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STRATEGIES; Weighing Means, Not Just Ends, to Rate Fund Managers

By MARK HULBERT

THREE finance professors have devised a new mutual fund rating system that appears to do a better job of separating managers whose performance reflects genuine ability from those whose results depend on luck alone.

At its core, the new system assumes that a manager's ability can be detected by comparing his portfolio with those of other fund managers -- and not by looking at his own past performance. If the stocks he currently owns are also owned by managers with stellar records, for example, then the odds are high that he is a good manager. In contrast, he probably is not worth betting on if he holds only stocks that are primarily owned by managers with awful records.

The idea is a significant departure from traditional approaches to rating mutual funds. Under the new system, a fund with a dismal record may receive a high rating, provided that its current holdings overlap with those of portfolios with good records.

The ratings system of Morningstar Inc. is similar in some ways, because it judges a fund's record in comparison to other funds that have a similar style. But unlike the new system, Morningstar's would never give a higher rating to a fund whose performance was inferior to others in its category.

The authors of the research, Randolph B. Cohen and Joshua D. Coval of the Harvard Business School and Lubos Pastor of the University of Chicago Graduate School of Business, use a basketball analogy to illustrate their reasoning. Imagine a 10-shot free-throw contest between two players, one who shoots with one hand and the other who shoots with both hands. Which player would you bet on if, at the halfway mark, both players had made all five of their shots?

If you rate basketball players by their records, you have no preference. But what if you find that, across the league, two-handed shooters make a much higher percentage of their free throws? The intelligent bet would then be on the two-handed shooter, because luck probably played a larger role in the one-handed shooter's good record.

In other words, technique matters. Yet current systems focus on results alone. They overlook a wealth of information that can give insight into managers' ability.

To show how much technique matters, the three professors constructed an elaborate rating system in which a fund's score is a function of the track records of all other funds that hold any of the same stocks. The highest-rated funds will be those whose stocks are primarily owned by market-beaters, while the lowest-rated will hold stocks that are mostly owned by losing funds.

The new system is superior in two ways to approaches that focus only on results. First, there is a higher degree of statistical confidence in its conclusions -- from four to eight times higher, according to the professors, depending on how those traditional approaches adjust performance for risk.

Consider funds that have been around for less than five years -- a group that, according to Lipper Inc., now contains 55 percent of all United States diversified and sector equity funds. According to Professor Cohen, a focus on track records alone for such funds "can be quite misleading" because there is not enough data to have much confidence that winning managers have genuine ability or that losers were not just unlucky.

The professors largely sidestep this difficulty. Even a young fund typically owns several dozen stocks, providing many data points. Generally, confidence levels increase as more data becomes available.

The second advantage of the new system is its better ability to identify funds that will outperform the market. Had this system been used from April 1977 to December 2000, investors who followed it would have made as much as 1 percent more per year than they would have by relying on ratings systems that focus on track records alone.

Though this new research has not yet been published, it has been the subject of nearly a dozen graduate school seminars over the last few months. It is available at http://ssrn.com/abstract_id=353620.

One early criticism concerned the professors' treatment of window-dressing -- the end-of-the-quarter tendency to buy stocks that have performed the best during the quarter and to sell losers. Window-dressing makes managers look like shrewd stock pickers. Wouldn't the

new system erroneously conclude that such managers have great ability, because their portfolios now hold stocks that are owned by top-performing funds?

In response, the professors modified their system, so that it now also looks at when a manager buys or sells. It gives a higher score to a manager whose timing of transactions more closely matches that of other managers with good track records.

To be sure, funds do not divulge the precise dates on which they buy or sell stocks. But one can get a good idea by comparing their end-of-the-quarter reports.

But how can the new system accurately rate an innovative manager -- one whose stocks are not held by any other fund? To return to the basketball analogy, imagine that one of the two contestants in the free-throw contest was Rick Barry, who was famous in the 1960's and 70's for his unique underhand free-throw technique and for having one of the higher free-throw percentages in professional basketball. Since there were too few other professional players with whom to compare his technique, how could the professors' system recognize his abilities?

THE professors do not deny the theoretical possibility of a Rick Barry in the mutual fund arena. But they do minimize the probability. According to Lipper, there are 6,843 United States diversified or sector equity mutual funds, more than twice the number of publicly traded American companies with market capitalizations of at least $100 million. Because the average fund owns several dozen stocks, the odds are very small that none of a fund's stocks will be owned by any other fund.

The professors do not yet know the answer to one question: Can their rating system be improved further by combining it with more traditional approaches? Consider two funds that hold stocks that are also owned by top-performing funds. Is the one that has made the most money a better bet for future performance? Professor Cohen says research on that issue is just beginning.

Unfortunately, the mathematics and data needed to replicate the professors' new system are beyond most individual investors' capabilities. Our best hope of taking advantage of this new research is that a major fund rating service will incorporate it.

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