



Step 5 ~ Manager Pickers

Copyright © 2005 Index Funds Advisors, Inc. All Rights Reserved.

# STEP 5 Manager Pickers



*"I have become increasingly convinced that the past records of mutual fund managers are essentially worthless in predicting future success. The few examples of consistently superior performance occur no more frequently than can be expected by chance."*

- Professor Burton G. Malkiel, *A Random Walk Down Wall Street*



*"History shows that in the long run a thoughtfully designed, diversified strategy of 'passive' funds typically beats all but a few active managers. It's not easy to structure and maintain such a strategy. It requires some initial research and discipline to stay the course. But it's much easier than predicting which active managers will randomly beat this approach."*

- Eugene Fama, Jr.



*"Studies show either that most managers cannot outperform passive strategies, or that if there is a margin of superiority, it is small."*

- Zvi Bodie, *Investments*



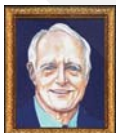
*"By day we write about 'Six Funds to Buy NOW!'... By night, we invest in sensible index funds. Unfortunately, pro-index fund stories don't sell magazines."*

- Anonymous *Fortune* magazine writer, *Fortune Magazine*, 4/26/99



*"People exaggerate their own skills. They are overoptimistic about their prospects and overconfident about their guesses, including which [investment] managers to pick."*

- Richard Thaler, *Investment Titans*, by Jonathan Burton



*"Wall Street's favorite scam is pretending that luck is skill."*

- Ron Ross, Ph.D. *The Unbeatable Market*

*"Statisticians will tell you that you need twenty years worth of data - that's right, two full decades - to draw statistically meaningful conclusions [about mutual funds]. Anything less, they say, and you have little to hang your hat on. But here's the problem for fund investors. After twenty successful years of managing a mutual fund, most managers are ready to retire. In fact, only twenty-two U.S. stock funds have had the same manager on board for at least two decades - and I wouldn't call all the managers in that bunch skilled."*

- Susan Dziubinski, Morningstar, Inc.

*"All the time and effort people devote to picking the right fund, the hot hand, or the great manager have, in most cases, led to no advantage."*

- Peter Lynch, *Beating the Street*

*"Most depressing of all, the 'superstar' fund managers I encountered in the early 1990s had a disconcerting habit of fading from supernova to black hole: Rod Linafelter, ..., Richard Fontaine, John Hartwell, John Kaweske, Heiko Thieme. I soon realized that if you thought they were great, you had only to wait a year and look again: Now they were terrible."*

- Jason Zweig, "I don't know, I don't care, Indexing lets you say those magic words." *CNNMoney.com*

*"Yet even the smartest, most determined fund picker can't escape a host of nasty surprises. Next time you're tempted to buy anything other than an index fund, remember this — and think again."*

- Robert Barker, "It's Tough to Find Fund Whizzes," *BusinessWeek.com*

*"... skepticism about past returns is crucial. The truth is, as much as you may wish you could know which funds will be hot, you can't - and neither can the legions of advisers and publications that claim they can. That's why building a portfolio around index funds isn't really settling for average. It's just refusing to believe in magic."*

- Bethany McLean, "The Skeptic's Guide to Mutual Funds," *Fortune*

## 5.1 INTRODUCTION

**S**tep 5: Manager Pickers: Realize that the winning managers were just lucky.

Like stock and time picking, manager picking is a worthless endeavor; however, there are still investors out there who believe they can select an all-star manager or financial guru who can beat the odds. To be sure, there is no shortage of managers out there who are willing to try to beat the odds for their clients or mutual fund shareholders—for a hefty fee. Like all speculators, these managers do win occasionally, attracting lots of media attention and new clients. Truth be told, the majority of expenses and fees in the investment industry go toward money managers who gamble with other peoples' money. Investors would be wise to pose the following questions to their money managers:

1. Do you have skill or were you just lucky?
2. Were you the beneficiary of the market's random walk or did you really know tomorrow's news and how it would affect the investments you picked for your clients?
3. Will there be persistence in your performance?
4. Is a three to five-year time period long enough to judge your success?
5. Statisticians say we need 20 years of data to judge success. Have you ever managed a mutual fund for 20 years or more or do you know anyone who has?

So-called star money managers attract about 75% of new mutual fund investors. This is despite the fact that what are considered "today's top 10 mutual funds" often tank within three years.

Typically, investors first invest in a "star" fund run by a "star" manager when they read about the "latest and greatest funds." Then they sell their investments within a few years when they become disenchanted by the fund's shoddy performance. This trend supports the findings of the 2004 Dalbar study on investor behavior, which shows that investors hold mutual funds for an average of 4.2 years, buying at the highs and selling at the lows. This results in the average investor greatly underperforming a market.

Manager picking has become so popular among investors that an entire industry has sprung up to help identify future winners based on past performance. Media advertisements feature winning mutual fund managers boasting of their recent success. The performance histories of mutual funds regularly appear in such publications as *Barron's*, *BusinessWeek*, *Fortune*, *Money*, and *Consumer Reports*. Even highly sophisticated consultants retained by multi-billion dollar pension plans use recent fund performance as the most important criterion in selecting "the best" money managers.

But, as Figure 5-1 clearly shows, that top performance rarely repeats in following years. Only about 14% of the top 100 managers from the one-year periods repeated their top 100 performance in the second year. In 1999, only one of the top 100 managers made the list in 2000.

## 5.2 DEFINITION

### 5.2.1 Manager Ratings

Since more than 95% of mutual funds are actively managed, the various mutual fund ratings exist primarily for manager pickers. However, a recent review of these ratings show a wide variation in rating methods and results. For example, the

