Why Typical Investors Underperform

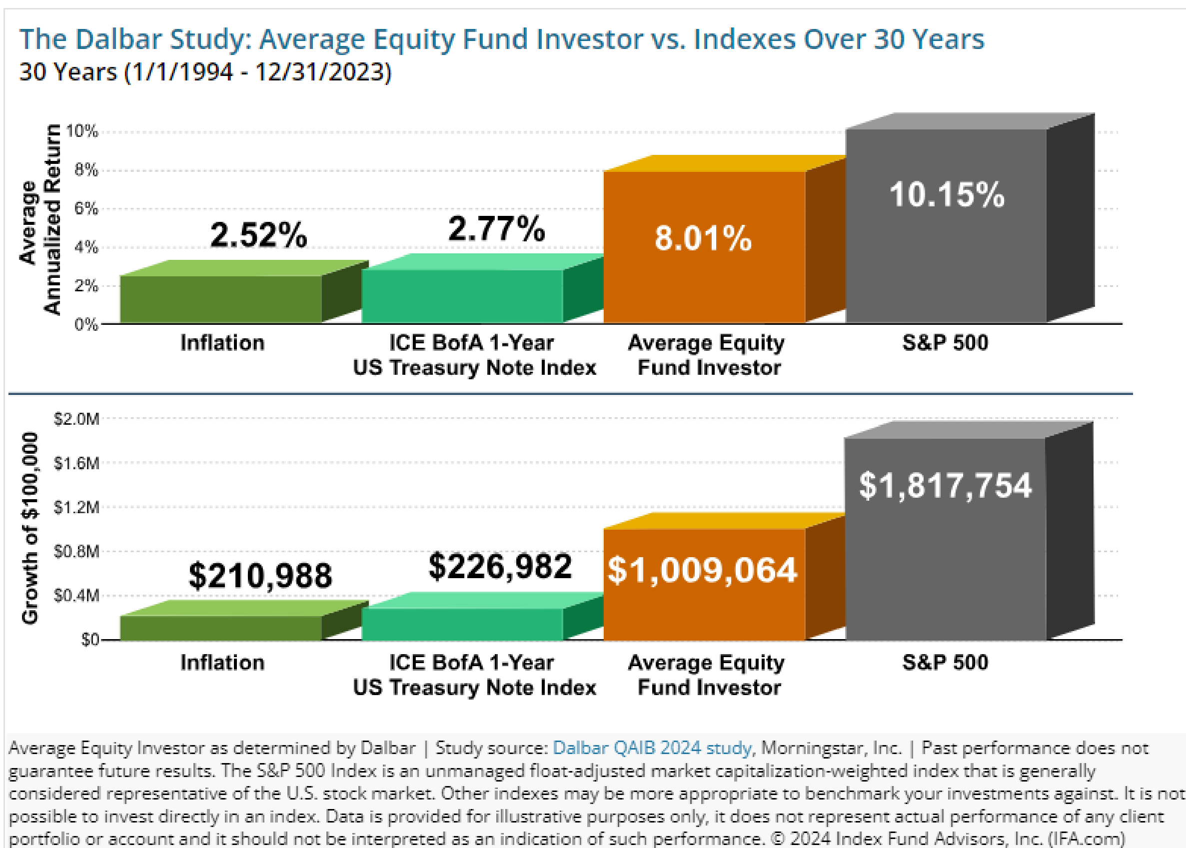
And How to Set Yourself up for Success

The stock market, a dynamic arena of wealth creation and investment opportunities, attracts a diverse range of participants, including institutional investors, professional fund managers, and individual retail investors.

Despite the democratization of investing and the availability of vast resources, retail investors often find themselves lagging the market's overall performance.

Look no further than the chart below, which illustrates the average investor return, relative to the S&P 500, and inflation. The bottom chart is particularly powerful, as it illustrates the growth of $100,000 over time, with the average investor ending up with 44% less than the stock market!

This segment of Mastering Your Wealth aims to unravel the complex reasons why retail investors typically underperform in the stock market, and more importantly, how retail investors can set themselves up for greater success.

