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WEEKEND INVESTOR

# And the Next Star Fund Manager Is ...

We detail what makes one more likely to be a winner

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By **JOE LIGHT** [CONNECT](#)

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Finding a mutual-fund manager who can beat the market is tough. Winners flame out. Losers revive. The resurgent losers flame out again.

No wonder low-cost index-based exchange-traded funds and mutual funds—which seek only to mimic the return of a designated slice of the market—have eclipsed actively managed funds as the

investment of choice for many people.

Indeed, low-fee funds that seek to track, rather than beat, indexes such as the S&P 500 have been shown over time to outperform active managers.

But investors don't always have that choice. Some 401(k) plans offer only actively managed funds for exposure to certain asset classes.

And some investors might still be looking for a market-beating edge to an index-fund-heavy portfolio, despite the long odds.

### Is Your Fund a Closet Index Fund?

Compare funds' accompanying "active share" percentages.

#### Is Your Fund a Closet Index Fund?

Mutual funds that offer the most from indexes tend to perform better than those that are the most similar. You can look a fund's fee as an accompanying "active share" percentage. The higher the number, the less similar the fund is to its benchmark. Consensus of funds who compiled this data says that is just perfect. Use common sense when judging whether to not the related index as a fair comparison. Active share is based on its U.S. stock holdings only. While a specific share class is listed, the active share applies to all its fund classes.

Fund Name	Benchmark It's most similar to	Percentage of a benchmark
Berkshire Capital Trust: Private Equity Fund	RUSL US Small Cap Value USD	95%
Parsons Global Int'l Portfolio: Global Fund	S&P 500 Index TR	95%
Advanced Micro Device Fund: QIBF Capital Long-Term Fund: Institutional Class: Shares	RUSL US Mid Cap Growth USD	95%
JP Morgan Trust II: Morgan Strategic Income Opportunities Fund: Small Cap: Shares	S&P Composite RM USD	95%
Woodford Global Fund: Global Growth Fund: Class A: Shares	S&P SmallCap 600 Value TR	95%
Frontier Asset Management Trust: FASD Small Cap Fund: Investor Class: Shares	S&P SmallCap 600 Growth TR	95%
Coastal Funds Variable Series Trust II: Variable Portfolio - Coastal Target Int'l: Sustainable Fund: Class A	RUSL US Mid Cap Growth USD	95%
Linnus Science Fund II: Linnus Science Investment Grade Fund: Income Fund: Institutional Class	S&P MIDCAP 400 Pure Growth TR	95%
Corner Variable Series Trust: CornerHealthcare Morgan Healthcare Fund: Class A: Shares	S&P MIDCAP 400 Pure Growth TR	95%
Windsor Mutual Funds, Inc.: Small Cap Opportunities Fund: No Load: Class	RUSL US Small Cap Growth USD	95%
<a href="#">View Graphics</a>	Fund: Institutional Class: Shares	95%

Academic research has found steps that can better the odds in identifying future winners. They include picking funds with low fees and low turnover and portfolios that differ sharply from the index.

And even though passive funds win the fee war in most cases, there are some asset classes—such as municipal bonds and high-yield bonds—where a low-fee active manager might be a better pick.

"It's hard to find an active manager to consistently give good performance," says

Russ Wermers, a finance professor at the Robert H. Smith School of Business at the University of Maryland in College Park, Md. who co-wrote a textbook on picking fund managers, "Performance Evaluation and Attribution of Security Portfolios." "If you have no time, just go for the lowest-fee [index fund] you can find."

Here's a guide to when it pays to be active and how to up your odds of finding a good manager.

### Finding the Winners



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Picking the best active managers takes work. Investors need to keep their bets focused on just a few choices and reassess their picks every couple of years.

One problem: Over long periods, few fund managers continue to outperform, says Laurent Barras, a finance professor at McGill University in Montreal.