Figure 5-1

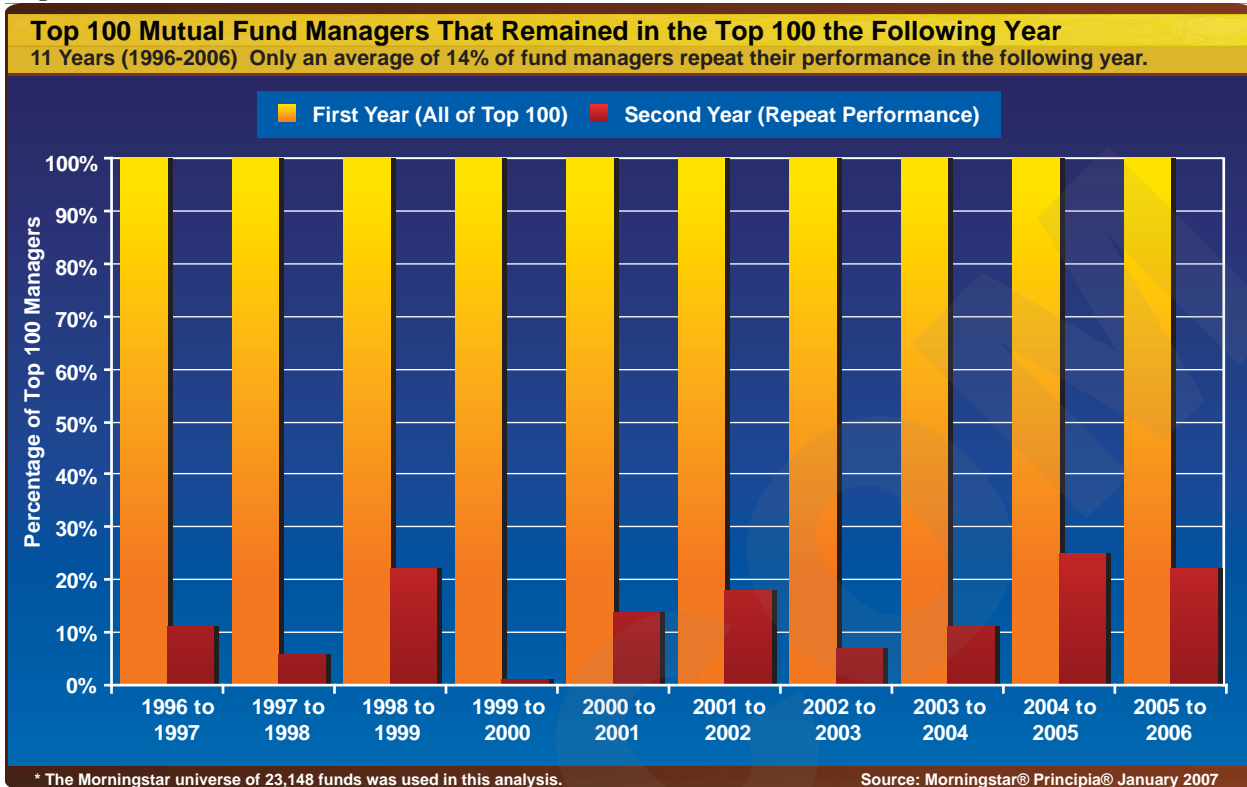


Table 5-1

Publications:	Mutual Funds Managers			
	Mutual Fund A	Mutual Fund B	Mutual Fund C	Mutual Fund D
Forbes (12/00)	C	A	A+	D
U.S. News & World Report (12/00)*	34	50	10	93
Wall Street Journal (1/01)	E	C	A	B
Business Week (1/01)	A	No Ranking	B+	C

\* 100 is highest rating; 1 is lowest rating.

same four funds were rated according to four different publications. Table 5-1 reveals the results.

On this table, funds A, B, C, and D are actual mutual funds. They are not identified because the purpose of this illustration is not to sell a particular security. It is to emphasize that ratings, in

and of themselves, do not provide enough information for making an investment decision.

These systems measure criteria about managers that is about as useful as a tipster giving advice at the race track. To make matters worse, there are countless stockbrokers, money managers, hedge fund managers, investment advisors, private money managers, and newsletter publishers, who do not operate publicly traded mutual funds. They are not required to report the same detailed information that is required of mutual fund managers. These managers are often criticized for the smoke and mirrors they have created to mask their results.

Luckily, investors received a gift from the SEC that blew away some of the smoke. In 2001 the SEC adopted a rule that requires mutual funds to disclose after-tax returns in their prospectuses.

This requirement equipped investors with a more accurate report on returns.

The ruling also helped open the eyes of investors, especially those using actively managed funds in taxable accounts.

### **5.3** PROBLEMS

#### **5.3.1 Past Performance is No Guarantee of Future Results**

Unlike the 20-year characteristic of an index, the past performance of money managers has no bearing on their future performance. Every reputable study of mutual fund performance over the past 30 years has found there is no reliable way to know if past superior managers will win again in the future. This is why some variation of the disclaimer “past performance is no guarantee of future results” must appear in all mutual fund advertisements and prospectuses, even though the SEC allows it to be written in very small print.

Studies show that those who have outperformed some past benchmark are more likely to underperform it in the future. Burton Malkiel, author of the long-time investment best seller, *A Random Walk Down Wall Street*, conducted a study in 1995. In the study’s conclusion, he states, “It does not appear that one can fashion a dependable strategy of generating excess returns based on a belief that long-run mutual fund returns are persistent.”

Investment experts give several reasons why past performance is no guarantee of future results. The most frequently cited is that any outstanding track record turned in by a money manager is the result of the market favoring his particular investment style. One implication of this

is that any such performance is entirely unpredictable—as is the time period that such good fortune may or may not last. Since market returns are correlated to risk factors (not to managers), there is no reason to expect that one manager will do better than another.

In addition, outstanding performance is often achieved when a mutual fund is small. This performance usually fuels an exponential growth in the amount of money that must be invested by the fund. The trading and other costs generated by the investment of this much larger amount of money can neutralize or even outweigh the margin by which a mutual fund manager may beat the market in the future.

These factors alone are all that is needed to prove that manager picking doesn’t work and is not a good basis on which to invest money.

#### **5.3.2 Persistence in Track Records**

Once again you can see that manager picking is virtually impossible. As Bob Dylan said in the last verse of his tune, “The Times they are a Changin’,” “the first one now will later be last, for the times they are a changin’.”

There happens to be one correlation between the past and the future, which seems to ring true for some mutual funds. Past poor performance tends to persist in the future, primarily because of the high costs charged by many funds. A 1996 study by Mark Carhart concluded, “Persistence in mutual fund performance does not reflect superior stock picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. While the popular press will no doubt continue to glamorize the best performing mutual fund managers, the mundane explana-



tions of strategy and investment costs account for almost all of the important predictability in mutual fund returns.”

Any predictability in performance has little to do with the stock picking skills of a specific mutual fund manager. A better way to determine which funds will do better over the long run is to find those that have captured the appropriate risk factors, are low cost, and generate minimal taxes. Index mutual funds fit these criteria very well.

An analysis of the Morningstar database of 800 domestic equity funds with 10 years of returns is shown in Figure 5-2. The top graph shows the rankings of 800 managers from best to

worst for the first five year period from 1991 to 1995, and then maintains the first period ranking for the subsequent five years, from 1996 to 2000, to see if manager performance persisted. It came as no surprise to the researchers that what appears to be a sorting of skilled and unskilled managers in the first period turns into randomness in the subsequent period. The second study shown in Figures 5-3 looks at another five-year period from 1995 to 1999. The second period of 2000 to 2004 also shows total randomness of manager performance. Figure 5-4 is a similar analysis, but for three-year periods and only 100 managers so the lines are more visible. As can be seen, there is no useful information in three-year returns either. Whether it is five-year or three-

## Step 5: Manager Pickers

year track records, the conclusion is the same: managers' track records of returns are of no value to manager pickers.

An example showing how the performance of actively managed mutual funds can be the result of luck rather than skill is illustrated in Table 5-2. Data in the center column represent returns at the end of five-year periods from 1971 to 2000 for the top 30 mutual funds. Contrast those returns with the column to the right, which shows the performance of the same top 30 mutual funds in a subsequent period. The Table shows that the so-called "great 30 funds" did worse than the S&P 500 in subsequent years. If the performance were due to skill, one would expect returns that continued to beat the S&P 500 Index in the subsequent period, which was not the case.

An investment strategy that focuses on investing in index funds using an asset allocation

method does not require chasing the recent performance of a particular money manager or index because that index is already known to be a winner over the long term.

Seventy-five percent of mutual fund inflows typically follow the previous year's "winners," usually based on the Morningstar Rating for funds. As already stated, a Dalbar study concluded that the average investor holds a mutual fund for 4.2 years. The result of this short-term holding pattern is a phenomenon called "investor whipsaw."