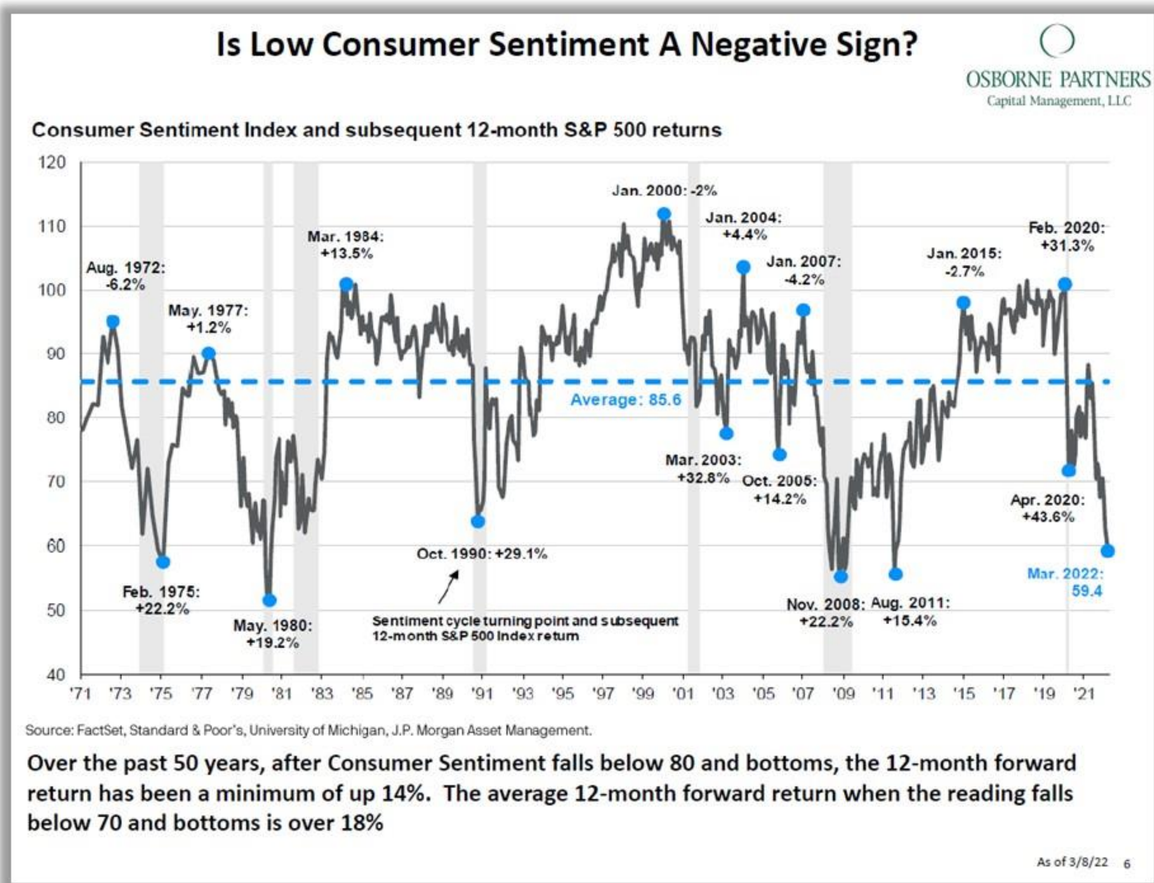


1. Behavioral Biases: The Influence of Emotions

While there are many factors which drive a typical investor's underperformance, we believe behavioral biases play one of the most significant roles in retail investors' underperformance. Emotions such as fear, greed, and overconfidence can cloud judgment and lead to suboptimal investment decisions.

More specifically, when investor and consumer emotions are negative, historically markets have delivered some of their best returns. On the flip side, when consumer sentiment is positive, the market has delivered lower returns.

There are a number of indexes / metrics that demonstrate this phenomenon (known as a contrarian indicator). We often refer to the Consumer Sentiment Index. The chart below illustrates Michigan University's Consumer Sentiment Index, along with the S&P 500's subsequent 12-month returns, following index highs and lows through March of 2022.



