

When to pull the plug on a loser fund



ROB CARRICK

The Globe and Mail, April 5, 2008

It's starting to look as if China funds could be to investors this year what funds loaded with financial stocks were in 2007.

In good times or bad for financial markets, there are always trouble spots. Inevitably, some mutual funds will get caught up in them and lose serious money for their clients, who are then faced with the decision of whether to hold or sell.

In this edition of the Portfolio Strategy column, we look at how three investment advisers handle the question of what to do with funds that have fallen disastrously. If you think you're going to be told to hold and be patient in all cases, then guess again. Advisers hate shockingly bad fund returns as much as their clients, and they have strong ideas about when it's appropriate to bail out.

Most investors have at some point had to confront the question of whether to stay in a losing fund in hopes of a rebound or moving to something else in hopes of better returns. Natural resource and precious metals funds, believe it or not, have delivered horrible returns in the past. Obviously, the thing to do was stay invested because the long-term results are great in these two areas. Tech funds are still laughably short of their highs of several years ago, so cutting your losses early on was probably the right move.

Today, some investors have to be wondering what to do with Canadian and U.S. equity funds with heavy weightings in financial stocks. These funds have delivered previously unimagined losses in the past year and are still struggling. Right now, emerging markets funds, notably those with a focus on China and India, are starting to look worrisome. For the first three months of the year, some China funds are down about 20 per cent.

Here's how Tony De Thomasis, president of Thornhill, Ont.-based De Thomas Financial Corp., attacks the question of whether to hold or sell. First, he compares the fund against both its peers and its benchmark index (this is easy to do using Globefund.com's fund profiles).

"If a fund is way worse than the index, it takes guts to hang in there," Mr. De Thomasis said. "If it's down as much as the index, it doesn't bother me. I might buy more." He's doing just that right now with global real estate funds that have fallen in the 30-per-cent range in the past 12 months. The reason: This is a typical loss in this hard-hit sector.

Funds that have lost more than their peers and the index require some investigation. Mr. De Thomasis said he would be inclined to stick with a manager who has long focused on a particular sector – like financials, for example – that happens to be out of favour at the moment.

As for managers who have made an ill-timed move into a particular sector, he looks at their background to help make a decision about whether to stay or go. “If it’s an old, experienced manager, and by old I mean 10 years of experience, I might stay. If it’s less than 10 years of experience managing this sort of fund, I’d probably say no. I can’t afford my clients taking a gamble on this guy maybe working out.”



Investment Advisor Tony De Thomasis; “If a fund is way worse than the index it takes guts to hang in there. If it’s down as much as the index it doesn’t bother me”

The mathematics of investment returns add some urgency to the decision of whether to sell a dud fund. A fund that loses 25 per cent of its value in a year needs to generate a gain of about 33 per cent just to get back to even. Recoveries like this are rare, but by no means impossible. Natural resource funds lost almost 28 per cent on average in 1998 and then tore off average gains of about 20 per cent in the next two years.

Then again, tech funds posted average losses of 25.8, 34.5 and 41.1 per cent from 2000 through 2002. They made 29.1 per cent in 2003, but subsequent average results have ranged from a loss of 2 per cent to a gain of 10.3 per cent.

These are two extremes, though. On the whole, some advisers say staying put has worked out most often, though not always.

“For the most part, it has been the right thing to stay,” said Anni Markmann, an adviser with Rice Financial in Ste. Anne, Man. An example from her own business occurred early this decade, when she changed firms and inherited some clients who held high-risk funds focusing on small companies. Instead of selling these funds and locking in losses, she waited and then capitalized on a rebound to extricate her clients. “As soon as these funds started going up, we began moving money out on a gradual basis. So waiting was the right thing to do.”

Hard analysis plays a big role in deciding whether to dump a disastrous fund or stick with it, but so do investor needs and emotions. For example, Ms. Markmann said she’d be more inclined to stick with a problem fund if the client was many years away from needing his or her money. Selling might make more sense for people who are closer to retirement, or who are nervous about the markets.

Mike Morrow of Morrow Financial in Thunder Bay, Ont., said his challenge as an adviser is to prevent clients from making what he considers to be the top mistake that causes people to fail as investors. That is, selling a struggling fund in order to buy something that has just posted big returns. Too often, moves like this create a perpetual cycle of buying high and selling low.

Where funds with good long-term records are concerned, Mr. Morrow believes investors should actually put money into a loser. In reality, though, this is a tough sell. “You tell a guy who's down 30 per cent to give you more money and see what happens. They don't want to put it in.”

Mr. Morrow recalls this being the case back in March, 2003, when the stock markets were coming off a multiyear losing streak and even mainstream funds had posted double-digit losses. If you look at a long-term chart of the S&P/TSX composite index, you'll see that a five-year bull market pretty much began at that point.

In situations where Mr. Morrow decides to get a client out of a losing fund, a gradual retreat is often used. For example, he might sell 30 per cent and then take a wait-and-see attitude with the remainder. Investors will find it interesting to note that Mr. Morrow, the investing professional, admits to sometimes feeling an emotional pull to simply dump a struggling fund.

“I want to sell it all – that's really what I want to do,” he said. “But if I look back, I realize that most of the time I'm going to make a mistake by doing that.”

Should you stay or should you go?

Here's a list of mutual funds that have posted significant losses in the past 12 months, thereby raising the always tricky question of whether investors should stay in them in hopes of a rebound or sell and look for something better. Check the fund profiles on Globefund.com for the data you need to make the right decision.

| Fund | Assets (\$million) | Category | Category | |
|---|-----------------------|--------------------------------|---------------------------|---------|
| | | | 12-month average loss* | loss |
| AIC American Focused | \$326.2 | U.S. equity | - 45.0% | - 17.4% |
| Brandes U.S. small-cap equity | \$40.0 | U.S. small- to mid-cap | - 43.5% | - 19.8% |
| Brandes Cdn. equity | \$100.9 | Cdn. focused small- to mid-cap | - 37.5% | - 3.7% |
| Brandes U.S. equity | \$162.4 | U.S. equity | - 36.9% | - 17.4% |
| Mackenzie Universal World Real Estate cl. | \$68.4 | Real estate | - 36.9% | - 25.8% |
| AIC Value | \$139.1 | U.S. equity | - 36.3% | - 17.4% |
| Northwest U.S. equity | \$15.5 | U.S. equity | - 35.8% | - 17.4% |
| Fidelity Global Real Estate A | \$67.1 | Real estate | - 34.1% | - 25.8% |
| CI Value Trust Corp. cl. | \$806.1 | U.S. equity | - 33.4% | - 17.4% |
| Investors Global Financial Services A | \$42.1 | Fin. services equity | - 32.9% | - 24.0% |
| Trimark Global Endeavour | \$1,291.0 | Global small- to mid-cap | - 28.0% | - 10.5% |
| AIM Global Health Sciences | \$130.6 | Health care equity | - 27.1% | - 12.1% |

*to Feb. 29/08

DOUGLAS COULL/THE GLOBE AND MAIL; SOURCE: GLOBEFUND.COM