Please look several pages forward for Tables 5-3 through 5-15. These tables provide an interesting analysis of managers' performance over time. They track the rankings of the top 10 mutual funds from one year into subsequent years. The total number of mutual funds for each year is listed at the bottom of each column. The managers are tracked up to 2006 to see how those

Figure 5-2

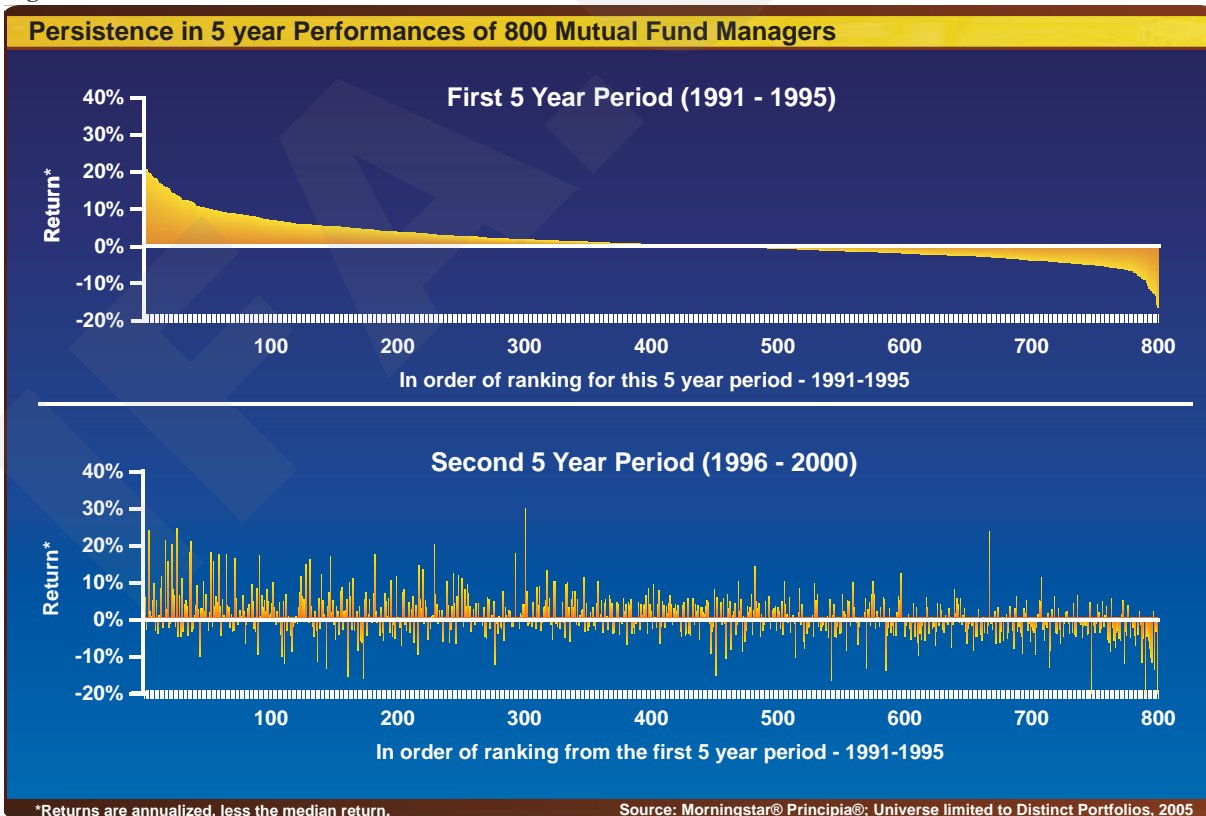


Figure 5-3

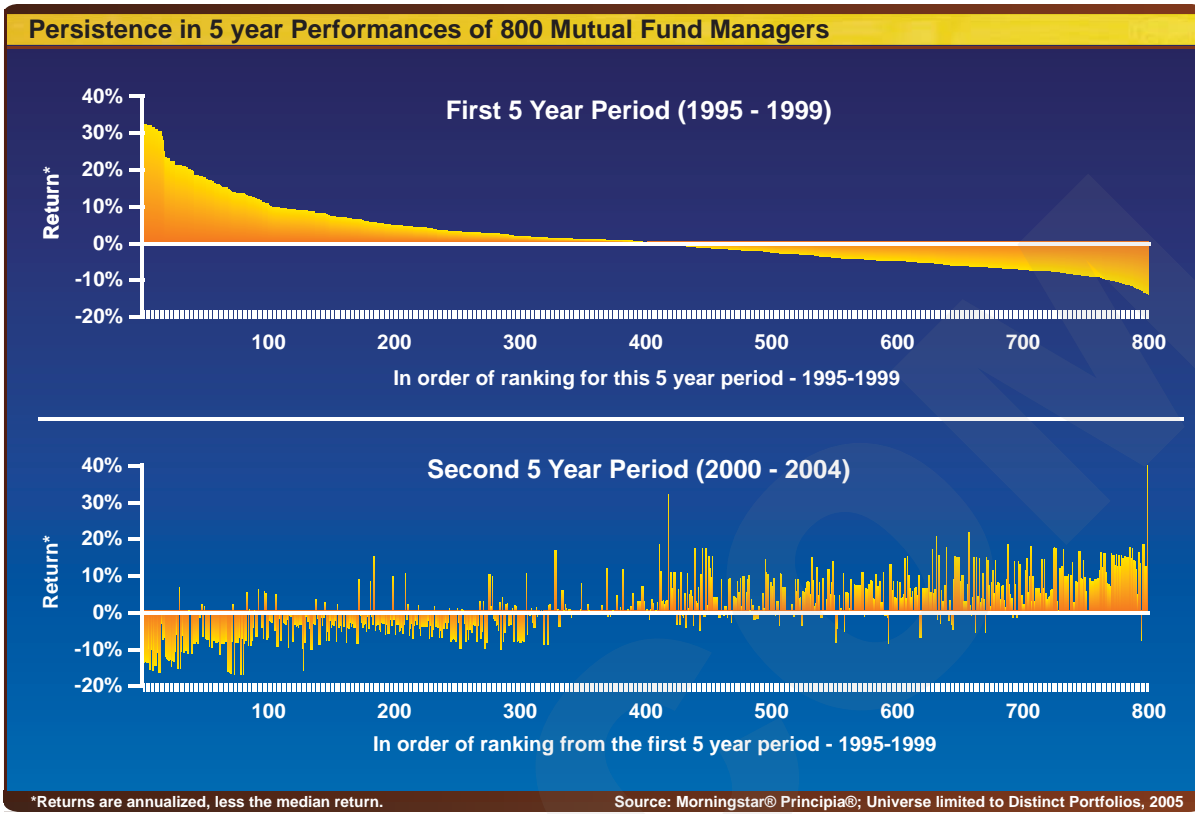


Figure 5-4

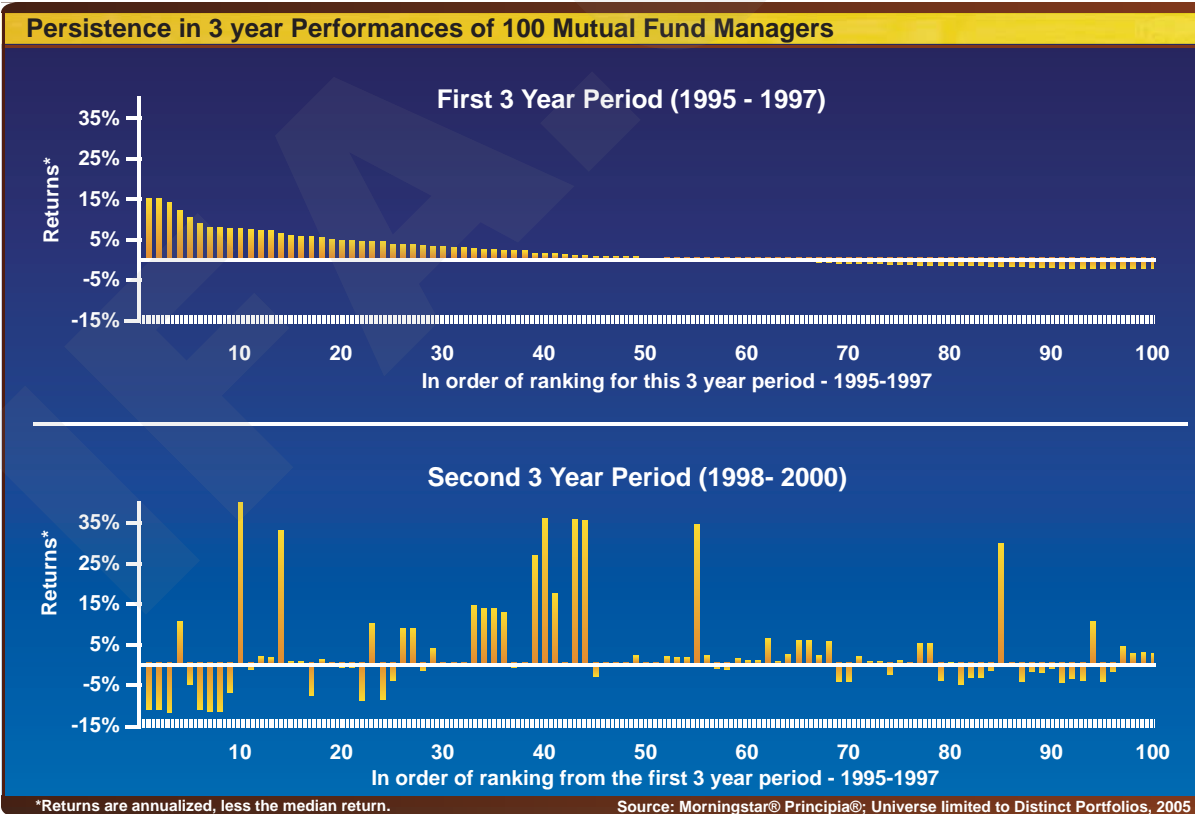


Table 5-2

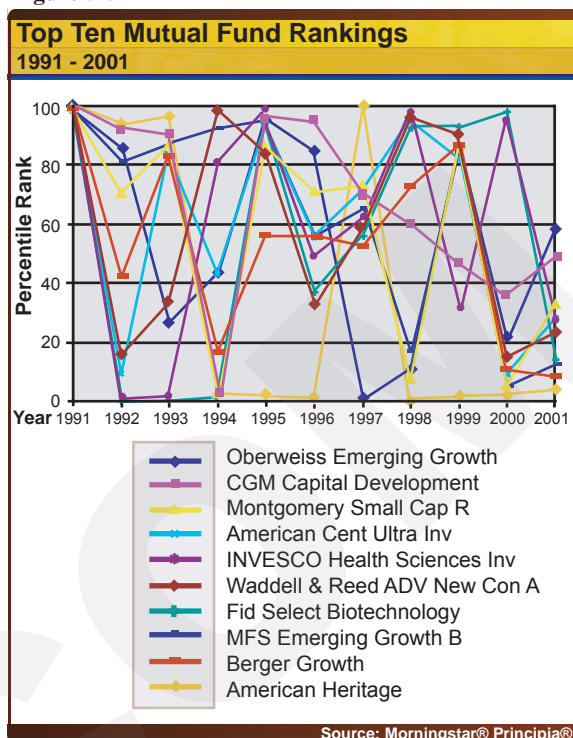
Subsequent Performance of Top 30 Mutual Funds		
Jan 1971 - Dec 2002		
	Annualized Return 1971-1975	Annualized Return 1976-2002
Top 30 funds 1971-1975	6.81%	13.21%
All Funds	1.31%	9.00%
S&P 500 Index	3.21%	12.54%
	Annualized Return 1976-1980	Annualized Return 1981-2002
Top 30 funds 1976-1980	34.33%	9.85%
All Funds	15.83%	7.74%
S&P 500 Index	13.95%	12.23%
	Annualized Return 1981-1985	Annualized Return 1986-2002
Top 30 funds 1981-1985	21.72%	9.71%
All Funds	10.93%	7.99%
S&P 500 Index	14.72%	11.50%
	Annualized Return 1986-1990	Annualized Return 1991-2002
Top 30 funds 1986-1990	14.91%	10.14%
All Funds	8.09%	8.89%
S&P 500 Index	13.16%	10.82%
	Annualized Return 1991-1995	Annualized Return 1996-2002
Top 30 funds 1991-1995	39.78%	2.05%
All Funds	16.27%	4.68%
S&P 500 Index	16.59%	6.88%
	Annualized Return 1996-2000	Annualized Return 2001-2002
Top 30 funds 1996-2000	30.97%	-22.83%
All Funds	15.23%	-17.21%
S&P 500 Index	18.34%	-17.15%

Source: Morningstar® Principia®

“great funds” from the first years did in subsequent periods. The results are similar, whether looking at all funds or one asset class. Tables 5-13 through 5-15 show the top ten managers of specific asset classes and their subsequent performance. As the tables show, those funds that were the winners in one year performed poorly in subsequent years. For the top ten managers from 1996 (Table 5-12), the highest ranked from that group fell to 4,695 out of 6,348 in 2006. And the number eight performer from 1996 came in at 5,330 out of 6,348, and was outperformed by 84% of his peers--quite a tumble indeed.

Figure 5-5 illustrates how investors can get whipsawed after buying a top fund. It lists the

Figure 5-5



