of funds with modest volatility than those with high volatility. Bailing out of your funds during down markets is a sure way to destroy wealth. The better strategy is to increase your comfort level by lowering your portfolio's risk. Chances are you'll end up boosting your return.