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The Return of the Market-Beating Fund Manager

The Stage Is Set for Stock Pickers to Shine; Here's What You Need to Know to Find the Best Ones

By ELEANOR LAISE

It has been a tough few years for stock-picking mutual fund managers trying to beat the market — but that's beginning to change.

Stocks' lockstep behavior has been breaking down in recent months, which means active managers should have more opportunity to shine.

Of course, everyone knows that trying to beat the market can be a fool's game. But there are new tools that can help investors find managers who have a better chance of outperforming.

The trick is to find stock pickers who actually pick stocks — and are willing to chart their own course rather than cling to a market index.

Research has shown that the most active managers can beat their benchmarks handily. Yet according to a new study by Antti Petajisto, visiting assistant finance professor at New York University's Stern School of Business, about one-third of U.S. stock fund assets are managed by "closet indexers": fund managers who claim to be picking and choosing investments but are in fact closely hugging their market benchmark.

Investors in these funds are overpaying, since they could be getting the same results in an index fund for a fraction of the price. Actively managed U.S. stock funds have average expenses of 1.39% of assets, according to investment research firm Morningstar Inc., compared with less than 0.1% for some of the cheapest index funds.

Even the active managers who don't hew closely to an index have had a rough time

lately. That's partly because stocks have moved more or less in sync, making it difficult for managers to stand apart. In the one-year and three-year periods ending June 30, 56% of U.S. stock funds lagged the broad market, according to Standard & Poor's.

But things may be looking up for active managers. More than half of both large-cap value and large-cap growth managers beat their benchmarks in November, according to Bank of AmericaMerrill Lynch.

One key is shifting "correlations," which measure whether stocks are moving in sync or if many zig while others zag. After hitting historically high levels in May and June, stock correlations fell sharply in October, according to Matthew Rothman, head of quantitative-equity strategies at Barclays Capital.

The decline, which appeared to coincide with the kickoff of third-quarter earnings season, suggests fundamental drivers of stock returns are gaining attention — a good sign for stock pickers, Mr. Rothman says. Though correlations ticked up again in November, they remained well below the levels seen earlier this year, according to Barclays.

New Tools

As the outlook brightens for active management, new tools can help investors find stock-picking funds that are worth the price of admission.

One metric to consider is "active share," which measures the percentage of fund assets that are invested differently from the benchmark. While funds with active share under 20% are likely to be pure index funds, those with active share

between 20% and 60% generally purport to be "actively managed" but are actually closet indexing, according to Prof. Petajisto's study.

Active share can have a direct influence on returns. Looking at U.S. stock fund performance in the 20 years ending 2009, Prof. Petajisto found that the most active stock pickers beat their benchmarks by 1.26 percentage points annually after fees. On average, funds with lower active share didn't beat their benchmarks.

Closet indexing has gained popularity in recent years. Some 31% of U.S. stock fund assets were in funds with active share between 20% and 60% in 2009, up from roughly 19% in 2006, according to the study.

High volatility and steep stock declines in recent years may have prompted managers to hug benchmarks more closely, Prof. Petajisto says. While investors never like their funds to lag behind market indexes, the underperformance is especially painful in a down market, and "generates more career risk for managers," he says.

The closet indexers include such well-known names as American Funds' Growth Fund of America, whose active share was 54% at the end of 2009, according to the study — down from about 60% in 2008. The roughly \$150 billion fund, which has beaten its benchmark over the past 10 years, has lagged in 2010. Its massive size may make it more difficult to distinguish itself from the benchmark, analysts say. Some funds "are forced to be more index-like by asset growth," says Russel Kinnel, director of fund research at Morningstar.

"We have not seen any

correlation between size and returns," nor between active share and fund performance, says American Funds spokesman Chuck Freadhoff.