top 10 mutual funds in 1991, then tracks them by decile rankings through 2001. A 100th percentile rank means that those funds performed in the top one-hundredth of all funds that year. Note continued randomness of future percentile rankings. After wildly bouncing around, eight of the 10 funds ended up in the lower 50th percentile at the end of the 10 years. The other two landed in the lower 60th percentile. The long-term performance of each fund was neither consistently good nor consistently poor.

### 5.3.3 Sources of Information Used by Manager Pickers

Morningstar, *Forbes*’ “Mutual Fund Honor Roll,” and mutual fund advertisements are some of the most well-known sources of investment information used by manager pickers. Examining these sources shows why superior performance cannot be correlated to past superior performance; because the future cannot be predicted.

## Step 5: Manager Pickers

Table 5-3

2005 Top Ten Managers and Subsequent Performance			
Fund Name	Manager Name	Annual Rankings	
		2005	2006
ProFunds UltraJapan Inv	Petit/Banke/Joshi/Ames/Rubin/Croll	1	2,337
ING Russia A	Mignon/Derks/Oubadia	2	7
Fidelity Adv Korea A	Urquhart, David	3	2,813
Gartmore Global Nat Res A	Kotik/Gerlach	4	994
Guinness Atkinson Glb Eng	Guinness/Harris	5	6,273
T. Rowe Price Latin Amer	Pangaro, Gonzalo	6	15
T. Rowe Price Em EurMedi	Alderson, Christopher	7	156
Matthews Korea	Matthews/Headley/oh	8	2,610
BlackRock Glb Res Inv A	Rice III/Walsh III	9	4,695
iShares SP Latin 40	Leung/O'Connor	10	53
<b>Total Number of Mutual Funds:</b>		<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®, Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

Table 5-4

2004 Top Ten Managers and Subsequent Performance				
Fund Name	Manager Name	Annual Rankings		
		2004	2005	2006
iShares Austria Index	O'Connor/Chen	1	250	126
Pro Funds Ult Mobile Inv	Foster/Najarian/Neches/Fleites	2	1,402	6,250
Bruce Fund	Bruce/Bruce	3	2,062	1,399
Metzler/Payden EuroEmMkts	Brueck, Markus	4	75	28
US Global Inv East Euro	Bottcher/Wiles	5	54	206
Eastern European Equity	Faschang, Guenter	6	305	297
iShares Mexico Index	O'Connor/Chen	7	33	38
BlackRock Glb Res Inv A	Rice, III/Walsh, III	8	9	4,695
Morgan Stan Ins IntlR/E A	Paske/Kemenade/Ho/Bigman	9	560	12
Pro Funds Ultra Oil&Gas Iv	Foster/Najarian/Neches/Fleites	10	29	421
<b>Total Number of Mutual Funds:</b>		<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®, Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

