Monthly Mutual Funds Review; What Helps to Find Fund Winners?; Investors Shouldn't Let Past Performance, Fees Be Their Only Guides

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Abstract (Document Summary)

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"I'm not about to back down from the idea that expenses are the best predictor of future fund performance," Mr. [John C. Bogle] says. "What they've found here is just what they should've found, because three years is too short a period." Mr. Clark doesn't disagree with Mr. Bogle's research, but notes that three years is the typical period used by investors and advisers to gauge a fund's performance.

"I'd be very dubious of the expense results," says Prof. [Matthew Morey]. "I personally believe a fund's ability to beat an index or its peers is still closely related to the expenses it charges." Mr. Clark asserts that considering all fund share classes provides a more complete picture of performance, since investors don't always invest in a fund's oldest share class.

Full Text (1613 words)

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WITH THE THOUSANDS of portfolios to choose from, there is no task more confusing or confounding than finding a mutual fund that will perform well in the future.

The challenge has become even more perplexing in recent months because of the sprawling scandal involving mutual-fund trading abuses. Investors' odds of picking a winning fund portfolio have long been, well, long: At the start of this year, the investment performance of more than 70% of actively managed U.S. stock funds trailed that of the Standard & Poor's 500-stock index during the past decade.

Trying to improve their chances of striking gold while sorting through the more than 6,000 portfolios available in the U.S., investors can look at an ocean of data, but purchase decisions usually revolve around two factors:

-- Past performance: Sales trends show that many fund buyers believe today's hot portfolios are likely to keep trouncing their peers in the future.

-- Fund costs: Because a fund that keeps tight control over expenses has a built-in advantage over an identical fund with higher costs, many investors think that low-cost funds are destined to be winners more often than their more-expensive counterparts.

The only problem: Both strategies are largely bunk in many cases. Or so says research by fund tracker Lipper Inc.

"There's a temptation [by investors] to use a single indicator like returns or expenses in filtering funds," says Andrew Clark, an analyst with Lipper and author of a new study by the firm. "But doing so probably won't benefit you much."

To figure out if past returns or fund expenses were useful breadcrumbs leading to future winners, Mr. Clark assembled return data on the stock and taxable-bond funds that beat their category averages in one or more of the three-year periods between 1989 and the start of this year. He chose to look at returns in three-year increments because financial advisers often focus on results over that length of time in deciding whether to recommend to buy or sell a particular fund.

In each three-year stretch, he noted where the outperforming funds had ranked in terms of returns and expenses versus their peers during the previous three years. In theory at least, funds with high returns or low fees in one three-year period ought to produce above-average returns in the next.

But the data produced some surprises: High returns weren't of much use in pointing to funds that would produce higher future results. Meanwhile, low fees were useful in picking winners in only some cases, while in others, higher fees were actually more dependable indicators of top returns down the road.

Mr. Clark found that outperforming stock funds in a given three-year stretch were just as likely to have fared well or poorly versus their peers over the previous three-year period. In every period, less than a quarter of outperforming funds had ranked in the top 20% of their peer group over the previous three years. Indeed, investors didn't enhance their chances of picking an outperforming stock fund no matter how a fund ranked against its competitors in the previous three years.

With bond funds, investors were slightly more likely to find success by investing in funds that had done particularly well in the previous three years.

"In most cases, whether you chose funds from the top 20% or the bottom 20%, it didn't make much difference," Mr. Clark said in an interview.

That isn't to say that some funds aren't able to consistently beat their peers, Mr. Clark acknowledges. Take portfolios such as the Fidelity Low-Priced Stock Fund, where manager Joel Tillinghast has topped its small-cap fund peers over the past one-, five- and 10-year periods, according to Lipper. The fund currently is closed to new investors.

Mr. Tillinghast and other managers with winning records show that "there are a number of talented folks out there," Mr. Clark says. "But you can't expect good performance to persist as a rule."

Of course, Mr. Clark, whose study titled "How Well Do Expenses and Net Returns Predict Future Performance?" is to be published today, is far from the first researcher to conclude that past returns are a shaky predictor of future results.