The RiverSource Disciplined Equity fund hugged its benchmark even more closely at the end of 2009, posting an active share of just 44%, according to the study. The fund, whose name has since changed to Columbia Large Core Quantitative, "is actively managed," Ryan Lund, a spokesman for the fund, said in an email, adding that portfolio managers strive to keep the tracking error relatively low.

Tomorrow's Stars

Investors looking for star managers would do well to focus on funds making big active bets. What do such funds look like? Morningstar recently crunched the active-share numbers on more than 2,000 U.S. stock funds. Managers with the highest active-share rankings in their categories often focus on just a couple of dozen holdings and are willing to make big moves into cash when they don't see compelling bargains in the market.

Arthur Moretti, for example, is among the most active of large-cap fund managers, and tends to limit his Neuberger Berman Guardian and Neuberger Berman Socially Responsive funds' portfolios to 30 or 40 holdings. "We have a natural bias to stay away from crowds," which comes in part from a focus on buying stocks with relatively low valuations, Mr. Moretti says. Both funds have beaten more than 85% of their large-blend category rivals over the past 10 years, according to Morningstar.

One of the most active stock

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pickers among midcap managers is Chuck Akre, who had nearly 60% of his Akre Focus fund's assets in his top 10 stocks as of Sept. 30, and more than 20% in cash. Given the current economic environment, "it's prudent to be cautious," Mr. Akre says. As for market indexes, he says, "we pay no attention to benchmarks. People ask me how we should be benchmarked, and I say, 'I have no idea.'"

Mr. Akre built his reputation for flouting benchmarks as long-time manager of FBR Focus fund, which is now run by his former analysts but still has very high active share, according to Morningstar.

Managers who make lots of active bets, of course, give themselves plenty of leeway to underperform, as well as outperform, the indexes. John Deysher's Pinnacle Value fund, for example, has fallen near the bottom of the small-cap value category so far this year — but it fell only about half as much as the category average in 2008

and has beaten roughly 90% of peers over the past five years, according to Morningstar.

Mr. Deysher now holds roughly 40 stocks in the fund and has nearly half of its assets in cash. When the fund has made sizable gains on holdings "and the market is clamoring for the stocks, we're not shy about selling them," he says.

Other Tips

Though active share has gained attention from researchers and money managers, the data can still be hard to come by for small investors. Morningstar earlier this year added active share data to its Morningstar Direct research tool, available to investment advisers and other institutions.

But there is a simple way for small investors to get a rough sense of a fund's active share: Compare its top holdings to the top holdings of an appropriate index fund. If you see significant overlap, Prof. Petajisto says, "that's a bad sign."

While it is important for investors to select active managers who are actually making active bets, people also should consider whether the market environment is giving managers much opportunity to beat the benchmarks, market observers say. To help investors make such decisions, Russell Investments and Parametric Portfolio Associates in October launched a lineup of indexes that measure "cross-sectional volatility," or how differently stocks are behaving within a certain market segment.

The higher the cross-sectional volatility in a particular market sector, the better the opportunities for active managers to beat — or trail — market indexes, says Paul Bouchey, Parametric's director of research. Indeed, in a recent study, Parametric and Russell found that active managers' return dispersions (or gaps between best- and worst-performing managers) were higher in times of high cross-sectional volatility.

Overall cross-sectional vola-

tility is fairly low right now, but market segments such as U.S. small-cap growth stocks and emerging-market small caps look like better hunting grounds for active managers, according to the indexes. Investors can find monthly cross-sectional volatility data for many market segments at CrossVol.com.

Given overall low levels of cross-sectional volatility now, it is particularly important for investors to find active managers who are truly active, Mr. Bouchey says.

Investors choosing active stock pickers don't need to abandon index funds, researchers say. Investors who want a shot at beating the market but also want to reduce their risk of lagging far behind the indexes could divide their portfolios between low-cost index funds and true active managers.

But with the bulk of "active" funds trailing the benchmarks after fees, Mr. Petajisto says, "don't go with anything in the middle."