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STRATEGIES

A Quarter When Mutual Fund Rankings Didn't Matter

By MARK HULBERT

NEARLY all stock mutual funds had miserable returns in the fourth quarter of 2008 — even those that received excellent grades from the leading fund ranking systems.

Perhaps the best-known system is run by Morningstar, the fund tracker; it rates funds on a scale from one star (the worst) to five stars (the best), according to risk-adjusted returns over the previous 1-, 3-, 5- and 10-year periods. During the fourth quarter, however, the average five-star fund lost nearly as much as the stock market itself.

Consider a portfolio that was rebalanced at the start of each month into all no-load domestic equity mutual funds with five-star Morningstar ratings at the time. According to data from Morningstar, such a portfolio lost 22.3 percent in the fourth quarter. That was only slightly better than the 22.9 percent loss for the Dow Jones Wilshire 5000 index.

Morningstar wasn't alone in its inability to steer investors out of trouble during the quarter.

The fund-ranking system of Value Line Inc. performed nearly as poorly. A portfolio of its top-ranked funds lost 22.2 percent in the quarter, according to The Hulbert Financial Digest.

To be sure, some academic researchers have found fault with aspects of the approaches used by Morningstar and Value Line. Yet of ranking systems that have received academic seals of approval and that I could review for this column, none significantly beat the market in the quarter.

This isn't necessarily a criticism of those systems. After all, one can beat the market over the long haul by outperforming the averages during rallies and merely matching them during declines. But the systems' sizable fourth-quarter losses offer a reality check on what we can reasonably expect in bear markets.

Consider a fund ranking system based on momentum. Much research has found that stock funds with the best performance over the trailing 6 to 12 months tend to keep outperforming for up to an additional year.

Yet during the fourth quarter, the model portfolio of No-Load Fund*X, a newsletter that picks funds mechanically according to momentum, lost 22.3 percent, according to the digest.

More obscure fund ranking systems that have received even stronger academic seals of approval also couldn’t avoid the markets’ steep decline. One such system is based on a mathematical technique, the Kalman Filter, which was first used by engineers to better filter out noise in signals received from navigational devices. According to Alpha Investment Opportunities, a firm whose approach is based on this research, the funds that were top-ranked by this approach lost 22.2 percent in the quarter.

Another system that has shown great promise in research is the Return Gap model. It favors funds whose actual returns are furthest ahead of what they would have been had they kept holding — without any changes — the stocks listed in their most recent public disclosures. But according to a study by the digest, this model lost 20.6 percent in the quarter (based on the long-only domestic equity funds with the biggest return gaps, as identified by MutualDecisions.com).

Though such losses are clearly disappointing, they shouldn’t be a surprise, said Russ Wermers, a University of Maryland finance professor, in an interview. That’s because the return of the stock market itself is the greatest determinant of the typical equity fund’s return, he said.

He referred to a mutual fund’s beta — how much it moves in lock step with the overall market. An index fund that tracks the overall market has a beta of 1.0; he said that the betas of very few actively managed stock funds fall much below 1.0 and that a beta below 0.5 is “extremely rare.”

And betas tend to increase during bear markets, he said. Funds whose performances diverge widely when the market is rising still tend to fall more or less in unison in severe bear markets.

Of course, a good fund can perform better than its beta predicts. But this additional amount, known as alpha, is typically an order of magnitude smaller than the fund’s beta effect. “It’s very difficult in a down market for a fund’s alpha to overcome its beta,” Professor Wermers said.

As a result, he concluded, it’s unrealistic for stock fund investors to expect to weather a quarter like the last one without double-digit losses, even if they follow a ranking system with impeccable long-term credentials.

TO have sidestepped such losses in the last quarter, a stock fund investor would have had to be in cash. But market timing is notoriously hard.

Consider the contrasting stock market forecasts that prevailed at the end of the third quarter among the 10 best- and 10 worst-performing market timing newsletters of the 200 monitored by the digest. These groups were defined on the basis of risk-adjusted market-timing performance over the previous 15 years — seemingly long enough to separate out those with superior ability. Yet at the start of the fourth quarter, the 10 best, on average, were far more bullish than the 10 worst.

So, to have had good odds of avoiding the fourth quarter's losses, an investor would have had to choose on some basis other than past performance.

The bottom line is this: Periods like the last quarter are an inherent part of equity investing. Painful as they are, their very existence helps explain why stocks, in the long run, have outperformed safer investments. Without a risk premium, investors wouldn't endure stocks' ups and downs.

So think of the last quarter as the price we must pay to be equity investors. We've definitely paid our dues.

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