Prof. Barras took a database of active mutual-fund performance between 1975 and 2006 and attempted to count the number of managers whose stock-picking skills were able to add value, after controlling for fees, trading expenses, stock size, style and other factors.

In 1989, about 15% of active managers demonstrated such skill over time, he found. But by 2006, only 12 managers out of 2,076—or 0.6%—did.

What happened? Prof. Barras believes one reason could be that many skilled mutual-fund managers may have moved to more lucrative positions at hedge funds.



Prof. Wermers, one of Prof. Barras's co-authors, also says that skilled fund managers outperform under certain economic conditions and over short time periods but don't outperform for long periods.

If an individual investor wants to invest in an active fund, it means that the investor

has to reassess the managers in his portfolio every couple of years to account for changing skill levels, he says.

Some investors might be tempted to load up on several active funds in the hopes that they will stumble on a winner. Indeed, some financial advisers lately have argued that investors should "diversify" active managers by holding portfolios that include funds that employ many different strategies.

That could be a mistake, says Rick Ferri of investment adviser Portfolio Solutions in Troy, Mich., who in his own portfolios uses index funds almost exclusively.

In an analysis published this month in the Journal of Indexes, Mr. Ferri, with Alex Benke of New York-based investment adviser Betterment, found that increasing the number of active managers lowers a portfolio's chances of beating index funds.

He found that the underperformance from funds that lose to the market tends to wash out the outperformance from funds that win. Also, the more active funds a portfolio has, the closer the overall portfolio looks to an index fund, he says.

"You're 'di-worsifying,'" rather than diversifying, Mr. Ferri says.

**Looking Backward**

Many investors look to the recent past to find the best managers. That often ends in disappointment.

On Wednesday, Chicago-based investment researcher Morningstar celebrated the cream of last year's crop, giving Fund Manager of the Year awards in five categories: Dennis Lynch and team of [Morgan Stanley Institutional Growth](#) for domestic stock; David Samra and Daniel O'Keefe of Artisan International Value for international stock; Daniel Ivascyn and Alfred Murata of [Pimco Income](#) for fixed income; Steven Romick, Mark Landecker and Brian Selmo of [FPA Crescent](#) for allocation; and Brian Hurst and Yao Hua Ooi of [AQR Managed Futures](#) for alternatives.

All the managers handily beat their benchmarks in 2013, and Morningstar says it believes they will continue to do well. Yet Morningstar director of active funds research Michael Herbst warns the award shouldn't be the sole basis for a fund choice.

Indeed, a Wall Street Journal analysis of available data on Morningstar's picks for the top fund managers shows the uncertainty of such an approach. Award-winning U.S.-stock-fund managers have tended to beat their benchmark in the year following their wins about 58% of the time. They beat the benchmark in the subsequent three

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years about 45% of the time, and in the subsequent five years 56% of the time. Over 10 years, their record is better, beating the benchmarks 65% of the time.

Chasing past performance leads to much worse results. In September 2011, 692 U.S. stock funds achieved records that put them in the top 25% of all funds for the previous 12 months, according to a December report by S&P Dow Jones Indices. Through September 2013, only 50 remained in the top quartile.

### ***Fees Above All***

The first and most important rule to picking a mutual fund: Stick to funds that cost the least.

On average, active managers lose to passive funds not because they are bad at choosing stocks and bonds, but because they tend to charge more, says Matthew Morey, a finance professor at Pace University in New York who has written more than half a dozen studies on picking active managers.

"If anybody asked me how to choose, and said just to pick one factor, I would say 'Just buy low fees,'" he says.

In a handful of asset classes, active funds are cheaper and more diversified than their passive counterparts, Mr. Ferri says.

Index funds that attempt to track state municipal bonds frequently charge higher fees than the lowest-cost active funds, he says, often because the market for such bonds is relatively illiquid and difficult to index.

For example, the [iShares California AMT-Free Muni Bond ETF](#), [\(CMF -0.01%\)](#) which tracks an index of California muni bonds, holds 423 bonds and charges annual fees of 0.25%, or \$25 per \$10,000 invested.