Table 5-5

2003 Top Ten Managers and Subsequent Performance					
Fund Name	Manager Name	Annual Rankings			
		2003	2004	2005	2006
Apex Mid Cap Growth	Bhirud, Suresh L.	1	5,444	5,848	5,690
ProFunds Sem UltSec Inv	Najarian/Neches/Hanson	2	5,491	1,190	6,333
ProFunds Int UltSec Inv	Najarian/Neches/Hanson	3	139	1,572	6,260
Reynolds	Reynolds, Frederick L.	4	5,419	5,845	4,577
Eaton Vance Grtr India A	Mehta, Samir	5	975	35	104
iShares Brazil Index	Leung/O'Connor	6	72	18	37
Oberweis Micro-Cap	Oberweis, James W.	7	5,015	930	6,133
Schneider Small Cap Val	Schneider III, Arnie	8	219	1,466	884
iShares GS Network	Leung/O'Connor	9	2,745	4,526	5,767
ProFunds UltraOTC Inv	Petit/Banke/Joshi/Ames	10	1,414	5,741	4,588
<b>Total Number of Mutual Funds:</b>		<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®, Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

## Step 5: Manager Pickers

**Table 5-6**

2002 Top Ten Managers and Subsequent Performance						
Fund Name	Manager Name	Annual Rankings				
		2002	2003	2004	2005	2006
First Eagle Gold A	Eveillard/de Vault	1	1,009	5,438	187	863
OCM Gold	Orrell, Greg	2	480	5,473	188	96
Van Eck Intl Gold A	Foster, Joseph M.	3	678	5,452	87	32
Gabelli Gold	Bryan, Caesar	4	441	5,465	109	222
US Global Inv Wld PrecMin	Management Team	5	20	5,292	138	14
Tocqueville Gold	Hathaway, John c.	6	312	5,443	144	61
US Global Inv Gold Shrs	Management Team	7	103	5,446	115	17
AmCent Global Gold Inv	Martin/Schniedwind/Sterling	8	555	5,453	154	435
Evergreen Prec Metals B	Gunn, Gilman C.	9	123	5,447	98	136
USAA Precious Metals&Min	Johnson, Mark W.	10	74	5,463	62	44
<b>Total Number of Mutual Funds:</b>		<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

**Table 5-7**

2001 Top Ten Managers and Subsequent Performance							
Fund Name	Manager Name	Annual Rankings					
		2001	2002	2003	2004	2005	2006
ING Russia A	Management Team	1	35	54	3,725	2	7
Matthews Korea	Matthew/Headley	2	856	1,683	386	8	2,610
Corbin Small-Cap Value	Corbin, David A.	3	2,642	424	1,989	1,223	1,509
Wasatch Micro Cap	Gardiner/Chace	4	3,134	112	2,084	197	2,075
CGM Focus	Heebner, G. Keeneth	5	2,906	336	1,217	2,074	1,852
Robeco Boston Part Sm Cp II Inv	Dabora/Rosenbluth	6	1,266	1,628	914	12	3,088
iShares S. Korea Indx	Leung/O'Connor	7	1,590	1,404	1,807	3,560	1,381
Aegis Value	Barbee, Scott .	8	1,436	1,344	1,302	1,010	1,042
Third Millenium Russia	Connor, John	9	33	62	667	21	122
Satuit Capital Micro Cap	Sullivan, Robert J.	10	2,667	154	719	708	2,480
<b>Total Number of Mutual Funds:</b>		<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

**Table 5-8**

2000 Top Ten Managers and Subsequent Performance								
Fund Name	Manager Name	Annual Rankings						
		2000	2001	2002	2003	2004	2005	2006
Evergreen Health Care A	McCormick, Walter T.	1	2,042	3,952	493	3,241	1,384	3,072
Manning & Napier Life Scn	Andreach/Donlon/Gambill	2	309	3,153	2,236	4,747	715	2,723
Munder Health Y	Wald/Rajogopal	3	4,013	4,743	459	2,076	2,020	6,240
BlackRock Gib Res Inv A	Rice, III/Walsh III	4	2,459	1,371	185	8	9	4,695
Allianz RCM Biotech D	Tsuboi/Dauchot	5	4,225	4,785	962	1,366	5,758	6,264
Eaton Vance Wld Health A	Isaly/Hsu/Borho/Klemm	6	2,810	4,219	2,053	3,549	2,021	6,215
ICON Energy	Waller, J.C.	7	2,512	1,906	1,750	32	46	3,539
JennDry Jenn Health A	Chan/Del Balso	8	2,333	4,605	810	154	233	3,951
Allianz RCM Health D	Dauchot, Michael	9	3,544	4,267	2,319	1,995	4,886	6,178
Fidelity Sel Natural Gas	McElligott, James	10	4,116	2,178	2,351	22	30	4,616
<b>Total Number of Mutual Funds:</b>		<b>4,140</b>	<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

## Step 5: Manager Pickers

**Table 5-9**

1999 Top Ten Managers and Subsequent Performance									
Fund Name	Manager Name	Annual Rankings							
		1999	2000	2001	2002	2003	2004	2005	2006
Van Wagoner Emerging Gr	Van Wagoner, Garrett R.	1	3,826	4,598	4,911	532	5,482	5,847	3,182
Brown Advisory Opp Instl	Chew/Hathaway/Berrie	2	3,921	4,562	4,877	50	5,420	5,762	5,913
Credit Suisse Jpn Eq Comm	Tomiyama, Kunio	3	4,137	4,253	4,370	883	3,420	199	6,305
Old Mutual Col Cir TechZ	Rizza, Anthony	4	4,117	4,586	4,900	639	3,874	1,594	5,330
Fidelity Japan Small Co	Mizushita, Kenichi	5	4,126	3,942	1,603	177	483	49	6,341
ProFunds UltraOTC Inv	Petit/Benke/Joshi/Ames	6	4,138	4,601	4,914	10	1,414	5,741	4,588
BlackRock US Opps Inv A	Callan/Rosenbaum	7	3,137	3,586	4,767	535	978	719	1,309
Kinetics Internet	Stahl/Tuen/Boyle/Larsson	8	4,128	3,047	3,953	955	2,756	5,693	1,641
Firsthand Tech Value	Landis, Kevin M.	9	3,317	4,558	4,906	60	5,448	992	3,710
WF Adv Enterprise Inv	Slingerlend/Wilson	10	4,008	4,062	4,395	1,281	1,587	1,753	2,907
<b>Total Number of Mutual Funds:</b>		<b>3,837</b>	<b>4,140</b>	<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

**Table 5-10**

1998 Top Ten Managers and Subsequent Performance										
Fund Name	Manager Name	Annual Rankings								
		1998	1999	2000	2001	2002	2003	2004	2005	2006
Kinetics Internet	Stahl/Tuen/Boyle	1	8	4,128	3,047	3,953	955	2,756	5,693	1,641
ProFunds UltraOTC Inv	Petit/Benke/Joshi/Ames	2	6	4,138	4,601	4,914	10	1,414	5,741	4,588
Fidelity Adv Korea A	Urquhart, David	3	50	4,135	23	1,504	2,242	993	3	2,813
Direxion NASDAQ Bull I	Smyth/King/Murray	4	62	4,124	4,554	4,689	203	2,510	5,649	4,474
Berkshire Focus	Fobes III, Malcolm R	5	41	3,632	4,604	4,909	106	4,515	553	5,253
Dreyfus Prem Tech Gr A	Herskovitz, Mark	6	25	3,980	4,493	4,782	354	5,369	3,575	5,761
Munder Internet A	Lebovitz/Woodley/Smith	7	20	4,132	4,577	4,854	96	1,677	1,903	6,186
Fidelity Sel Computers	Lawrence, Heather	8	218	4,018	4,322	4,823	156	5,417	4,263	3,584
Matthews Korea	Matthews/Headley/Oh	9	106	4,130	2	856	1,683	386	8	2,610
Rydex OTC Inv	Dellapa/Byrum/King	10	129	4,098	4,492	4,756	578	2,883	5,258	4,345
<b>Total Number of Mutual Funds:</b>		<b>3,472</b>	<b>3,837</b>	<b>4,140</b>	<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

