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Focused Funds Go Further With Fewer Diversify Or Worsify? Holding more securities can smooth the ride, but also bring mediocrity

BY MURRAY COLEMAN

When Mark Mulholland started investing, saying no to stocks was hard to do.

"I found a lot of stocks that sounded great," said Mulholland, who now manages \$56 million in assets at the Matthew 25 Fund.

That led him to buy all sorts of stocks for the limited partnership he then worked for.

"It's really easy to become a collector instead of an investor," said Mulholland.

Like many pros, he's found that more doesn't always mean better. "It's ironic that diversifying is actually the easiest way to invest," said Mulholland. "But spreading your bets brings your returns closer to the market's average."

A new study by three University of Michigan business professors supports such a view. It looked at 1,771 actively managed funds during a 15-year period through 1999.

"Managers with better long-term records seem to prefer holding fewer, rather than more, stocks," said Lu Zheng, a finance professor at the university and a co-author of the study.

It found that greater focus directly translated into better risk-adjusted returns over time. The most concentrated group of funds beat their benchmarks' total returns by an average 3.5 percentage points before expenses.

By contrast, the least concentrated set of funds lagged their benchmarks by an average 0.4 percentage points.

Both groups averaged 150 funds. The study ranked all funds into 10 separate categories by order of concentration.

The most highly focused group was typically made up of funds with 55 stocks or fewer. The least averaged 152 stocks or more a year.

When expenses were taken into account, heavily focused funds again prevailed. Those funds produced a return of 2 percentage points above their benchmarks.

The least concentrated ones lagged by 0.64 percentage point. That proved to be the case in all asset classes except for large value.

Keep Money Working

"The most successful managers over time don't appear to go in and out of the market a lot," said Zheng. "They stay invested and keep putting their money to work."

Mulholland's fund, which is only 8 years old, wasn't included in the study. It would qualify today, though, with a 15-stock portfolio.

"To some investors, that might imply more volatile returns than a larger fund," said Mulholland. "But we find that being more focused makes you much more cautious about what you buy and much more attentive to what you hold."

In 2002, the fund lost 1.7%, better than 93% of its peers. This year going into Monday, the all-cap fund was up 21.92%.

Despite tough market conditions, it's gained an average annual 12.53% the past three years vs. 7.13% for its mid-cap value peers tracked by Morningstar Inc.

"The key is investing in only exceptional opportunities and not settling for anything less," said Mulholland. "A few solid picks will create more wealth over time than the average diversified portfolio."

Still, the University of Michigan study found that only 40% of all actively managed focused funds reviewed beat their respective indexes -- or the market average -- after expenses. Of those, only half were able to outperform passively managed funds on a consistent basis.

"So investors have about a 20% chance of picking a winner," said Zheng. "And even then, it's going to be difficult to find one that can beat a passively managed fund year in and year out."

If that's something you want to try, she says, investors can improve their odds of beating the market with a more focused fund.

That's certainly an approach Bob Killen is taking. He's lead manager of Berwyn Fund, a small-cap value fund with \$41 million in assets.

Gains Add Up

"An average gain (over a benchmark) of 2% a year might not sound like much," said Killen. "But it can really add up. The compounding effect makes any sort of improvement in performance a huge factor over time."

Berwyn Fund holds 36 stocks. It's returned 36.04% for its investors this year vs. 33.04% for its small-cap value peers. During the past three years, its average annual return of 18.64% beat 87% of its rivals.

"We're concentrated, but we're still diversified," said Killen. "We try to be in all the major industries. We just don't feel compelled to be diversified into everything."

Right now, he's not investing in telecom, media or software.

"If we find a sector that's unattractive, we're not going to jump in just to cover all the bases," said Killen.

A well-rounded fund, he says, can get overburdened trying to do too much.

"The more stocks you hold," said Killen, "the less chance you have to really understand what's going on with your entire portfolio."