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Stock-Picking Takes Concentration

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If recent market volatility makes you yearn for more steady returns, it may be time to turn over some of your mutual fund portfolio to an active manager. If you can handle the bigger price swings, higher costs and higher risk, there may be a payoff for your investments.

Financial advisers aren't abandoning their mantra that a diverse, balanced portfolio, aligned with a stated set of investment goals, is the best foundation for investment success. But this may be a time for smart stock-pickers to prosper. Funds whose managers pick their stocks selectively, rotating through different sectors and trying to time the market, charge more and can incur higher losses, but some of those funds, particularly those that hold stocks in fewer companies, are worth a look.

"With a sideways market, we noticed that actively managed funds trounced the indexes," says Jeff Tjornehoj, an analyst at mutual fund tracker Lipper.

The five-year total return for the S&P 500 is minus 1.2%. Actively managed funds tracked by Lipper are up 4.22% for the same period. Over the last 12 months, the index is up 35.12%, while the actively managed funds tracked by Lipper are up 37.88%.

A recent **University of Michigan** study concludes that less may be more when it comes to actively managed funds. Researchers tracked the returns of 1,800 actively managed funds (excluding sector-oriented ones) between 1984 and 1999, and found that funds with the most concentrated stock portfolios had higher returns than the ones with the most diverse holdings.

In essence, the study concluded that if a mutual fund had a few of the very best stocks in each given sector, it fared better than funds that spread their holdings through a larger number of companies in those categories. Funds with the highest concentrations of stocks had an average annual return 1.9% above their more diverse actively managed peers, according to the study.

Still, that wisdom comes from the ivory tower, and some investment advisers that say things play out differently on the Street.

Picking a concentrated portfolio fund is risky, in much the same way that buying one stock makes your investment dependent on one company's performance.

Concentrated portfolio funds, which Tjornehoj says generally have 30 or fewer stocks, are the clearest example of how managers make their case against overdiversification. They notch big gains when their stocks go up, and they have big dips as the same stocks drop.

"But when you get into this area, there are some very good concentrated portfolios and some particularly bad ones," he warns.

Tjornehoj says investing in them means taking on more risk, but some of these stock-picking funds have put up enviable numbers.

There's the Marsico Focus Fund (MFOCX:Nasdaq), a $2.78 billion mutual fund run by Thomas Marsico, who previously headed the Janus Twenty (JAVLX:Nasdaq) fund. Marsico rotates about 90% of his stocks each year, and he currently has UnitedHealth Group (UNH:NYSE) and Intel (INTC:Nasdaq) as the fund's top holdings. While the fund is down 1% against the S&P 500 for the year to date, it is up 27% since the start of 2003, which is 3.3% above the key stock index. Over the

past three years, it's up 2.43%.

The Marsico fund charges 1.34% a year, a fairly high price for a mutual fund.

The Janus offering deserves mention as well, outperforming the S&P 500 by 4.7% for the year to date, and topping the index by 3.8% since the start of 2003. Its three-year return isn't as strong -- it's down 1.92% against the S&P's 0.62% gain. It rotated fewer stocks than Marsico did last year, when it posted a 44% turnover. Its top holdings include eBay (EBAY:Nasdaq) and UnitedHealth.

eBay's stock split 2 for 1 last summer, and its price has nearly doubled in the last 12 months, climbing from $44.12 to $83.15. UnitedHealth's stock has also split in the past year, while its price has risen from $44.40 to $65.71 over the last 12 months.

The Janus fund is less expensive, though, charging 0.83% a year against the average of 1.67% among the actively managed funds tracked by Lipper.

But not every manager backs winners in a small portfolio.

Tjornehoj points to the American Heritage (AHERX:Nasdaq) fund, which dwindled to $1.1 million after investing 23% of its capital in penny stock ADM Tronics Unlimited and another 21% in Senetek (SNTK:Nasdaq), a biotech company.

Neither turned out to be worth the big bet. Senetek dropped from a high of $4 a share in March of 2000 and is now trading around 70 cents a share. ADM Tronics briefly topped 60 cents a share back in early 2000, but dropped to single-digit cents by the beginning of last year before rising to 37 cents recently.

Those sustained losses drove the fund's annual expenses up to a whopping 10%, and the fund has only recently begun the long, hard climb to breaking even.

"The joke was: 'Why not just buy the company?'" Tjornehoj says, adding that a $10,000 investment in the fund in 1994 is now worth about $1,200.

Sarat Sethi, a partner and portfolio manager at Douglas C. Lane, says he is skeptical about hiring a fund manager "to beat the pants off the market," because those claims don't hold up over long periods of time.

But he says that for the average investor, exchange-traded funds offer similar benefits as concentrated portfolio funds, and at a lower price. "Every industry is very narrow, and ETFs balance that out."

Glen Craman, a financial adviser with Pearson Financial Group in Lake Oswego, Ore., says bad experiences in the 1980s prompted him to avoid concentrated portfolios and sector funds, because market-timing never fit into his investment strategies. "At one time, our office was publishing 18 newsletters about these things, and while they made for great academic reading, the practical implications were ineffective. I haven't found a system [for market-timing] that really works."