**Table 5-11**

1997 Top Ten Managers and Subsequent Performance											
Fund Name	Manager Name	Annual Rankings									
		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
American Heritage	Thieme, Heiko H.	1	3,471	3,835	4,028	4,593	2,447	2,367	83	5,849	6,325
Munder Micro-Cap Eqty A	Hollinshead	2	3,167	256	3,527	183	3,706	136	463	1,143	4,280
FMI Focus	Lane/Primack	3	160	458	256	2,007	3,751	490	3,489	3,004	2,664
ING Russia A	Mignon/Derks	4	3,472	24	3,722	315	35	54	3,725	1,976	7
ING Financial Services A	Kloss/Rayner	5	3,061	3,821	176	3,003	2,574	1,799	1,884	146	1,478
Fidelity Sel Brokerage	Taylor, Yolanda	6	2,369	895	175	3,716	3,064	1,334	1,923	685	870
Baron Partners	Baron, Ronald	7	1,287	1,265	2,222	75	3,223	1,512	19	5,686	836
FBR Small Cap Financial	Ellison, David	8	3,312	3,611	101	68	890	1,295	5,686	2,924	
Alpine U.S. Real Est Y	Lieber, Samuel A.	9	3,382	3,817	280	62	1,488	37	25	1,491	6,231
Hartford Cap Apprec A	Catrickes/Pannell	10	2,845	318	1,731	2,820	3,870	934	970	598	1,851
<b>Total Number of Mutual Funds:</b>		<b>3,092</b>	<b>3,472</b>	<b>3,837</b>	<b>4,140</b>	<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

## Step 5: Manager Pickers

Table 5-12

1996 Top Ten Managers and Subsequent Performance												
Fund Name	Manager Name	Annual Rankings										
		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
BlackRock Glb Res Inv A	Rice,III/ Walsh,III	1	2,763	3,469	1,560	4	2,459	1,371	185	8	9	4,695
GMO Emerging Ctry DbtIII	Nemerever/ Cooper	2	354	3,438	857	249	232	62	1,349	803	525	2,103
Van Kampen Mid Cap Gr A	Lynch/ Norton	3	613	555	399	2,761	3,922	4,142	2,572	593	380	3,704
Firsthand Tech Value	Landis, Kevin M.	4	2,659	539	14	3,317	4,558	4,906	60	5,448	992	3,710
First Amer Sm Cp Gr Opp Y	McDougal/ McLeod	5	1,437	3,079	47	949	1,201	4,195	197	5,317	1,514	4,682
BlackRock Aurora Inv A	Archambo	6	24	3,323	816	68	194	3,420	429	1,518	4,099	2,669
Phoenix Emerging Mkt Bd A	Gagliardi/Marber	7	1,449	3,447	684	2,450	1,157	137	1,848	3,098	1,520	3,763
Old Mutual Col Cir TechZ	Rizza, Anthony	8	2,856	450	4	4,117	4,586	4,900	639	3,874	1,594	5,330
Phoenix Small-Cp Growth A	Lipsker/ Holtz	9	667	1,058	199	3,554	4,404	4,545	481	3,230	1,477	4,569
Needham Growth	Kloppenburg	10	1,334	688	224	1,904	297	4,399	527	3,672	666	1,342
<b>Total Number of Mutual Funds:</b>		<b>2,749</b>	<b>3,092</b>	<b>3,472</b>	<b>3,837</b>	<b>4,140</b>	<b>4,605</b>	<b>4,916</b>	<b>5,192</b>	<b>5,492</b>	<b>5,852</b>	<b>6,348</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes, Jan. 2007 Disc

Table 5-13

1996 Top Ten Large Growth Mutual Fund Managers and Subsequent Performance												
Fund Name	Manager Name	Annual Rankings										
		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Rydex OTC Inv	Dellapa, Byrum	1	57	3	272	312	19	384	28	156	415	308
Morgan Stan Ins Foc Eq A	Norton, Cohen	2	193	223	200	159	254	253	151	270	6	423
Fidelity Ewp & MultinatI	Victor Thay	3	77	201	176	40	369	44	113	45	22	200
Buffalo USA Global	Dornitzer, Gasaway	4	37	247	157	14	327	179	66	263	299	63
Aston/Montag Growth N	Ronald Canakaris	5	193	121	65	112	292	94	405	382	263	214
AXA Ent Growth A	Ronald Canakaris	6	176	128	58	120	291	113	411	391	281	246
White Oak Select Growth	Oelschlager, Barton	7	84	52	215	31	8	388	265	432	460	469
Morgan St Ins US LgCpGr A	Lynch, Norton	8	154	211	169	158	261	223	409	233	13	403
W.P. Stewart & Co. Growth	John Mahler Jr.	9	92	111	10	64	296	28	9	11	260	274
Franklin Flex Cap Gr A	Herman, Moberg	10	21	241	266	107	121	164	40	51	226	331
<b>Total Number of Mutual Funds:</b>		<b>198</b>	<b>219</b>	<b>255</b>	<b>279</b>	<b>316</b>	<b>376</b>	<b>397</b>	<b>414</b>	<b>433</b>	<b>463</b>	<b>499</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and indexes based on Morningstar Category of Large Growth, Jan. 2007 Disc

Table 5-14

1996 Top Ten Small Value Mutual Fund Managers and Subsequent Performance												
Fund Name	Manager Name	Annual Rankings										
		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
FPA Capital	Rodriguez, Robert	1	40	11	18	73	4	18	71	106	3	133
Evergreen Special Val A	Tringas, James M.	2	25	14	28	45	34	30	88	66	19	21
Morgan Stan InsUSSmVallns	Yaggy/Glass	3	19	12	9	66	79	71	70	65	34	3
Heartland Value Plus	Nasgovitz/Hathaway	4	20	40	40	74	5	17	18	91	106	96
Longleaf Partners Sm-Cap	Hawkins/Cates	5	26	1	36	50	73	16	37	99	18	12
Skyline Spec Equities	Fiedler/Odegard	6	6	34	70	17	50	32	57	93	16	58
Mainstay Small Cap Opp I	Samoilovich	7	10	5	38	75	51	15	16	11	13	106
DWS Dreman Sm Val A	Woodward/Roach	8	39	42	44	72	48	49	47	16	21	6
CornerCap Small Cap Val	Quinn/Bean	9	13	39	39	54	18	56	43	98	117	113
Allianz NFJ Sm Cap Val I	Magnuson/Mckinney	10	8	38	60	29	31	3	95	27	17	53
<b>Total Number of Mutual Funds:</b>		<b>35</b>	<b>41</b>	<b>47</b>	<b>70</b>	<b>75</b>	<b>81</b>	<b>87</b>	<b>101</b>	<b>110</b>	<b>124</b>	<b>135</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes based on Morningstar Category of Small Value, Jan. 2007 Disc

