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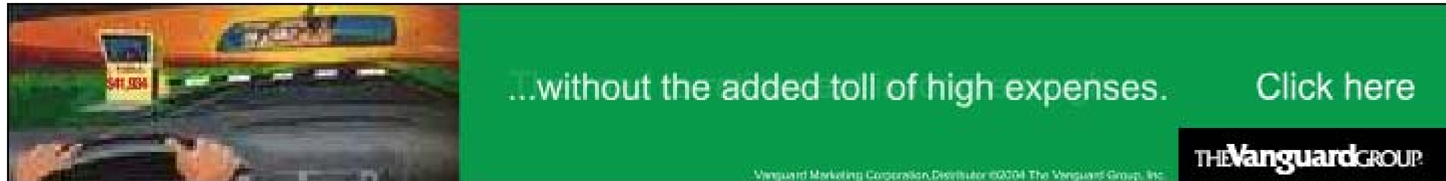

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Wednesday, Oct 13, 2004

Personal Finance

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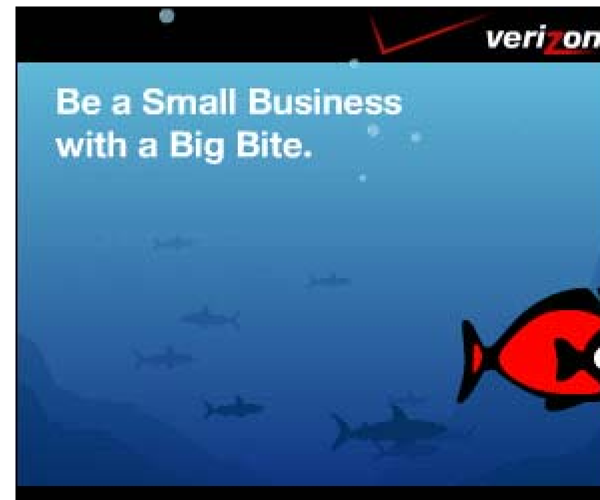
Posted on Tue, Oct. 12, 2004

On Personal Finance | Beating index funds takes rare luck or genius

By Jeff Brown
Inquirer Columnist



Over long periods, not many mutual-fund managers can beat the broad market indexes - hence the case for index-fund investing.

I've said that time and again. It's pretty standard advice.

Still, there must be some funds that *do* beat the benchmark indexes over long periods. Why not find them and invest in those?

Fair enough. How many are there?

That depends, of course, on the time frame and criteria used to compare funds. Yesterday, I used

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the online fund screener offered by fund-tracking company Morningstar Inc. to seek out such funds on the simplest and most useful basis.

I first ordered a list of "large-capitalization blend funds." These are U.S. funds that buy stocks in large companies such as those found in the Standard & Poor's 500. Blend means they include "growth" stocks - those of companies that are growing fast - as well as "value stocks," those trading at low prices relative to each company's earnings.

There are 1,446 large-cap blend funds. Over the last 10 years, only 35 of them matched or beat the performance of the S&P 500.

The top fund: The Mairs & Power Growth Fund (ticker MPFGX), which returned an average 17.19 percent a year, compared with about 11 percent a year for the S&P 500.

Before you run out and invest in it, note that Morningstar cautions investors not to count on such great results continuing. The fund's top manager has retired.

Also, even though it's classified a large-cap blend fund, it owns some small and mid-size companies, too, and that could hold it back when big stocks take off. The fund also has a quirky side: It looks for stocks in Minnesota companies.

This highlights the first problem in seeking out long-term winners. Did they win because their managers were good or just lucky?

To answer that, you'd have to evaluate all the managers' investment decisions. Not many of us are qualified to do that, and even if we were, fund companies don't disclose enough data on their day-to-day trades to support such a thorough examination.

The second thing to note is that only 2.4 percent of the funds in the category matched or beat the index - 35 of 1,446. That means 97.6 percent did worse.

Morningstar did a similar search, looking at the three years ended Friday. It sought funds that had the same manager for all three years, and that beat the S&P 500 in 2002 and 2003 and are doing so again this year. Result: just 22 of the 1,446 funds.

If such a small percentage beat the index, many of them do it with luck and there's no way to identify those that really are brilliantly managed... . Well, that's why index-fund investing is so attractive.

Instead of seeking hot stocks, index-fund managers simply buy and hold the stocks in the underlying index, so their performance matches the benchmark's almost exactly.

Active fund managers, even if they are very good, face obstacles that aren't shared by indexers, Morningstar says.

First, the large-company stocks in this category are well-known. They're subject to lots of Wall Street analysis and press coverage. Hence, there's not much chance a fund manager will uncover a bargain no on else sees.

Second, actively managed funds have higher expenses, since they have to pay all those analysts and stock pickers. Large-cap blend funds have average annual expenses equal to 1.25 percent of the assets in the fund, according to Morningstar. Many indexers in this category have expenses of less than 0.2 percent. Small as these numbers sound, they add up when compounded over the years.

I wouldn't argue that you should never own an actively managed fund. But I do think these data, and those of many other studies, place a heavy burden of proof on anyone pushing you to invest in a managed fund.

Ask: "Why that rather than an indexer?"

Then consider the answer with a healthy dose of skepticism.

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