

Financial Planning

Skilled Fund Managers Don't Diversify Says Study

Academics from the University of Michigan found that a narrow industry focus helps funds outperform.

By Kristen French

November 20, 2003- Diversification is one of the most often repeated mantras of the investing world, and a lesson that many learned the hard way in the wake of the tech stock bubble of the 1990s. Most investors now know that they must diversify or watch their portfolios implode.

But the same may not be true for individual mutual funds, according to a recent study from the University of Michigan Business School. In fact, skilled fund managers actually diversify less, according to Clemens Sialm, Marcin Kacperczyk and Lu Zheng, the authors of the study.

Sialm and his colleagues studied the performance of over 2,000 actively managed diversified equity funds from 1984-1999, and found that mutual funds with above-median "concentration" yielded an average return, adjusted for risk, of 2.18% per year before expenses and 0.82% per year after expenses. By comparison, more diversified mutual funds yielded an average return, adjusted for risk, of 0.39% per year before expenses and -0.73% per year after expenses. Concentration was measured by the number of industries held by a fund, and the weightings given to the various different industries.

Fund managers might want to hold concentrated portfolios if they believe that some industries will outperform the overall market or if they have superior information to select profitable stocks in specific industries, Zheng wrote in the report.

"I think [the study] has important implications for perceptions of mutual fund managers," said Sialm in an interview. "Are they skilled and do they add value? Our study supports that some of them are skilled, and those mutual fund managers tend to choose highly concentrated portfolios. Why do they do that? One manager might have a background in biotech stocks, maybe he is a medical doctor, or has an advanced degree in that area. And of course, he will primarily pick from this sector."

The study also found that managers who run concentrated funds tend to focus on small-cap and growth stocks. "We believe that mispricing in the asset market is most severe for small and growth stocks, so it's easier for mutual funds to find good stock picks in these areas," explained Sialm.

Some were skeptical about the results. Even if a fund manager concentrates on a limited number of industries, "if those industries are health care, tech and financial, it's a couple thousand stocks, so it can still be pretty broad," said Russell Kinnel, head of mutual fund research at Morningstar. "The other downside is that if a fund really ignores the other sectors, there is a possibility that a fund is going to be more erratic. There will be times when the sector that is doing well is one that you aren't paying attention to."

And while Kinnel agreed that active management has its benefits, he likes to combine actively managed funds with indexing. In his own portfolio he has some of both. "The biggest problem with active management is that it has high costs," he said.

On the other hand, one adviser agreed that a narrow industry focus could help a manager outperform, and might be the best case for active management. "The part that doesn't surprise me is that I have always found that when somebody really knows his or her product and they

invest in their own industry, they can do very well," said Benjamin Tobias, CFP and president of Tobias Financial in Fort Lauderdale, Fla. For example, a client of his who used to own radio stations started buying equities related to that business, and "what he did with that, was just astronomical," he said.

Tobias has been moving away from actively managed funds in recent years, but said he'd be willing to reconsider. "I've seen that the value added doesn't make sense as far as the added cost, with some exceptions, like American Funds," he said. "But I'm very curious to see that study," he added. "I'm always open to changing. The more we're in the business, the more we realize we don't know. That's why I read studies like that, and absolutely if it convinces me, I will start searching for active managers."

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