

Mutual Funds Report

In the Wild Fund Kingdom, Anyone Can Wear a Crown

By DANIEL AKST

IN kindergartens these days, all the children are special. You're special if you have blue eyes, but also if you have brown eyes. You're special if you like cookies. You're even special if you live in a house, although not any more special than if you live in a car.

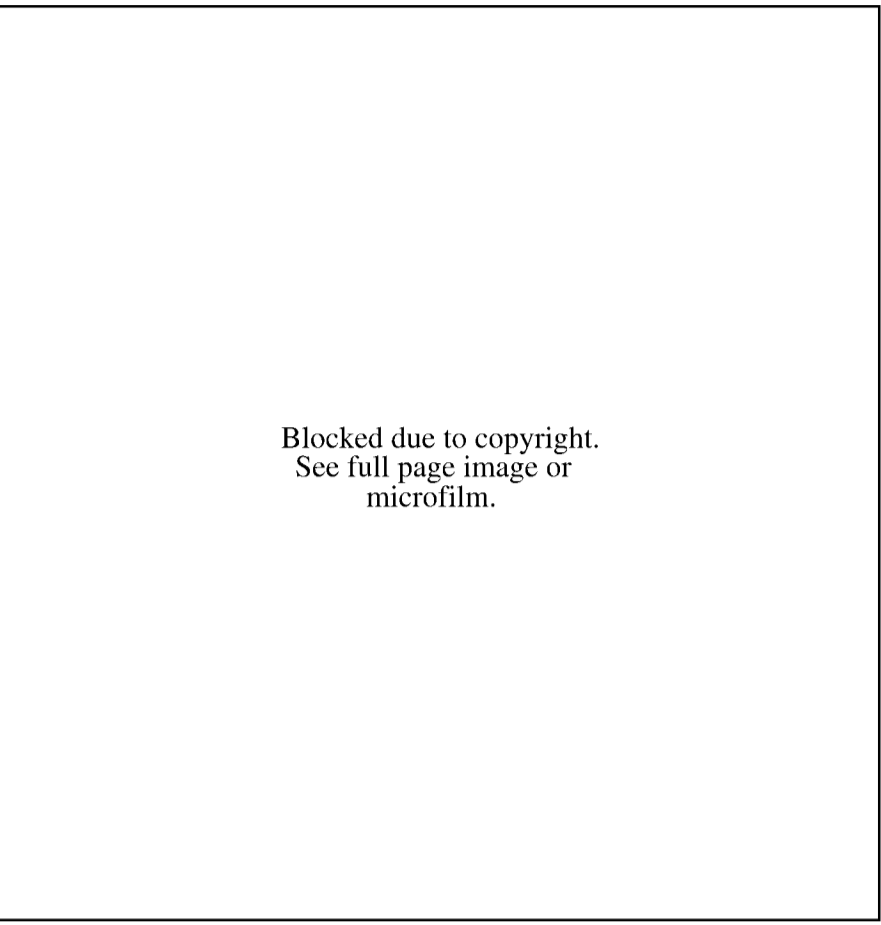
The world of mutual funds is not so very different. Nowadays, more and more funds are finding ways to trumpet their specialness. Thanks in part to the proliferation of mutual fund categories and rating services, more funds than ever can portray themselves as excelling at something while keeping a straight face.

This year, for instance, Lipper Inc., which tracks mutual funds, expanded from 8 to 14 the number of categories it uses to classify funds. In doing so, it followed in the footsteps of Morningstar Inc., another provider of mutual fund data, which scrapped its 36 fund "objectives" three years ago in favor of 50 fund "categories." They include flavors like specialty technology, high-yield bonds and small-capitalization value.

Indeed, the moves eliminated some ambiguities. (Weren't all funds, after all, interested in "capital appreciation"? And how did "growth and income" differ from "equity income"?) And they permitted fairer and more useful comparisons. But like the subdivision of baseball's National and American Leagues into regional divisions, the better to produce more champions and more playoff games, the subdivision of funds helps players that need to show they're near the top of the heap — by simply providing more heaps.

Categories aren't the only area where mutual fund information is expanding. Ratings of funds abound, too, and seem to be growing in direct, if not geometric, proportion to the number of funds.