Table 5-15

1996 Top Ten Large Value Mutual Fund Managers and Subsequent Performance												
Fund Name	Manager Name	Annual Rankings										
		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Dreyfus Prem Strat Val A	Ferguson, Brian	1	159	117	73	25	131	285	9	45	94	111
Sound Shore	Burn III/DeGulis	2	5	161	156	31	99	103	79	95	135	284
Legg Mason P Inv Val A	McAllister/Feitler	3	122	53	46	60	156	227	83	266	166	239
Ivy Value A	Norris, Matthew T.	4	161	169	157	215	231	108	202	143	266	297
Primary Trend	Arnold/Gust	5	169	180	179	24	69	44	203	316	336	266
Muhlenkamp	Muhlenkamp	6	15	164	47	12	16	198	4	2	107	386
First Amer Lg Cap Val A	Earley/Mellum	7	157	123	76	202	207	215	248	186	128	207
DWS Dreman HiRetEqA	Hutchinson/Dreman	8	28	89	208	3	79	167	90	167	110	252
T. Rowe Price Value	Linehan, John	9	64	146	64	55	73	129	115	93	160	120
WF Adv US Val Z	Costomiris, Robert	10	35	12	27	211	239	136	111	147	328	172
<b>Total Number of Mutual Funds:</b>		<b>158</b>	<b>173</b>	<b>190</b>	<b>210</b>	<b>231</b>	<b>262</b>	<b>294</b>	<b>310</b>	<b>333</b>	<b>355</b>	<b>387</b>

Source: Morningstar® Principia®; Universe limited to "Distinct Portfolios" and Indexes based on Morningstar Category of Large Value, Jan. 2007 Disc

### Is a Highly Rated Fund a Good Thing?

Morningstar, a well-known independent investment research firm, is one of the many sources of information used by manager pickers. Mutual funds are currently assigned stars based on three, five and 10-year performances, risks and fees. When available, the 10-year performance has a 50% weighting, while the three year has a 30% and the two year has a 20% weight. While the long-term overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Morningstar holds that the star ratings are designed to be a starting point for investors and that the ratings themselves are not predictive of future performance. Its goal is to help the individual investor make better decisions. Nonetheless, since they are commonly contained in mutual fund advertisements, it is my belief that many investors look to the stars as a guide.

In a July 15, 2003 report on investor behavior, Dalbar stated that, "Motivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation." The report goes on to state that the average holding period for equi-

ty mutual funds was a little more than two years. The average manager picker is not grasping the concept that past performance has nothing to do with future performance.

An April 5, 2005 report by John Waggoner, of USATODAY.com, illustrates the problem Dalbar has identified. Waggoner tracked the asset flows into the then highly rated Fidelity Aggressive Growth Fund, which had \$23 billion in assets in March 2000. Investors poured 65% of those assets, \$15.1 billion, into the fund the 12 months before the S&P 500 peaked in March of 2000. So, a \$10,000 investment back in March 2000 would be worth \$2,697 in April 2005—that's a 73% loss.

Other once hot funds that have subsequently performed badly include Janus Worldwide, once a \$13-billion fund that fell 45% over the five years; Nasdaq 100 Trust, once a \$10-billion fund that has fell 67%, and Janus Global Technology, a \$10-billion fund in March 2000 that plummeted 73%.

In total, investors put \$228 billion into the 50 best-selling stock funds in the 12 months before the market peaked, yet only two of the top 50 funds had a gain over the next five years: American Funds New Perspectives, up 2.3%, and Vanguard Capital Opportunity, up 1.5%. In

total, the active investors who plowed money into the 50 hottest-selling funds in March 2000 are down an average 42%, by March 2005, according to Lipper Analytical Services, a well-known mutual fund data firm. (Further details of this active investor madness are recounted in the book *American Sucker*, by David Denby.)

Another example of the difficulty of picking a winning fund manager is found in “Selling the Future: Concerns About the Misuse of Mutual Fund Ratings,” a May 16, 1994 study conducted by Lipper Analytical Services, a well-known mutual fund data firm. In the study, Lipper selected highly rated mutual funds from Morningstar at the beginning of a year and then measured their performances in the following 12 months against mutual fund averages. This study was conducted in four subsequent one-year periods: 1990, 1991, 1992, and 1993. The study found that the majority of highly rated stock mutual funds underperformed mutual fund averages in each of the four subsequent years. This means that investors who select mutual funds from the list of highly rated funds can often end up in the wrong mutual funds at the wrong time. This not only demonstrates the unreliability of investing based on past performance over a period as short as one year, it also shows how consistently unpredictable mutual funds can be in outperforming the market. The results of the Lipper study are depicted in Table 5-16.

The study also found that at the end of 1990, after a long period of superior performance by foreign-oriented mutual funds, only 32% (25 out of 77) of the total number of highly rated stock funds were listed in the “international” and “global” fund categories. Predictably, many investors jumped into these funds, believing that their past superior performance would be repeated in the future. Not surprisingly, every one of these 25 international and global funds subse-

Table 5-16

The Percentage of Morningstar's Five-Star Stock Mutual Funds Subsequently Underperforming Stock Mutual Fund Averages		
Beginning Year	Subsequent Year	Percentage Subsequently Underperforming
1990	1991	52.6
1991	1992	71.1
1992	1993	56.0
1993	1994	63.6

Source: Lipper Analytical Services, Inc.

quently underperformed the average stock fund in the following 12 months. At the end of 1992, after foreign-oriented mutual funds performed poorly for a year, no international or global funds appeared on a highly rated funds’ list. Few investors were attracted to these international and global funds because they were at the bottom of the pile. The result: investors missed the superior performance of international and global mutual funds that began at the end of 1992.

Morningstar, for its part, released a new star-rating system in July of 2002. The old system compared the historic risk and returns from a mutual fund with the risk and returns of a broad group of funds. The new star system attempts to compare a fund with a much smaller group of funds of a similar style. According to a March 2004 paper published in *The Journal of Financial Planning* by William Reichenstein, Ph.D., Morningstar’s decision to change rating systems reflects a decade of studies on the importance of investment style in explaining stock returns. As discussed several times in this book, a Fama and French study in 1992 concluded that stock returns vary systematically across two dimensions: size and value-growth. Actually, Fama and French came to this conclusion after completing two different studies. First, the researchers focused on returns from a period from 1963 to 1990. In a later study they conducted along with their colleague Jim Davis, the researchers looked at returns from a longer peri-

od—1929 to 1997. The researchers discovered that stock returns can best be explained when stocks are separated into portfolios based on size as measured by market capitalization and value-growth as measured by book/market ratios. Many studies over the past decade have confirmed and reinforced Fama and French's conclusion that returns vary systematically across size and value-growth dimensions. This type of fund analysis was pioneered by Dimensional Fund Advisors (DFA), where Fama is the director of research. Fama also has written extensively on the random walk and efficient market theories and is one of the world's most cited economists. DFA uses a Fama/French designed factor regression analysis to show that active managers' returns are attributable not to skill, but to exposure to these risk factors. Consistent with the Fama and French research, DFA offers no actively managed funds, but has a complete assortment of passively managed index funds.

### **The *Forbes* Mutual Fund Honor Roll**

The *Forbes* Mutual Fund Honor Roll is hailed by the media as a dependable way to find superior performing mutual funds. Each year since 1973, the highly respected *Forbes* magazine has singled out 15 to 30 stock mutual funds and elevated them to *Forbes* Honor Roll status. These funds are selected on the basis of their total returns over at least a 10-year period, the stability of their investment management over at least seven years, and their relative performance in both bull markets and bear markets over several market cycles.

A comprehensive 1992 study by John Bogle titled "Selecting Equity Mutual Funds" examined the record of the *Forbes* Honor Roll covering the period of 1974 to 1990. The study sought to answer two questions: (1) did Honor Roll mutual funds continue to beat comparable non-

Honor Roll funds in subsequent years during the 1974 to 1990 time period and (2) did Honor Roll funds continue to beat the market in the ensuing years during this time period?

