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Strategies

A Fund vs. Its Former Self

By MARK HULBERT

INVESTORS have searched for years for a reliable way to choose mutual funds that are likely to outperform the market. Of the few approaches that have shown promise on paper, most require access to hard-to-find data - or statistical techniques beyond the reach of all but the most sophisticated of quantitative research firms.

A new study has taken a big step forward, suggesting a selection method so easy and direct that investors can only wonder why it hasn't received more attention. The idea is to compare each fund's returns with how it would have performed had it simply held, without trading, the stocks it listed in its most recent public disclosure.

The study was done by three finance professors: Marcin Kacperczyk of the University of British Columbia and Clemens Sialm and Lu Zheng of the University of Michigan. They focused on what they called the "return gap": the difference between a fund's actual returns and what it would have earned had it stuck with its most recently listed holdings. The S.E.C. requires that funds make such disclosures twice a year; the professors report that nearly half of all funds do so at least quarterly.

The study found that, on average, funds with consistently positive return gaps were much better bets for future performance than those that were consistently negative, regardless of the frequency of portfolio disclosures. They analyzed more than 2,500 domestic equity mutual funds over a 20-year period - 1984 through 2003. (The study has been circulating as an academic working paper; a copy is at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=676103.)

The professors say they believe that their approach works well because it evaluates fund performance more precisely than the customary practice of comparing it with a market benchmark. The benchmark comparisons are fraught with peril, because a fund can look unjustifiably good or bad if it is compared with the wrong index.

Benchmark confusion is more widespread than you may think. That's because of a phenomenon known as style drift, in which the actual holdings of funds often shift among the small-, mid- and large-cap categories, as well as between the growth and value styles of investing. As a result, funds are often compared with the wrong benchmarks, leading to erroneous conclusions about which funds are good or bad bets.

The professors' approach sidesteps these problems because it doesn't compare funds with generic benchmarks. Each fund is compared only with itself - or what its performance would have been had it not made changes in its portfolio. In this approach, the usual fund pigeonholes don't mean a thing. It doesn't matter whether the fund's manager is more oriented to small- or large-cap stocks, or is more of a

value manager than a growth manager - or whether his style falls outside standard categories. With such issues now moot, the professors believe that a fund with a consistently positive return gap should be a particularly good bet.

To show how funds with positive return gaps can outperform, the professors built two hypothetical portfolios. The first contained the 10 percent of funds with the highest and most consistent return gaps over the trailing year; the second contained the 10 percent at the opposite end of the spectrum. The first portfolio beat the market by an annual average of 3.8 percent from 1985 through 2003. But the second portfolio performed 4.4 percent worse than the market. That difference is one of the biggest that any researchers have found in back-testing various fund selection systems over long periods.

Try as they might, the professors could not explain away the results by referring to any known patterns. For example, they tested whether their portfolio of top funds had a disproportionate number of small-cap value funds, or of funds with the strongest recent performance. Previous research has shown that small-cap value funds beat the market in the long term, and that a fund's momentum tends to persist. But this study found that even among small-cap value funds, or funds with strong momentum, those with mostly positive return gaps go on to perform significantly better than those with mostly negative return gaps.

Calculating a fund's return gap is straightforward. Almost all funds' Web sites list portfolio composition, and sites like Morningstar's allow users to calculate monthly performance of virtually any portfolio they specify. Though the researchers do not see the return gap as the only factor in choosing a fund, they do suggest that, other things equal, it's a powerful indicator.

Of course, calculating return gaps for more than just a few funds may be too cumbersome for many individual investors. And it remains to be seen whether any research organization will use this method to rank a wide universe of funds. In the meantime, the professors believe that investors who are evaluating just a handful of funds can easily and profitably add the return gap to their arsenal of evaluation tools.

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