Ratings are published not only by Lipper and Morningstar, but also by Business Week and a host of other publications. Value Line, which once



report, issued in March by the Financial Research Corporation of Boston, found that from 1988 to 1998, the average performance of funds placing in the top 10 percent of their peer groups in one year almost invariably fell back toward the middle the next year. "In fact," the study found, "out of the 40 quarterly periods measured, only once did the average performance of top-decile funds place into the first quartile in the subsequent year." (That was in the first quarter of 1991.)

The Financial Research study also found that Morningstar's closely watched five-star rating system didn't matter much either, because there wasn't much difference in the subsequent performance of funds awarded three, four or even five stars. The study's conclusion: "Past investment performance fails miserably as an indicator of future performance."

Another study, by Christopher R. Blake, an associate professor of finance at Fordham University's Graduate School of Business and Matthew Morey, assistant professor of economics at Fordham, found Morningstar ratings of equally dubious usefulness, except for funds given one star. Such rock-bottom ratings, over several different five-year periods, turned out to be reliable indicators that a fund will continue to underperform.

Despite all this research, several avenues of academic inquiry remain unexplored. For instance, if all the money spent by investors on fund information were invested in a low-cost index fund, how much would it be worth after 10 years? Or 20? Or 30?

And given the apparent futility of professional fund management, how much would America's gross domestic product increase if all the spending on active mutual fund management were diverted to more productive ends? Just think of all the costs associated with fund-switching, not to mention 800 numbers and Web sites, record-keeping and postage.

Spurred by a patriotic impulse to safeguard our nation's economic health, I decided to look into this question. Based on average cost and fund asset data from the Investment Company Institute, I calculated that Americans will spend about \$60 billion this year on mutual fund management fees, sales loads and other charges. Assuming that \$10 billion of this is well-spent (a generous assumption, based on the performance of most funds), that translates to \$50 billion a year in waste, or more than half of 1 percent of G.D.P. — roughly the entire annual output of Ecuador.

Fortunately, some characteristics of funds do appear to have value as

indicators of future performance, although they are not the factors many funds crow about. For example, the study by the Financial Research Corporation, which looked at 766 funds from the former Lipper categories of Growth, Growth and Income, and Capital Appreciation, found that size really is important. Over the last 10 years, the study showed, stock funds with smaller asset pools have outpaced their larger competitors by eight-tenths of a per-



confined itself to stocks, ranks funds these days, too, as do a passel of newsletters, some of them focusing on single fund families. Standard & Poor's and Moody's Investors Service once jostled over bond ratings: now they do the same over funds.

There is also a tendency to focus on ever shorter periods of time: Some newspapers give prominent display to one-month, or even one-week, returns.

But does it really matter whether a fund is first in its class in Grasping Magazine's rating of Southeast Asian mid-cap value funds for the three-year period ended April 30? Of course not. For all the sound and fury over who is No. 1 in any year or any category, a growing body of discouraging evidence suggests that it makes little difference.

The reason is that funds that outperform for a year or two rarely maintain any lead over their peers. Most funds tend to revert to the mean; hardly any consistently trump unmanaged index funds over the long run. Burton Malkiel, author of "A Random Walk Down Wall Street" and an advocate of index investing, wrote recently that "the fund managers who beat the index in one period are unlikely to do so in the next." Among other things, he noted that broad market indexes regularly outperform about two-thirds of actively managed mutual funds and that the Standard & Poor's 500 index, in particular, beat 9 of 10 active managers over the past 10 years.

TO put this in stark perspective, he wrote, "Over the past 30 years, a \$10,000 investment in the index would have grown to \$311,000 (after expenses); in the average general equity fund, the same investment would have grown to \$171,950."

A number of studies confirm that obsessing over mutual fund performance is largely a waste of time. One



centage point annually. "Portfolio size is indeed an effective screening tool," the report said.

The same study also found that funds less than five years old tended to turn in above-average performance and that those older than 10 years turned in below-average returns. The authors suspect that this is a corollary of the size issue, since newer funds tend to be smaller.

On the other hand, small funds tend to become large, perhaps in part because of that very performance advantage. The small funds that remain small tend to be the underperformers, which can't draw much new money. But while strong performance brings in new assets, the study found that "top-selling funds deliver slightly below-average performance downstream."

Still, all this makes me wonder why fund marketers don't trumpet the "world's tiniest mid-cap blend fund with a mediocre decile record since its inception less than three months ago." Maybe they should. □