To answer the first question, the study found that there was a virtual tie in performance between the Honor Roll funds and the average stock mutual fund in subsequent years during this time period. To answer the second question, the study found that after commission loads were taken into account, the Honor Roll funds subsequently underperformed the market by a significant amount over the 1974 to 1990 period. The cumulative returns of the Honor Roll funds was 439.7% and the cumulative return of the market was 633.4%. That's a difference of 193.7%.

The study found that mutual fund winners from the past significantly underperformed the market in the future for several reasons. For one thing, the superior performance generated by an active fund manager's investment style is dependent on the time period in which the market favors that style. Since the stock market unpredictably favors different investment styles for different time periods, a manager's past superior performance is closely tied to a past time period in which the market happened to favor his or her kind of investment style.

A good example of the link between superior performance and a certain time period is found in the 1983 *Forbes* Honor Roll. In that year it contained a large number of small company stock mutual funds because small company stocks had generally outperformed large company stocks over the previous six or seven years. In the following years beginning in 1984, small company stocks began a dismal run in performance relative to large company stocks. As a result, small company stock funds began to drop out of the Honor Roll after 1983. Although the

small company stock funds in the 1983 Honor Roll had outstanding performance histories, their returns in 1984 and in the following years were inferior on average to the market and to the average stock mutual fund.

The *Forbes* Honor Roll study reached two conclusions: (1) investors can't pick a future winning mutual fund based on its past performance and (2) over the long run, even highly rated active funds underperform their respective benchmark.

### Mutual Fund Advertisements

Mutual fund advertisements are another source investors turn to when manager picking. Unfortunately, they convey this false message: "Since these funds have done well in the past, they will do well in the future, so buy them today."

Mutual fund advertisements carry an SEC mandated disclaimer stating: "Past performance is no guarantee of future results." There is a reason why the SEC requires this — it's true! According to Dalbar it appears that many investors act as if this disclaimer is not true at all. They continue to buy and sell mutual funds based on short-term past performance falling for the implied message of mutual fund advertising.

### 5.3.4 Markets Make Managers

There is one other point regarding the futility of attempting to identify skillful money managers. An old investment proverb observes that "markets make managers." This means that if the market favors a money manager's particular investment style anyone can achieve outstanding performance.

Markets can make a money manager look good or bad — a factor that's independent of their "skillful" stock picking or market-timing abilities. An active money manager that an investor selects will usually turn out to be a winning or a losing manager because of the behavior of the market itself, rather than the manager's skill at picking stocks or timing markets. Active money managers play a game that's almost entirely random in conferring long-term investment success among them.

### 5.3.5 Irrelevant Benchmarks

There are at least three other problems associated with manager picking. For one thing, investors are seldom aware that active funds or separate portfolios that have good performance histories are always riskier than the indexes they outperform. According to the Modern Portfolio Theory, any portfolio of investments that hold fewer stocks than the index in which it is invested must be, by definition, underdiversified relative to that index portfolio. It follows then that any mutual fund or separate portfolio that has turned in a market-beating performance achieved it by holding investments that somehow were different in kind or amount from those of the relevant index. Any mutual fund or separate portfolio that boasts a superior performance history must therefore be riskier.

A mutual fund manager with recent performance success has bet money and concentrated it in specific stocks or bonds. The bet may pay off, but people are too blinded by the "brilliant investment insight" to understand that the bet was too risky in the first place. Peter Lynch, the legendary manager of Fidelity's Magellan mutual fund, concentrated about 25% of the fund's holdings in foreign stocks in the 1980s. These stocks turned out to be top performers, and Magellan widely outpaced the S&P 500. The

irony is that these stocks weren't even represented in the S&P 500.

Lynch's performance was not measured against an appropriate benchmark comprised of a proportionately weighted mix of U.S. and foreign stocks. It was measured against the wrong benchmark, the S&P 500. Using an appropriate benchmark would have reduced, perhaps even eliminated, his successful performance during this period. Lynch's bet was nevertheless deemed a winner by popular acclaim, and he was widely hailed as the leading investment guru of the decade.

Had Lynch's bet turned out wrong and Magellan underperformed, Lynch would have been widely criticized as a fool for making such a risky bet. Right or wrong, it was still a risky bet because Magellan had a greater amount of diversifiable risk than was represented in the benchmark by which it was measured.

There are two lessons to be learned from this. First, any active investment strategy is inherently risky, but is not considered risky in hindsight if it turns out to be a winner. Second, a mutual fund's outstanding performance history is nothing more than the market's reward for exposure to excessive investment risk. Due to the unpredictable nature of the market, the same excessive risk that produces outstanding performance today can turn and produce miserable performance in the future. Once the market begins to favor sectors other than those a manager is invested in, his or her luck has run out.

Yet another problem with manager picking is that outstanding performance histories can be surprisingly fragile. Few investors realize that the most important factor separating a winning performance history from a losing one is the choice of starting and ending dates. Fidelity's

Magellan beat the S&P 500 for the decade ending in mid-1995. Lengthening the ending date by one year to mid-1996 would have painted a very different picture. Fidelity's Magellan underperformed the S&P 500 for that 11-year period.

Lastly, outstanding performance histories don't always reflect taxes or commission loads. Published mutual fund ratings are often pre-tax returns that disguise their true after-tax performance in taxable accounts. Fidelity's Magellan generated an average annual pre-tax return of 18.3% over the 10-year period from mid-1985 to mid-1995. Once the taxes and commission loads were factored in, the net return dropped to 12.7%. At first glance, this fund appeared to widely outperform the market. A closer look reveals that Fidelity's Magellan came very close to underperforming it. However, an investor may never know this because mutual fund advertisements often feature only pre-tax and/or pre-commission load returns. Tax-adjusted returns are now available from Morningstar on the Internet at [www.morningstar.com](http://www.morningstar.com). Morningstar's tax-adjusted returns only account for federal income taxes, but not state income taxes. Investors should also consider that state income taxes need to be deducted in order to see a complete picture of how all taxes impact investment performance, especially relative to a tax-efficient index fund.

### 5.4 SOLUTION

The solution for manager pickers is to stop being fooled by randomness, stop believing in Santa Claus, and give up the hope that a fund manager can be selected in advance to consistently beat a market in the future.

## 5.5 SUMMARY

Statisticians have stated their case saying they need at least 20 years worth of risk and return data to establish skill in a manager. The real problem is choosing those managers at the beginning of the period. Therefore, index funds are a far better choice for investors because of their nearly 80-year track records.

## 5.6 REVIEW QUESTIONS

1. Statisticians tell you that you need a minimum number of years of performance data on mutual funds to draw conclusions about future risks and returns. How many years are required?
  - a. 1 year
  - b. 5 years
  - c. 10 years
  - d. 20 years
2. The problem with picking a manager to beat the appropriate index is that:
  - a. they can't pick next year's winning stocks
  - b. they can't pick the best time to be in or out of the market
  - c. they can't determine which style of investing is the best
  - d. there is no persistence in manager performance
  - e. all of the above
3. A Dalbar study found manager pickers changed their managers every:
  - a. 7 months
  - b. 5.3 years
  - c. 2.6 years
  - d. 15.5 years
4. There are overlooked factors when investors review the past performance of managers. They include:
  - a. improper benchmarks
  - b. after-tax returns in taxable accounts
  - c. exact same time periods
  - d. commission charged on the purchase of the fund
  - e. all of the above
5. According to the mutual fund tracking service, Lipper, the top 50 hottest selling mutual funds in March 2000 were reviewed again in March 2005. On average, the top 50 funds had a total change in value of:
  - a. up 83%
  - b. down 42%
  - c. up 5%
  - d. down 10%
  - e. up 22%