amazing how, in a completely different atmosphere of regulation and prohibitions, Wall Street was able to duplicate so much of the excesses and errors of the 1920s.

No doubt there will be new regulations and new prohibitions. The specific abuses of the late 1960s will be fairly adequately banned from Wall Street. But it is probably too much to expect that the urge to speculate will ever disappear, or that the exploitation of that urge can ever be abolished. It is part of the armament of the intelligent investor to know about these "Extraordinary Popular Delusions,"[4] and to keep as far away from them as possible.

The picture of most of the performance funds is a poor one if we start *after* their spectacular record in 1967. With the 1967 figures included, their overall showing is not at all disastrous. On that basis one of "The Money Managers" operators did quite a bit better than the S & P composite index, three did distinctly worse, and six did about the same. Let us take as a check another group of performance funds—the ten that made the best showing in 1967, with gains ranging from 84% up to 301% in that single year. Of these, four gave a better overall four-year performance than the S & P index, if the 1967 gains are included; and two excelled the index in 1968–1970. None of these funds was large, and the average size was about $60 million. Thus, there is a strong indication that smaller size is a necessary factor for obtaining continued outstanding results.

The foregoing account contains the implicit conclusion that there may be special risks involved in looking for superior performance by investment-fund managers. All financial experience up to now indicates that large funds, soundly managed, can produce at best only slightly better than average results over the years. If they are unsoundly managed they can produce spectacular, but largely illusory, profits for a while, followed inevitably by calamitous losses. There have been instances of funds that have consistently outperformed the market averages for, say, ten years or more. But these have been scarce exceptions, having most of their operations in specialized fields, with self-imposed limits on the capital employed—and not actively sold to the public.*

* Today's equivalent of Graham's "scarce exceptions" tend to be open-end funds that are closed to new investors—meaning that the managers have

Closed-End versus Open-End Funds

Almost all the mutual funds or open-end funds, which offer their holders the right to cash in their shares at each day's valuation of the portfolio, have a corresponding machinery for selling new shares. By this means most of them have grown in size over the years. The closed-end companies, nearly all of which were organized a long time ago, have a fixed capital structure, and thus have diminished in relative dollar importance. Open-end companies are being sold by many thousands of energetic and persuasive salesmen, the closed-end shares have no one especially interested in distributing them. Consequently it has been possible to sell most "mutual funds" to the public at a fixed premium of about 9% above net asset value (to cover salesmen's commissions, etc.), while the majority of close-end shares have been consistently obtainable at *less* than their asset value. This price discount has varied among individual companies, and the average discount for the group as a whole has also varied from one date to another. Figures on this point for 1961–1970 are given in Table 9-3.

It does not take much shrewdness to suspect that the lower relative price for closed-end as against open-end shares has very little to do with the difference in the overall investment results between the two groups. That this is true is indicated by the comparison of the annual results for 1961–1970 of the two groups included in Table 9-3.

Thus we arrive at one of the few clearly evident rules for investors' choices. If you want to put money in investment funds, buy a group of closed-end shares at a discount of, say, 10% to 15% from asset value, instead of paying a premium of about 9% above asset value for shares of an open-end company. Assuming that the future dividends and changes in asset values continue to be about the same for the two groups, you will thus obtain about one-fifth more for your money from the closed-end shares.

The mutual-fund salesman will be quick to counter with the

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stopped taking in any more cash. While that reduces the management fees they can earn, it maximizes the returns their existing shareholders can earn. Because most fund managers would rather look out for No. 1 than be No. 1, closing a fund to new investors is a rare and courageous step.

TABLE 9-3 Certain Data on Closed-End Funds, Mutual Funds, and S & P Composite Index

Year	*Average Discount of Closed-End Funds*	*Average Results of Closed-End Funds*[a]	*Average Results of Mutual Stock Funds*[b]	*Results of S & P Index*[c]
1970	– 6%	even	– 5.3%	+ 3.5%
1969		– 7.9%	–12.5	– 8.3
1968	(+ 7)[d]	+13.3	+15.4	+10.4
1967	– 5	+28.2	+37.2	+23.0
1966	–12	– 5.9	– 4.1	–10.1
1965	–14	+14.0	+24.8	+12.2
1964	–10	+16.9	+13.6	+14.8
1963	– 8	+20.8	+19.3	+24.0
1962	– 4	–11.6	–14.6	– 8.7
1961	– 3	+23.6	+25.7	+27.0
Average of 10 yearly figures:		+ 9.14%	+ 9.95%	+ 9.79%

[a] Wiesenberger average of ten diversified companies.

