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INVESTING IN FUNDS: A MONTHLY ANALYSIS

As Firms Boost Analyst Ranks, Here's How to Sort Out Funds

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With much of the fund industry focused on computer-driven trading models and sophisticated new ways to track market indexes, investors might be forgiven for thinking that human stock pickers are going the way of the slide rule.

Index-tracking exchange-traded funds and numbers-centric quantitative portfolios leave little role for the Peter Lynch-style manager who spends his days meeting with corporate management and touring factory floors. But kick-the-tires stock pickers remain alive and well as many fund companies pour more resources into research efforts -- trying to improve performance in the face of the proliferation of ETFs and other low-cost competitors.

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- See [fund quotes, listed A-Z by family](#)², plus the complete [Investing in Funds: A Monthly Analysis](#)³, formerly called *Mutual Funds Monthly Review*.

Fidelity Investments has added more than 120 stock analysts since 2005, bringing the total number to more than 340. Rather than hiring exclusively from college and business-school campuses, it's recruiting more experienced people. The firm also has increased the length of time that analysts are assigned to specific areas, to allow them "to know and understand the sectors better," says Brian Hogan, head of domestic equity research at the Boston-based company.

Janus Capital Group Inc. now has more than 50 stock and bond analysts with an average of more than nine years of industry experience, up from 40 analysts with an average of six years of experience in 2003. To encourage analysts to make the position a career, the Denver firm put analysts in charge of two funds, Janus Global Research and Janus Research.

Changes also have taken place at Franklin Resources Inc.'s Franklin Templeton Investments, where the number of investment professionals jumped nearly 70% to more than 400 between 2001 and last year.

Sun Life Financial Inc.'s MFS Investment Management has increased the size of its U.S. equity-research team by roughly 20% to 25% over the past few years and has tied analysts' compensation more closely to contributions to funds' longer-term performance. The best analysts are paid as much as -- or even more than -- some portfolio managers, says Kevin Beatty, an MFS portfolio manager and director of U.S. equity research.

Investors are also pouring more money into actively managed funds. Strategic Insight, a fund research and consulting firm, predicts that net flows this year into actively managed stock and bond funds will be close to \$265 billion, the highest level in a decade.

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Fund companies' renewed focus on research may mean better returns for investors. Yet those considering actively managed mutual funds should step carefully. Index funds' low fees and tax efficiency make them tough competition for active managers.

And improvement doesn't come overnight. While Oak Value Capital Management Inc., which runs the Oak Value Fund, started reorganizing its research effort several years ago, "only now is it obvious that we did the things we should have done," says Larry Coats, the firm's president and chief executive. The fund falls near the bottom of Morningstar Inc.'s "large blend" category on a three-year basis, while it has climbed into the top half of the category this year through the end of October.

To help investors sort through the more than 6,000 actively managed mutual funds and take advantage of the heightened focus on research, we pulled together recent fund-performance studies from investment-research firms and academia. Here's what we found:

1.If a manager doesn't own shares of his own fund, you may not want to invest, either.

Managers who hold shares of their funds tend to post better results -- and that's especially true for active managers, according to a study published this year in the *Journal of Financial Economics*. The study, by researchers at the Georgia Institute of Technology, London Business School and University of South Florida, looked at more than 1,400 funds that had reported manager-ownership data as of the end of 2004. It found that those with managers who held shares delivered an average return of 8.7% in 2005, compared with an average 6.2% return for funds with managers who held no shares.

The managers may have good information about how their funds will perform in the future, or their ownership of fund shares may simply give them more incentive to outperform, according to the study.

Only 43% of the funds had managers who held any shares, according to the study. U.S. stock funds had the highest manager ownership, on average, while international bond funds had the lowest.

A number of fund companies have begun requiring managers to put their own money in their funds. Janus has started directing a portion of managers' compensation into shares of their funds. **Legg Mason** Inc.'s Royce & Associates, which manages funds like Royce Opportunity and Royce Special Equity, requires senior portfolio managers to accumulate an investment of at least \$1 million in each fund they manage; assistant managers must invest at least \$500,000.

The Securities and Exchange Commission in 2005 started requiring funds to disclose managers' investments in the funds they run. The data are found in the fund's statement of additional information, which is often available on the fund company's Web site or at sec.gov/edgar.shtml⁴.

The figures don't tell all, however. Managers' investments are reported in broad dollar ranges, such as \$1 to \$10,000 or \$500,001 to \$1,000,000, and they aren't disclosed as a percentage of a manager's net worth. And while an investment of, say, \$500,000 may seem hefty, investors should consider the figure in light of the manager's compensation. The median compensation for equity portfolio managers in the U.S. is \$456,000, according to a new survey by the CFA Institute, an association of investment professionals.

