I HAVE a new entry for Ripley's Believe It or Not: Even if you believe no portfolio manager can consistently pick winning stocks, you should still keep the bulk of your portfolio in actively managed mutual funds, not indexed ones.

That is the conclusion reached by Lubos Pastor, an assistant finance professor at the University of Chicago, and Robert F. Stambaugh, a finance professor of the Wharton School of the University of Pennsylvania. The research, presented last week at the Federal Reserve Bank of New York, can be found at http://finance.wharton.upenn.edu/~stambaugh/eval1.pdf.

The professors started by adopting the popular academic theory of what makes stock prices move -- the Fama-French model. The theory says one stock does better or worse than others because of its sensitivity to three factors: the movement of the overall stock market, the performance of value stocks relative to growth issues and the performance of small-capitalization stocks relative to large-cap stocks.

While academics and Wall Street strategists treat the theory with varying degrees of orthodoxy, the professors adopted the extreme position -- that the Fama-French factors alone explain stocks' average returns over time -- in order to make their point. They also assumed that no fund manager could consistently pick stocks that perform any differently than would be predicted by the Fama-French model -- in essence, that stock-picking skill simply doesn't exist.

Given that puritanical stance, forecasting a fund's return becomes a simple task of projecting into the future its fees, turnover rate and sensitivities to the three Fama-French factors. For example, based on decades of returns, a small-cap fund should outperform a large-cap fund, just as a value fund should beat a growth fund.

Constructing the optimal portfolio in terms of both performance and volatility is easy, too. After finding the funds with the highest expected returns, one simply chooses the ones whose returns are least correlated with one another. That results in a fund portfolio with less volatility, making for an even better investment than any of the funds on their own.

One might presume that this ideal portfolio would invest exclusively in index funds. After all, such funds have low expenses and turnover and often focus on specific market capitalizations and growth or value styles.

But the professors assumed nothing. They tracked all funds from the beginning of 1963 to the end of 1998, focusing on United States stock funds that had no sales charges, and whose managers at the end of 1998 had three-year records. That left 505 funds.

They found that many index funds responded sluggishly to the Fama-French factors and that a few actively managed funds, by contrast, were acutely sensitive to them. The model thus suggests that many index funds will underperform these actively managed funds, and so just 23 percent of the professors' ideal portfolio is in index funds.

So what mutual funds made their ideal portfolio? The actively managed offerings were Legg Mason Total Return, 40 percent of assets; First American Real Estate Securities, 19 percent; and Mutual Discovery, 18 percent. The index funds in the portfolio were DFA Real Estate Securities, 13 percent; Galaxy Utility Index, 8 percent; and DFA U.S. Large Cap Value, 2 percent. (For the record, this portfolio returned just 1 percent in 1999).

None of this, of course, justifies investing in just any actively managed fund. And the professors are not recommending this particular portfolio. But even investors with no regard for fund managers' stock-picking skills should now think twice before putting most of their money into index funds.

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