[b] Average of five Wiesenberger averages of common-stock funds each year.

[c] In all cases distributions are added back.

[d] Premium.

argument: "Ah, but if you own closed-end shares you can never be sure what price you can sell them for. The discount can be greater than it is today, and you will suffer from the wider spread. With our shares you are guaranteed the right to turn in your shares at 100% of asset value, never less." Let us examine this argument a bit; it will be a good exercise in logic and plain common sense. Question: Assuming that the discount on closed-end shares does widen, how likely is it that you will be worse off with those shares than with an otherwise equivalent purchase of open-end shares?

This calls for a little arithmetic. Assume that Investor A buys some open-end shares at 109% of asset value, and Investor B buys closed-end shares at 85% thereof, plus 1½% commission. Both sets of shares earn and pay 30% of this asset value in, say, four years,

TABLE 9-4 Average Results of Diversified Closed-End Funds, 1961–1970[a]

	1970	*5 years, 1966–1970*	*1961–1970*	*Premium or Discount, December 1970*
Three funds selling at premiums	–5.2%	+25.4%	+115.0%	11.4% premium
Ten funds selling at discounts	+1.3	+22.6	+102.9	9.2% discount

[a] Data from Wiesenberger Financial Services.

and end up with the same value as at the beginning. Investor A redeems his shares at 100% of value, losing the 9% premium he paid. His overall return for the period is 30% less 9%, or 21% on asset value. This, in turn, is 19% on his investment. How much must Investor B realize on his closed-end shares to obtain the same return on his investment as Investor A? The answer is 73%, or a discount of 27% from asset value. In other words, the closed-end man could suffer a widening of 12 points in the market discount (about double) before his return would get down to that of the open-end investor. An adverse change of this magnitude has happened rarely, if ever, in the history of closed-end shares. Hence it is very unlikely that you will obtain a lower overall return from a (representative) closed-end company, bought at a discount, if its investment performance is about equal to that of a representative mutual fund. If a small-load (or no-load) fund is substituted for one with the usual "8½%" load, the advantage of the closed-end investment is of course reduced, but it remains an advantage.

The fact that a few closed-end funds are selling at *premiums* greater than the true 9% charge on most mutual funds introduces a separate question for the investor. Do these premium companies enjoy superior management of sufficient proven worth to warrant their elevated prices? If the answer is sought in the comparative results for the past five or ten years, the answer would appear to be no. Three of the six premium companies have mainly foreign investments. A striking feature of these is the large variation in

TABLE 9-5 Comparison of Two Leading Closed-End Companies[a]

	1970	*5 years, 1966–1970*	*10 years, 1961–1970*	*Premium or Discount, December 1970*
General Am. Investors Co.	–0.3%	+34.0%	+165.6%	7.6% discount
Lehman Corp.	–7.2	+20.6	+108.0	13.9% premium

[a] Data from Wiesenberger Financial Services.

prices in a few years' time; at the end of 1970 one sold at only one-quarter of its high, another at a third, another at less than half. If we consider the three domestic companies selling above asset value, we find that the average of their ten-year overall returns was somewhat better than that of ten discount funds, but the opposite was true in the last five years. A comparison of the 1961–1970 record of Lehman Corp. and of General American Investors, two of our oldest and largest closed-end companies, is given in Table 9-5. One of these sold 14% above and the other 7.6% below its net-asset value at the end of 1970. The difference in price to net-asset relationships did not appear warranted by these figures.

Investment in Balanced Funds

The 23 balanced funds covered in the Wiesenberger Report had between 25% and 59% of their assets in preferred stocks and bonds, the average being just 40%. The balance was held in common stocks. It would appear more logical for the typical investor to make his bond-type investments directly, rather than to have them form part of a mutual-fund commitment. The average income return shown by these balanced funds in 1970 was only 3.9% per annum on asset value, or say 3.6% on the offering price. The better choice for the bond component would be the purchase of United States savings bonds, or corporate bonds rated A or better, or tax-free bonds, for the investor's bond portfolio.

