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Why institutional investors outperform individuals

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PERSONAL FINANCE

There's little debate about institutional investors being far more successful than individual ones. Dalbar, an investor behavior and investment product research firm in Boston, has documented this in its study reflecting significant underperformance by individuals.

In addition, a study by Mercer, a pension, investment and actuarial consultant in Louisville, Ky., concluded that for 10 years, ending Dec. 3, 2004, the average individual investor returned 6.2 percent, while the pension funds averaged 10.5 percent and endowments returned more than 11 percent.

Why have institutions consistently outperformed individuals?

• Goal-oriented. The spending policy of an endowment or the actuarial assumption of a pension fund directs the investment committee toward achieving those goals over time.

Often, individuals don't have a specific goal of an entire portfolio. Consequently, they consider only the characteristics of a specific investment. Typically, only the upside is considered and downside risk is ignored. Without a thoughtful approach to goal setting, investments are considered in isolation. Consequently, unintended risks occur, which can lead to poor performance.

• Design focus. The majority of an investment portfolio's results will be determined by its asset allocation or design. The asset allocation should be based on the goal of the portfolio, and adjustments should be made to the portfolio periodically only after extensive analysis.

Individuals tend to make emotional "deal-of-the-day" decisions without proper analysis. Again, this approach can lead to an overweight in specific risk factors and can lead to underperformance.

• Know what they don't know. Often, individuals are overconfident in their ability to manage money. Although investment committees often are comprised of lay people, fiduciary law holds them to standards similar to investment professionals.

Consequently, trustee investment education often is encouraged, and quality advisors usually are retained as an extension of the committee. Individuals typically are less educated on the basic principles of investing, but quickly make decisions on complicated matters, when professional trustees would require intense analysis.

• Better advice. Although there are bad apples in every arena, institutions typically will engage experts who are more objective and research-focused. Individuals often use planners who may be sound at planning, but often are weak on investment solutions.

Further, individuals may utilize brokers who earn a commission for product implementation, and thus are conflicted. While objectivity doesn't guarantee quality advice, it does eliminate the recommendations that line the pockets of the advisor.

• Better pricing. There's no doubt that larger investors command better pricing. However, many individuals ignore the impact of fees. With many investment platforms available today, individuals can take advantage of institutional products and solutions. In addition, passive solutions can help with fee reduction.

While institutional pricing does help foundations and pension funds, it's a minor component in explaining the vast difference in performance between individuals and institutions.

• Tax-exempt status. Taxes are a factor in considering a strategy or product for an individual, while institutions don't have to worry about the tax impact of investment strategies. Individuals should use IRAs and tax-exempt accounts to take advantage of tax-insensitive strategies.

Mutual funds can be tax-inefficient as well and because of this, larger taxable investors should utilize separately managed accounts when possible.

• Ongoing monitoring and evaluation. Unfortunately, many individuals use a custodian statement as their evaluation tool and have limited information as to how they're performing relative to their goals and objectives, or how they're doing as compared to the markets.

Trustees have a fiduciary responsibility to monitor and evaluate their progress and investments. Individuals should take a cue from institutions and develop a formal monitoring process, as they, too, need a compass to help them steer toward their ultimate goal.

While individuals have underperformed institutions by a large degree, they have the opportunity to be more "institutional" with their approach to making investment decisions. That can help close the performance gap.

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