

Lake Wobegone and Investors

Portfolios heavy with under-performing stocks almost never outperform the market. Ignat's Law

In mutual fund investing, performance is all that counts. The name of the fund doesn't matter. The letter to shareholders doesn't matter. The size of the fund doesn't matter and may actually be a negative for very large funds—conversely very small funds are small for a reason—they haven't delivered enough performance to attract new investors. Performance is what counts.

[A](#) collection of recent newsletters is available on the web site.

Market Dynamics

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In the award winning public radio broadcast “A Prairie Home Companion”, the host Garrison Keillor describes a mystical place called Lake Wobegone and he says that in that community “all the kids are above average.” This is an absurdity. But investors seem to have their own version of Lake Wobegone where all the “mutual funds are above average.” That can't be true either.

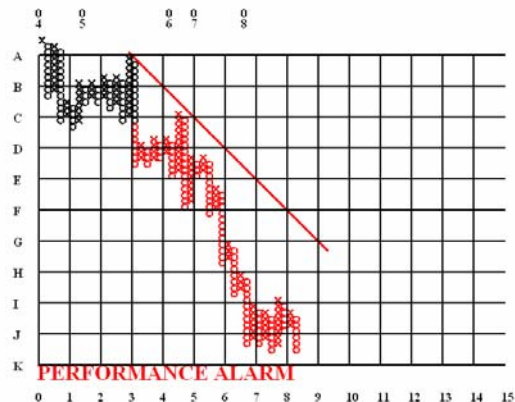
In a large random sample of mutual funds, usually at least 50% will have below average performance over a fairly long measurement period, perhaps a year,. And about 50% will outperform the average over the same period. How does an investor tell if his fund is in the poorly performing group or not? After all, he bought the fund in the hopes that it would outperform other funds. He didn't place his capital in the fund so that it would under-perform.

He needs to measure the performance of the fund against a broad stock market benchmark such as the S&P 500 index.. This is usually referred to as relative strength and it applies to mutual funds as well as stocks. If the fund is outperforming the index he is probably outperforming other funds as well.

The investor probably doesn't even know who the portfolio manager is or even what his track record might be. He probably doesn't know anything about the investment philosophy being used to manage the fund and to select the investments held by the fund. Does the portfolio manager show up for work on most days? Does the board of directors of the fund really care about the shareholders of the fund? Does it really matter what the fund shareholder knows about the fund? Probably not.

What the mutual fund shareholder can readily determine about the mutual fund is whether it is performing as well as expected. The

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This fund has significantly under-performed the S&P 500 since the peak almost three years ago.

daily record of net asset values is all that is needed to calculate the relative strength of the fund. If the fund is performing well against the market, the trend of relative strength will be up. If the performance is poor, the trend of relative performance will be down.

The mutual fund has a job to do and that job is to beat the market. The investor can always switch from a poorly performing fund to a fund that is performing well. The performance measurement should be based on a long-term perspective and the investor shouldn't wait until the fund has beaten the market for several years before buying the fund. The performance measurements should be continuous and the investors should be willing to withdraw from a fund when its performance starts to lag.

The investor should scan a fairly large universe of funds to find funds that are starting to improve in a significant way. Economic sector funds are a good way to identify funds that are starting to show good performance and when a sector fund starts to improve, it will probably last for several quarters or even several years. Index funds and broadly diversified funds that are often “closet index” funds seldom outperform the average for very long. The investor must always remember that it is impossible for all funds to be above average. Why stick with a dog?
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