"Finding persistence using past performance is nearly impossible," says Michael Stutzer, a professor of finance at the University of Colorado. And if individual investors needed to be convinced of the point, consider that the more than 170 funds that posted returns topping 100% in 1999's frothy markets went on to average 29% annual losses over the following three years.

It may be harder for many investors to accept that low fund costs aren't always a good indicator of future winners. Many fund buyers in recent years have wrapped their arms around the idea that cheap funds were the most reliable path to outperformance.

After all, a fund's returns are reported after its annual expenses are subtracted from gains, or heaped on top of losses. So, a fund charging an annual expense ratio of 1.5% of assets -- about average for U.S. stock funds -- would need to beat the performance of a fund with a 0.5% expense ratio by a full percentage point to deliver the same return.

But Mr. Clark found fund investors weren't always right to let expenses guide their purchases. Unlike most studies that, for convenience, focus on a fund's oldest class of shares and screen out other share classes linked to the same portfolio, the Lipper study included all fund share classes. (A single fund may have Class A, B and C shares, and sometimes other classes as well, each carrying different sales charges and fee structures appealing to different types of customers; no matter their class, all the shares own a piece of the same underlying portfolio of securities).

Including all share classes led to an interesting discovery: Among no-load stock and bond funds -- that is, those that don't carry a sales charge -- focusing on lower-expense funds did improve investors' chances of picking a peer-beater. But among shares classes that do charge a load when shares are bought or sold, outperforming funds were more likely to come from those with higher expenses than from cheaper offerings. Mr. Clark says the return figures he used included load charges.

This flouts conventional wisdom in the fund world. Time and time again, researchers have found that, in aggregate, cheaper funds are more likely to post stronger returns in the long term than more- expensive peers, if only because their lower fees are the equivalent of a head start each year. At the start of this year, for example, the actively managed U.S. stock funds that beat the S&P 500 over the past decade carried annual expenses averaging about 1.1%; those funds underperforming the S&P carried a 1.4% average expense ratio.

So the findings weren't what Mr. Clark expected. But after re- examining and testing his data, the results still indicated that among load funds sold by brokers and other financial advisers, those with higher expenses were more likely to be top performers than those with lower expenses. Adviser-sold funds "with higher fees and expenses apparently earn rates of return that are sufficient to offset higher charges," Mr. Clark concludes.

Others think low fees are more important than that. Fund expenses are a particularly sensitive issue these days, with industry critics urging better disclosure of items such as what funds pay in trading commissions and regulators led by New York Attorney General Eliot Spitzer pushing fund-management companies caught up in the share-trading scandal to reduce their advisory fees charged to investors.

Regarding the Lipper study, John C. Bogle, founder of the Vanguard Group and a longtime advocate of low-cost funds, believes three years is too short a period to examine. In his own research, Mr. Bogle has found that when looking at data for 10-year periods, expenses are indeed more predictive of future returns than performance or other metrics.

"I'm not about to back down from the idea that expenses are the best predictor of future fund performance," Mr. Bogle says. "What they've found here is just what they should've found, because three years is too short a period." Mr. Clark doesn't disagree with Mr. Bogle's research, but notes that three years is the typical period used by investors and advisers to gauge a fund's performance.

Matthew Morey, a finance professor and fund researcher at New York's Pace University, questions the sense of examining all share classes, including Class C shares that are structured for investors who might not hold their shares for three years.

"I'd be very dubious of the expense results," says Prof. Morey. "I personally believe a fund's ability to beat an index or its peers is still closely related to the expenses it charges." Mr. Clark asserts that considering all fund share classes provides a more complete picture of performance, since investors don't always invest in a fund's oldest share class.

Setting numerical and academic quibbles aside, investors are still left wondering how they should shop for funds among the thousands available. Mr. Clark says there are other factors, including how long a manager has run a fund and whether the manager succeeds in avoiding disastrous years, that should figure into the decision.

"My suggestion is that you might use returns and expenses together to do your initial filtering," says Mr. Clark. "Then I'd use other measures like manager tenure or worst-year losses to get down to a smaller pool of funds and use your best judgment to make your choices."

Journal Link: WSJ.com subscribers can see how their funds stack up on returns, risks and expenses, and how they rank in their categories, at WSJ.com/Funds.