On the other hand, the actively managed [Vanguard California Intermediate-Term Tax-Exempt Fund](#) holds more than 1,100 bonds and charges only 0.12% if someone has at least \$50,000 to invest.

The same is true with many muni funds that invest in other states.

For high-yield corporate bonds—those issued by higher-risk companies—the [Vanguard High-Yield Corporate Fund](#) charges 0.13% (with at least \$50,000 invested) versus 0.5% for the [iShares iBoxx \\$ High Yield Corporate Bond ETF](#), [\(HYG +0.10%\)](#)

"Some fund companies have sold investors on the 'magic' of ETFs without explaining that it's the fees that matter. If an ETF costs more than active, on average, active should perform better," Prof. Wermers says.

In the same vein, actively managed mutual funds that trade infrequently don't have to pay as much in trading costs and are less prone to generate capital gains that can hurt investors come tax season.

The average U.S. stock fund has an expense ratio of 1.1% and churns 68% of its portfolio a year, according to Morningstar data. An investor who sticks with cheaper and less frenzied funds will be well on his way to finding a good manager.

### ***Make Sure Your Fund Is Trying***

The good news: Competition from passive funds has led many active funds to cut costs.

Since 1998, the average fee that investors pay for an actively managed stock fund, when weighted by how big the funds are, fell by 0.1 percentage point to 0.92% in 2012, according to the Investment Company Institute.

But that masks a disturbing trend, says Martijn Cremers, a finance professor at the University of Notre Dame in Indiana. While fund expenses have fallen, active managers have increasingly built portfolios that mirror their benchmarks—a phenomenon known as "closet indexing."

In other words, managers are charging less but aren't trying as hard as they used to.

Let's say an investor combined every actively managed fund into one portfolio and then measured how much that aggregate portfolio differed from the index.

Between 1998 and 2011, the percentage of U.S. stock funds' portfolios that wasn't closet-indexed—a measure known as "active share"—dropped to 24% from 28%. In effect, that means that the fees investors pay for active management has increased over the past 15 years rather than dropped, says Prof. Cremers.

The active-share measure is difficult for individual investors to calculate. [See the extensive list of funds and their 'active share' percentages above, as provided by Prof. Cremers.](#)

What is a good number? Prof. Cremers says the best funds tend to have active-shares percentages that are at least 60%. Large-stock managers should ideally have an active share above 70%. Midcap managers should have active share above 85% and small-cap managers should exceed 90%, he says.

Some of the funds with the highest active shares also have happened to be among the top-performing funds. The [Yacktman Fund](#), for example, had an active share of 76% as of March 2013, the latest data available. Over the past five years, the fund, which has an expense ratio of 0.76%, has beaten the S&P 500 by about four percentage points annually.

The Dodge & Cox Stock Fund, which costs 0.52%, has an active share of 71% and has beaten the S&P 500 by 1.5 percentage points annually.

[Morgan Stanley Institutional Mid Cap Growth Fund](#)—which is managed by the team that won Morningstar's top U.S. honors this year—charges 0.96% for its A shares, has an active share of 89% and has beaten Morningstar's midcap growth category by four percentage points annually over the past five years.

#### ***Will Active Management Rise Again?***

A rational investor, without much time to research funds, might logically decide just to pick low-fee index funds and forget about it.

However, sometime down the road, perhaps in the next decade, active funds should start to outperform again, says Lubos Pastor, a finance professor at the University of Chicago.

That is because as more money flows from active funds to index funds, it should become easier for active funds to find underpriced stocks and outperform, he says.

"Are we three years away or 30 years away? That's a hard question," says Prof. Pastor, adding that he thinks it's somewhere in between.

For now, though, his own portfolio is exclusively in index funds.

Write to Joe Light at [joe.light@wsj.com](mailto:joe.light@wsj.com)

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