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The Best Investing Advice? Maybe Not the Conventional Method

By PAUL SULLIVAN

WITH the stock market so volatile lately, investors have been asking how to ride out the swoons and maybe even outperform the major indexes. The answers — at least according to an analysis by one firm — do not necessarily conform to accepted wisdom.

The best-performing funds over time were not necessarily the ones with the lowest fees, run by the best-known managers or focused on any particular strategy, according to more than 20 years of data examined by DAL Investments, an investment adviser and publisher of the NoLoad FundX newsletter in San Francisco. DAL analyzed the returns on 306 mutual funds for The New York Times.

Janet M. Brown, president of DAL Investments, said the deep dive was motivated as much by trying to figure out what worked as by testing the effectiveness of the firm's own unconventional strategy. (More about that later.)

"The overall challenge of mutual fund investing is selecting funds in advance that people think will do well in the future," Ms. Brown said. "The easiest thing would be to buy and hold or to select a manager with a good long-term track record and buy it and forget it. That was not an effective way of selecting funds."

The 306 funds in the study were founded before 1989 and still exist. They all invest broadly with various styles and none concentrated on one sector. The data spans 21.75 years, from Dec. 31, 1989, to Sept. 30, 2011. The performance of the funds was measured against the Vanguard S. & P. 500 Index Fund, which had annual returns of 7.65 percent during that time.

As much as people in the fund industry may want to measure their performance against a narrowly defined index, the reality is that most investors judge their returns against the S. & P. 500, for better or worse.

So what did the study find?



PETER DaSILVA FOR THE NEW YORK TIMES

Janet M. Brown is the president of DAL Investments, which analyzed 306 mutual funds over 20 years.

PERFORMANCE Over the two decades of the data, no one investment strategy dominated, and most were successful for only four to five years, on average. Not one fund beat the benchmark every year.

In fact, most funds underperformed the S. & P. 500 about a third of the time.

The top-performing mutual fund in the study was the FPA Capital Fund, which invests in small- and midcapitalization stocks, generally defined as companies with market capitalizations of \$300 million to \$10 billion. It had an annual return of 14.43 percent, and it beat the index 15 times.

The best manager against the benchmark was Bill Miller, chairman and chief investment officer of Legg Mason Capital Management. His Value Trust fund outperformed the benchmark in 16 of the 22

periods of the survey. Yet it ranked only 187, with an annualized return of 7.37 percent. This was lower than the benchmark.

The eighth-ranked fund in the survey, the Heartland Value, underperformed 10 times and still returned 11.66 percent annually. Its long-term performance demonstrated how stellar years attract the attention, but the bad years, when the fund kept losses in check, were more significant. The RS Investments Small Cap Growth fund, for example, underperformed the S. & P. 500 more than it outperformed it, yet still beat it with an annual return of 9.85 percent.

The study also disputed the value of hitching your strategy to star managers. Mr. Miller was one example but so, too, were the various managers of Fidelity's famous Magellan Fund. It underper-

formed the benchmark 14 times and ranked 222, with annual returns of 6.74 percent.

One reason star managers fail over the long term is that they become known for a particular style of investing that may go in and out of favor. DAL's research found that no one style was dominant for the whole period. But funds focused on small- and midcap stocks did perform the best over this period. (Ms. Brown cautioned against reading anything into this for the future.)

"In my view, it has less to do with the brilliance of the portfolio manager as when their styles are in sync with the market," she said.

EXPENSES One belief that investors take as gospel is that high expenses erode gains. On the one hand, this is obvious — the more that goes to the manager, the less that goes to you. But what the DAL study found was that there was only a slight correlation between lower expenses and higher performance. And the level of fees was not a determining factor in which funds beat the benchmark over the long term.

DAL divided the results into quintiles. Funds in the top performing group had fees that ranged from 0.45 to 2.01 percent. Funds in the middle had fees from 0.10 to 2.0 percent, while those in the worst-performing group had fees from 0.39 to 3.84 percent. (There were only three with fees higher than 2.5 percent.)

The expenses on the top-performing FPA Capital Fund were 0.87 percent. The

average expense of the top 20 funds was 1.07 percent. The fund with the lowest expenses, the Fidelity Spartan 500 Index fund, was ranked 161st with an annual return of 7.58 percent.

The two worst-performing funds, the Stonebridge Institutional Small-Cap Growth Fund and Midas Magic, did charge the highest fees in the study at 3.4 and 3.84 percent. Their annual returns were 2.66 percent and 0.58 percent.

If expenses, and not return, were the primary concern, Ms. Brown said an investor should simply invest in an index fund and forget about it.

(Even then, though, there were variations not correlated with fees. The benchmark Vanguard index fund returned 7.65 percent with expenses of 0.17 percent, while the Fidelity Spartan fund, with the lowest fee of the funds examined, had slightly lower returns of 7.58 percent.)

Still, if investors picked the 15 funds with the lowest fees over the period of the study, they would have outperformed the benchmark, with an 8.8 percent annual return.

A DIFFERENT APPROACH DAL, which manages \$1.3 billion, has been using data like this to make its investment decisions. It calls this strategy "upgrading," an approach that it has been advocating in its newsletter since the 1970s.

The strategy looks at one-, three-, six- and 12-month fund returns. The belief, which began with Burt Berry, DAL's founder, in the 1970s, was that market

trends could not be forecast and were clear only in retrospect. But the trends lasted long enough so that you could capitalize on it. Call it the hot hand of investing.

DAL applied its strategy to the funds in this study, starting with the top 15 in 1989 and tracking their one-, three-, six- and 12-month returns. When a fund dropped out of the top third — below 99 — it sold the fund and reinvested the money in the top-ranked fund that it did not own.

Over the 21.75 years of the study, the upgrading strategy had an annual return of 12.19 percent, second to the top-ranked FPA Fund. It had a 1 percent fee, and it underperformed the benchmark nine times. . . .

Of course, investors can use the data published in the NoLoad FundX newsletter and apply the strategy themselves.

The obvious knock against the strategy is taxes. If you are buying and selling securities in less than a year, you will be paying short-term capital gains taxes, currently 35 percent for the highest earners, instead of the 15 percent long-term capital gains rate.

But Ms. Brown said that the strategy had been fairly tax-efficient, with two-thirds of its gains being distributed as long-term capital gains.

"Most people assume that active strategies are not tax-efficient," she said. "When we invest, we want to invest in a fund for a year and stay with it. But if we buy a fund and it does not continue with good performance, we'll cut our losses pretty quickly and capture those losses to offset gains."