2. Beware of "closet indexers."

If you're paying up for active management, you should get active management -- not an index fund in disguise.

Fund expenses cut into investors' returns. The average annual expense ratio of a stock ETF is 0.50% of

assets, while the average actively managed stock fund charges about 1.46%, according to Morningstar.

But true active management is getting harder to find, according to a study by Antti Petajisto and Martijn Cremers, professors at Yale School of Management. The study looked at funds' "active share," which basically measures what percentage of a fund's holdings actually differ from the index that serves as its benchmark.

Actively managed funds with a low active share -- those that have holdings quite similar to their benchmark -- held about 30% of fund assets in 2003, up from next to nothing in the 1980s, the study found. The average active share of so-called actively managed large-cap funds dropped to roughly 60% from about 80% over the same period.

The study found that funds whose holdings differ the most from their benchmarks tended to substantially outperform their indexes. And actively managed funds with low active shares generally charged fees almost as high as those with high active shares -- essentially charging active-management fees for index-fund performance.

While there is good reason for index funds' growing popularity in recent years, the increasing prominence of low-active-share funds is "a much less desirable development," Mr. Petajisto says.

There are some high-profile exceptions to this trend. At Fidelity Magellan, for example, manager Harry Lange is taking more risk versus the Standard & Poor's 500-stock index, one of the most commonly used benchmarks in the industry, than did his predecessor, Robert Stansky, says Greg Carlson, a Morningstar analyst. Magellan charges an annual expense ratio of 0.53%.

Investors can get a sense of how much a fund differs from an index by looking at its holdings and how the allocations stack up against the benchmark. The "portfolio" tab on morningstar.com⁵ shows how a fund's sector weightings compare with a broad-market index and its category average.

Fund-research site MutualDecision.com⁶ plans in the coming weeks to offer a tool that lets users screen for funds with high "active share." The site plans to offer the data for free for 30 or 60 days, after which users will need to pay a quarterly fee, which hasn't yet been determined.

3. Don't get too caught up in a fund's performance against its benchmark.

It's important to size up a fund's long-term track record against an appropriate market index. But investors shouldn't make snap judgments. Instead, focus on the fund's strategy and risk level to find out why it might be diverging from the index. A fund that lags behind its benchmark may be taking on less risk or staying away from inflated segments of the market.

The fact that Vanguard Selected Value Fund has trailed its benchmark over the past few years doesn't concern Daniel P. Wiener, publisher of Independent Adviser for Vanguard Investors newsletter and chairman of Adviser Investment Management in Newton, Mass. A big reason for the underperformance: The fund didn't load up on real-estate investment trusts, he says.

The fund ranks in the top half of Morningstar's midsize-stock "value" category over the past five years, and he says its managers have "a long-term track record I'm happy to stick with."

Another reason not to make snap judgments: The index cited by the fund may be inappropriate.

Research by Berk Sensoy, assistant finance professor at the University of Southern California's Marshall School of Business, found that roughly one-third of actively managed U.S. diversified stock funds name

a benchmark in their prospectus that doesn't match the fund's actual investment style.

To get a sense of whether a fund is citing an appropriate benchmark, check out its "style box" on the "snapshot" page at morningstar.com. If the fund's style is midcap value but it gauges itself against, say, a large-cap growth index, then you may not be getting an apples-to-apples comparison.

4. Don't wait around for a "stock-pickers' market."

Conventional wisdom holds that active managers often lag behind indexes during big rallies, but can beat the market during more turbulent times by moving to defensive positions like cash.

But investors shouldn't try to jump between indexing and active management based on market conditions, advisers and analysts say. And research by Russel Kinnel, director of fund research at Morningstar, challenges the basic notion of a stock picker's market.

To better judge active managers' skill, he constructed custom benchmarks to accurately reflect the holdings of various types of funds. The average large-company growth fund, for example, devotes the biggest chunk of its assets to this type of stock, but it also holds large value stocks, and even small caps. So instead of simply comparing large-company growth funds with a large growth benchmark, Mr. Kinnel built an index including large growth, large value, small caps and other holdings found in large growth managers' portfolios. When he compared funds against these more-accurate benchmarks, he found that there isn't a lot of variation year to year in the percentage of active managers who beat the benchmark.

"For a good active manager, all markets are stock-pickers' markets," says Mr. Wiener, who publishes the Independent Adviser.

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