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## FUND TRACK

# Professors Shine a Light Into 'Closet Indexes'

Measurement May Help Investors See How Much of Their Holdings Are Actively Managed -- And Not

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Are your mutual-fund managers earning their keep?

A complaint lodged against many managers of funds that invest in stocks is that they collect big fees for doing little more than basing their stock picks on the market index -- say, the Standard & Poor's 500-stock index -- against which their fund's performance is measured. There's even a term for this behavior: closet indexing.

For investors, there hasn't been an easy way to tell if a fund falls into this category. Now a pair of Yale University professors have developed a simple way of measuring to what degree a fund's holdings are actively managed, as opposed to passively mirroring an index. It also turns out that -- at least according to the research -- this measure could be a useful predictor of fund performance.

The new measure, created by Antti Petajisto and Martijn Cremers from the Yale School of Management, takes a simple approach. Called the "active share" of a portfolio, it matches the holdings reported by a fund in Securities and Exchange Commission filings against the components of an index, and then measures the percentage of overlap. For example, if General Electric and Exxon Mobil each account for 4% of an index, and a fund had a portfolio exactly mirroring the index except it had 8% in GE and nothing in Exxon, its active share would be 4%. The more a portfolio differs from an index, the higher the active share percentage.

The study found that the average fund using the S&P 500 as a benchmark (generally, funds investing in large-company stocks) has an average active-share percentage of 66%. In other words, the average large-company stock fund had a portfolio that was 66% different than the benchmark and the rest essentially mirrored the index.

The study, which examined data from 1980 through the end of 2003, found an increase in funds that could be described as closet indexing during the 1990s, a period of major growth in the mutual-fund industry. Closet index funds (generally, those with active share falling into the 20% to 60% range) contained about 30% of all assets in 2003, up from virtually no assets in the 1980s.

One reason investors should care: Actively managed funds charge higher fees, on average, than index funds. After all, the idea is that you're paying a premium for the talents of a skilled stock

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picker -- not just someone who is mirroring a stock index.

But the study found that funds charged similar fees, regardless of their active-share reading. Funds with an active share of 70% or higher have expense ratios averaging roughly 1.57%. However, closet-index funds with an active share of 40% to 50% charged an average of 1.31%. Portfolios with an active share of 30% or 40% charged an average of 1.13%. (Index funds in the study charged on average 0.55%, though many are substantially cheaper.)

According to the study, active-share percentages are a good predictor of performance. Funds registering the highest active share beat their benchmark index by an average of 1.39 percentage points per year, while those in the lowest active-share group produced returns that, on average, fell short of their benchmark by 1.41 percentage points. This makes sense, argues Mr. Petajisto, one of the study's authors. Once fees are subtracted, a fund hugging an index is going to be hard-pressed to provide investors with returns that top the index.

In addition, the study found that, in general, funds with higher active-share readings tend to repeat top performance. "It's consistent with the idea that the most active funds are likely to have more skilled managers," Mr. Petajisto says.

Mr. Petajisto suggests investors compare a fund's active share against the fees they're paying. "If a closet indexer has 30% active share but only charges 0.30% [a fee not much more than most index funds], it may still be a reasonably good deal," he says.

The classic example of a mutual fund accused of being a closet indexer is Fidelity Investment's giant Magellan. In the early 1980s, Magellan's active share under famed manager Peter Lynch ranged between 70% and 90% -- a time when the fund earned its reputation by being a strong-performing, invest-anywhere portfolio. However, the active share declined later in the decade, to the mid 50%, coinciding with massive growth in the fund. By the mid-1990s, when Robert Stansky took the helm, the fund's active share started plunging to extremely low readings in the 30% range, a time when Magellan was widely criticized for being a closet index fund. During this time Magellan's performance suffered and the fund consistently landed in the bottom half of its peer group.

When Harry Lange took over the controls at Magellan late last year, the fund's active share rebounded from 41% in September 2005 to 66% in December. "When Lange replaced Stansky, the fund became significantly more active within only a few months," Mr. Petajisto notes.

A commonly voiced concern of fund industry observers is whether, as was the case with Magellan, mutual funds are more likely to become closet indexers as they grow in size. The Yale study did find that for funds investing in large-company stocks, active-share readings tend to decline after assets top \$1 billion. "That doesn't mean a fund necessarily always has to become an extreme closet indexer," Mr. Petajisto says.

For example, the \$19 billion Legg Mason Value Trust, run by William Miller, had an active-share reading of 85% for 2005 and the \$36 billion Fidelity Low Priced Stock Fund, which compares itself to the Russell 2000 index of small company stocks, has an active-share reading of 90%.

When making any investment, investors should consider a wide variety of factors and active share is no different. However, it can raise questions about whether funds are living up to the claim of being actively managed. For example, the \$3.6 billion Thrivent Large Cap Stock fund tells

investors that it employs an "individual, bottom-up approach to stock selection" focusing on "corporate fundamentals." However, its active share percentage is just 38%.

Thrivent didn't respond to a request for comment.

At Calamos Investments, active share points to possible differences between two funds that the firm says use similar investment strategies. Calamos Growth, which sports a top long-term performance record, clocks in among the most actively management funds with an active share percentage of 89%. But Calamos Blue Chip, which tells investors it uses "intense research" to pick stocks, posts an active share rating of just 40%. Meanwhile, investors in Calamos Blue Chip are charged expenses of 1.46%, far more than the 1.16% in fees levied on the average large-cap blend fund, according to Morningstar Inc. (Investors also pay a commission to purchase the fund).

In a statement, Chief Investment Officer Nick Calamos said, "The Blue Chip Fund is not an index product...It is big-company, blue-chip biased and more sector-constrained than the Growth Fund."

At the other extreme, funds with active-share readings above 95% include managers with top long-term track records built through years of building eclectic portfolios. Among them are CGM Focus Fund, **Brandywine Blue Fund** and **Longleaf Partners** funds.

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