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Young Funds

By Daniel Kadlec

Common wisdom holds that you should never invest in a stock mutual fund that has less than a three-year record--no matter how well the fund performed the previous year or two. Even a monkey throwing darts has a 50% shot at superior returns over one year, and the ape's odds of doing well over two years remain uncomfortably high. Do you really want to take the chance that your fund manager is nothing more than a lucky primate? Of course not. But you don't want to rule out potential winners either. New evidence suggests that young funds hold more inherent promise than older funds--and that you may be able to spot the good ones early by finding similarities between their portfolios and the portfolios of funds that have done well over long periods.

These are fairly radical findings. Young funds tend to have high expense ratios--an average of 1.53% of assets for funds less than three years old, vs. 1.48% for all others--and so face a higher hurdle before they make money for investors. They also blow up more often and quietly disappear. As for drilling down into their portfolios, that has always been a good idea--to get a sense of what the fund manager likes to own. Yet with the typical stock-fund-turnover rate of 105%, that information gets stale fast. "There's no substitute for proven management and low expenses," argues Russ Kinnel, director of research at fund tracker Morningstar.

But two new studies suggest otherwise. As a fund becomes successful, it quickly begins to underperform its potential, even though it may keep outperforming its peers, according to Jonathan Berk, a business professor at the University of California, Berkeley, and Richard Green, a business professor at Carnegie Mellon University. Why? Investors inevitably flood a winning fund with cash until the manager runs out of ideas and can no longer invest as profitably as before. So it pays to get on board early.

The question then is, How do you spot a hot young fund before it's obvious--and the money pours in? You should ignore one-or two-year returns and focus on what stocks a fund holds at any given moment, according to Randolph Cohen, finance professor at Harvard Business School; Joshua Coval, finance professor at Harvard; and Lubos Pastor, finance professor at the University of Chicago Graduate School of Business. If the stocks that a young fund holds are largely the same as those held by funds with proven success, it follows that the manager of the young fund thinks along the same lines as the best in the business and is likely to succeed as well. "We think we can identify managers who are good but have had bad luck, and managers who are bad but have had good luck," Cohen says.

Unfortunately, the exhaustive data needed to determine which young funds have the most promise are out of reach for most investors. So I asked Cohen to rerun his study and highlight the best young funds now. His list is on this page. The funds have done relatively well, but that isn't why they pop up on Cohen's screen. He compared

funds begun since 2001 with the best and worst long-term performers in their categories. The most promising of these young funds are those with the highest percentage of stocks in common with the long-term winners and the lowest percentage in common with the long-term dogs.

Cohen hopes that research firms like Morningstar and Thomson Financial will one day incorporate his method into their rating systems. In the meantime, you can approximate his research by focusing on the top 25 holdings. That fund information is available at morningstar.com Compare a young fund's top holdings with those of good and bad older funds in the same category. You want a lot of hits with the good funds and few with the bad ones-- unless you're feeling lucky.

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