Investors should compare the twelve month returns when consumer sentiment hits a high and it feels good to invest (generally, the observations in the top half of the chart), relative to the returns when sentiment hits a low and it is painful to invest (the observations in the bottom half of the chart). You'll certainly observe that the returns in the lower half of the chart (low consumer sentiment) are much higher.

For instance, in March of 2003, as we were emerging from the dot-com crisis and Sept 11th attacks (and sentiment was low), the S&P returned more than 32% over the next 12 months. And in April of 2020, during the depths of the COVID-19 pandemic, consumer sentiment had plummeted, however, the S&P returned 43.6% over the next 12 months.

2. Lack of Expertise and Discipline

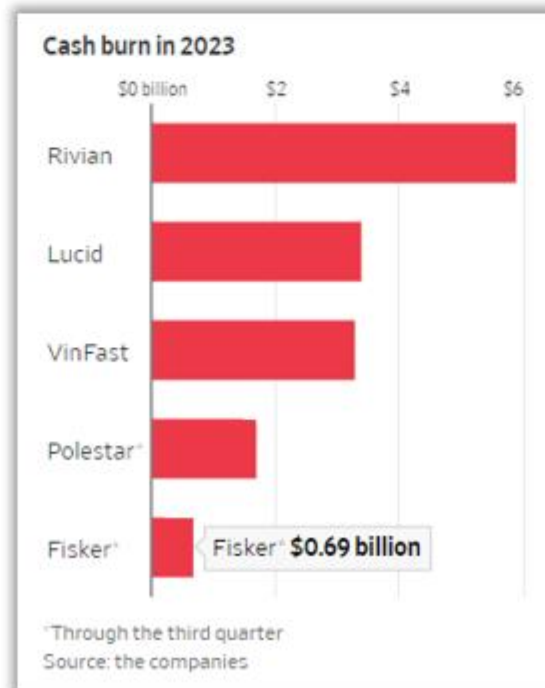
Retail investors often lack the resources, time, or expertise to conduct thorough research and due diligence before making investment decisions. While many retail investors may feel comfortable making their own investments, it would be worth asking, “Would you operate on yourself?” or “Would you climb Mt. Everest without a guide?”

Unlike institutional investors with dedicated research teams of disciplined Chartered Financial Analysts and well refined processes and systems, retail investors rely on superficial information, tips from unreliable sources, or market sentiment (see previous section). This lack of in-depth analysis and emotional investing can drive subpar investment performance.

An example we often cite that drives market under performance for retail investors is an overreliance on “hot tips” or market timing. That’s what happened in 2021 with a rush to invest in electric vehicle (EVs) manufacturers.

The hype surrounding these sectors often leads to inflated stock prices that cannot be justified by the companies' underlying fundamentals (which could have been identified with a disciplined process). Investors may want to rush into these stocks driven by FOMO (Fear of Missing Out) causing prices to surge beyond reasonable valuations.

This creates a scenario where investors end up paying a premium for these stocks, making it challenging for them to achieve significant returns relative to the risk taken. When the hype fades or market expectations are not met (as it has since 2022), these stocks can experience sharp corrections, resulting in losses for investors who bought in at inflated prices.



