STRATEGIES

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The Manager Is in a Slump (Or Maybe It's Just a Phase)

FEW mutual fund managers beat the stock market over the long term. That sad truth is widely understood, and it helps to account for the vast popularity of index funds, which aspire only to match the returns of a particular market.

But a new study suggests that it may be too soon to give up on actively managed mutual funds. While few managers can outpace the market as it moves up and down, year in and year out, substantial numbers can predictably outperform it during parts of the economic cycle, the study has found. And investors who are willing and able to make frequent switches among top funds may be able to make some money from this insight.

The study, called "Investing in Mutual Funds When Returns Are Predictable," is forthcoming in the Journal of Financial Economics. Its authors are Doron Avramov and Russ Wermers, finance professors at the University of Maryland; a copy is at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=555462.

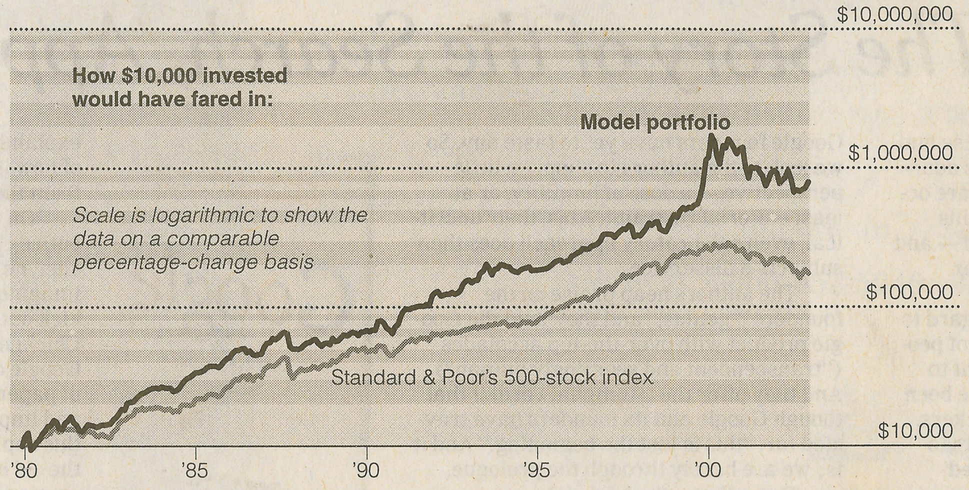
In the past, the professors say, most mutual fund research assumed that managers' ability or inability to outperform the market was constant, regardless of the waxing and waning of the market cycle. But the professors made a different assumption: that significant numbers of managers may have market-beating ability at some stages of the economic cycle but not at others. A manager who can beat the market during a recession, for example, or in periods of high inflation, may well lag behind it in periods of robust economic growth or low inflation.

These managers will never be found by comparing their long-term performances with a market average, the professors said. The managers' stellar gains in parts of a cycle will tend to be offset by poor performance at other times. As a result, their long-term records will be unexceptional. The professors designed complex tests, hoping to find managers with such part-time promise.

Specifically, they correlated funds' returns with four macroeconomic variables that previous studies found to be good leading indicators: the 90-day Treasury bill rate, the stock market's dividend yield, the difference between the interest rates of junk bonds and higher-quality issues (the so-called default spread) and the rate difference between longer-term Treasuries and 90-day Treasury bills (the term spread).

A Cyclical Strategy

A new study identifies mutual funds that tend to outperform the market during certain stages of the economic cycle. A model portfolio, investing in stock mutual funds that have historically performed best under similar market conditions, outperformed the overall market from 1980 to 2002.



Source: Doron Avramov and Russ Wermers

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As they expected, the professors found that the typical manager's likelihood of beating the market was strongly related to these four variables. Professor Wermers estimates that as many as a third of the fund managers in the study showed market-beating ability during at least some phase of the market cycle. That compares with just 10 percent of managers who, he said, were able to beat the market's overall return over the last two decades.

How can this help investors beat the market? To find out, the professors built a hypothetical portfolio that invested each month in the no-load funds that historically performed the best when the four macroeconomic variables were similar to that month's readings. They back-tested the portfolio from 1980 through 2002, being careful to use only the information that was publicly available going into each month.

The professors say they were startled by this model portfolio's large and consistent returns over the 23 years. Not only did the model outperform the overall market by eight percentage points a year, on average, but it also handily beat a benchmark portfolio of funds that was similar to it in three ways: in its risk level, in the market capitalization of its holdings and in its place on the growth-to-value spectrum. The professors also compared their portfolio's gain with that of several strategies that previous research had found to have market-beating potential. None of those others came close.

THE professors' strategy does come with significant caveats about its real-world profitability. Because the portfolio is rebalanced monthly, it can require frequent switching among funds. According to Professor Wermers, the average holding period of funds in the portfolio was only about four months, so almost all the capital gains would be taxed at the higher short-term rate. That means the strategy works better in tax-deferred accounts.

And what happens if a fund under consideration imposes huge fees or other restrictions on frequent short-term trading, as some funds have started to do? In such a case, the professors would simply avoid the fund. After all, Professor Wermers says, there are still plenty of funds that don't have such restrictions but do have managers that can beat the market during part of a cycle.

The professors concede that their strategy is probably more appropriate for institutions than for individual investors, because it requires the application of complex statistics to a large database of fund returns. Still, the research can teach us not to be too quick to conclude from the fund industry's dismal long-term record that virtually no managers have market-beating ability — or that it never makes sense to invest in an actively managed fund. □

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