3. Higher Expenses and Lack of Control Over Taxes

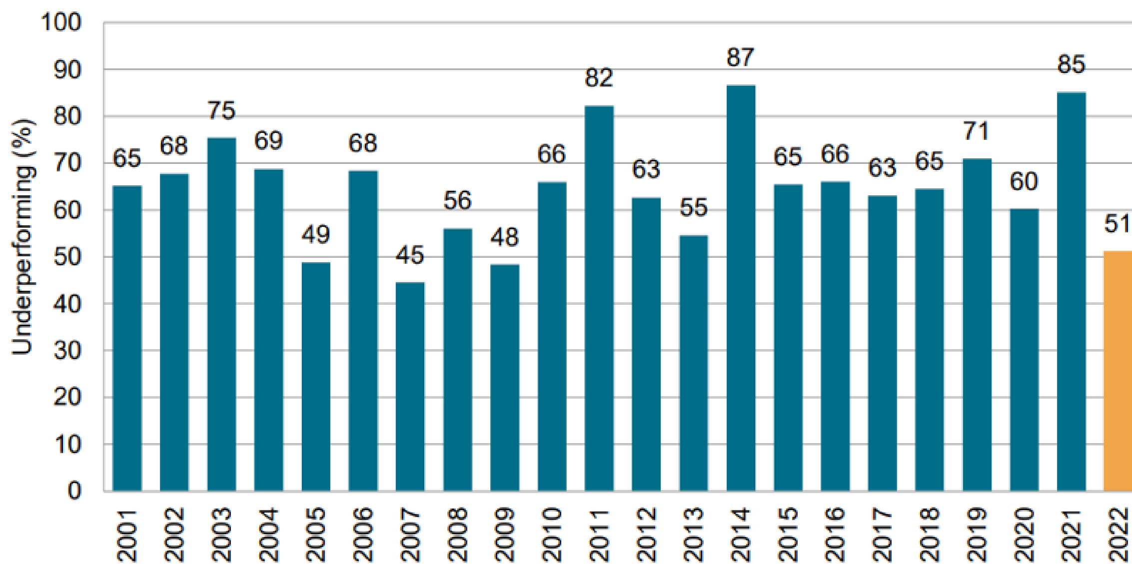
Retail investors often incur higher transaction costs due to trading fees, taxes, and bid-ask spreads, especially when engaging in frequent buying and selling or owning mutual funds. These trading strategies can obviously lead to increased costs, reducing net returns and contributing to underperformance, particularly for short-term traders.

Mutual funds come with various expenses that investors should be aware of. These expenses include management fees which are charged by the fund manager for overseeing the fund's portfolio.

Additionally, there are administrative expenses, such as recordkeeping and shareholder services that are covered by the fund's assets. Sales loads, either front-end or back-end, are charges associated with buying or selling mutual fund shares, while expense ratios represent the annual percentage of a fund's assets used to cover operating costs. Worse, investors in mutual funds have no control over tax exposure. Often mutual funds will distribute large capital gains at the end of the year and an investor has zero control over this tax hit.

These expenses are a main driver of why mutual funds (and retail investors who own them) underperform the market. See the chart below illustrating the percentage of large cap domestic equity funds that underperform the S&P dating back to 2001.

% of Large Cap Domestic Equity Funds Underperforming the S&P 500 Each Year



Sources: S&P Dow Jones Indices, LLC, CRSP. Data as of 12/31/22. Past performance is not indicative of future returns. Chart is provided for illustrative purposes.

Setting Yourself Up For Success

In summary, retail investors' underperformance in the stock market is often influenced by a combination of behavioral biases, lack of expertise and discipline, information disadvantages, and higher transaction costs.

Overcoming these challenges requires a disciplined approach and adherence to sound investment principles:

1. **Education and Awareness:** Retail investors can benefit from learning about behavioral biases and developing disciplined investment strategies. This is especially true at market tops and bottoms, and remembering lessons learned from the "Consumer Sentiment" chart we reviewed earlier.
2. **Research and Analysis:** Conducting thorough research, due diligence, and utilizing available resources for analysis can lead to more informed investment decisions.
3. **Cost Management:** Minimizing transaction costs, optimizing tax strategies (e.g. do not own mutual funds) and avoiding excessive trading can improve net investment returns.
4. **Long-Term Wealth Management Plan:** By having a long-term financial plan in place, focusing on long-term goals, understanding risks and inevitable market fluctuations, investors are more likely to weather periods of volatility and stay on course to achieve financial goals.

We recognize adhering to the above principles is easier said than done. But by addressing these factors and adopting a proactive and disciplined investment approach, retail investors can improve their chances of beating the odds and not underperforming the market.

As you can imagine, these are subjects we are passionate about here at Osborne Partners. If you have questions, would like to share thoughts, or just learn more about our processes, please send an email or set up a time to speak.

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