COMMENTARY ON CHAPTER 9

> The schoolteacher asks Billy Bob: "If you have twelve sheep and one jumps over the fence, how many sheep do you have left?"
>
> Billy Bob answers, "None."
>
> "Well," says the teacher, "you sure don't know your subtraction."
>
> "Maybe not," Billy Bob replies, "but I darn sure know my sheep."
>
> —*an old Texas joke*

ALMOST PERFECT

A purely American creation, the mutual fund was introduced in 1924 by a former salesman of aluminum pots and pans named Edward G. Leffler. Mutual funds are quite cheap, very convenient, generally diversified, professionally managed, and tightly regulated under some of the toughest provisions of Federal securities law. By making investing easy and affordable for almost anyone, the funds have brought some 54 million American families (and millions more around the world) into the investing mainstream—probably the greatest advance in financial democracy ever achieved.

But mutual funds aren't perfect; they are *almost* perfect, and that word makes all the difference. Because of their imperfections, most funds underperform the market, overcharge their investors, create tax headaches, and suffer erratic swings in performance. The intelligent investor must choose funds with great care in order to avoid ending up owning a big fat mess.

TOP OF THE CHARTS

Most investors simply buy a fund that has been going up fast, on the assumption that it will keep on going. And why not? Psychologists have shown that humans have an inborn tendency to believe that the long run can be predicted from even a short series of outcomes. What's more, we know from our own experience that some plumbers are far better than others, that some baseball players are much more likely to hit home runs, that our favorite restaurant serves consistently superior food, and that smart kids get consistently good grades. Skill and brains and hard work are recognized, rewarded—and consistently repeated—all around us. So, if a fund beats the market, our intuition tells us to expect it to keep right on outperforming.

Unfortunately, in the financial markets, luck is more important than skill. If a manager happens to be in the right corner of the market at just the right time, he will look brilliant—but all too often, what was hot suddenly goes cold and the manager's IQ seems to shrivel by 50 points. Figure 9-1 shows what happened to the hottest funds of 1999.

This is yet another reminder that the market's hottest market sector—in 1999, that was technology—often turns as cold as liquid nitrogen, with blinding speed and utterly no warning.[1] And it's a reminder that buying funds based purely on their past performance is one of the stupidest things an investor can do. Financial scholars have been studying mutual-fund performance for at least a half century, and they are virtually unanimous on several points:

- the average fund does not pick stocks well enough to overcome its costs of researching and trading them;
- the higher a fund's expenses, the lower its returns;
- the more frequently a fund trades its stocks, the less it tends to earn;

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[1] Sector funds specializing in almost every imaginable industry are available—and date back to the 1920s. After nearly 80 years of history, the evidence is overwhelming: The most lucrative, and thus most popular, sector of any given year often turns out to be among the worst performers of the following year. Just as idle hands are the devil's workshop, sector funds are the investor's nemesis.

FIGURE 9-1 The Crash-and-Burn Club

Fund	Total Return 1999	2000	2001	2002	Value on 12/31/02 of $10,000 invested on 1/1/1999
Van Wagoner Emerging Growth	291.2	–20.9	–59.7	–64.6	4,419
Monument Internet	273.1	–56.9	–52.2	–51.2	3,756
Amerindo Technology	248.9	–64.8	–50.8	–31.0	4,175
PBHG Technology & Communications	243.9	–43.7	–52.4	–54.5	4,198
Van Wagoner Post-Venture	237.2	–30.3	–62.1	–67.3	2,907
ProFunds Ultra OTC	233.2	–73.7	–69.1	–69.4	829
Van Wagoner Technology	223.8	–28.1	–61.9	–65.8	3,029
Thurlow Growth	213.2	–56.0	–26.1	–31.0	7,015
Firsthand Technology Innovators	212.3	–37.9	–29.1	–54.8	6,217
Janus Global Technology	211.6	–33.7	–40.0	–40.9	7,327
Wilshire 5000 index (total stock market)	23.8	–10.9	–11.0	–20.8	7,780

Source: Lipper

Note: Monument Internet was later renamed Orbitex Emerging Technology.

These 10 funds were among the hottest performers of 1999—and, in fact, among the highest annual performers of all time. But the next three years erased all the giant gains of 1999, and then some.

- highly volatile funds, which bounce up and down more than average, are likely to stay volatile;
- funds with high past returns are unlikely to remain winners for long.[2]

Your chances of selecting the top-performing funds of the future on the basis of their returns in the past are about as high as the odds that Bigfoot and the Abominable Snowman will both show up in pink ballet slippers at your next cocktail party. In other words, your chances are not zero—but they're pretty close. (See sidebar, p. 255.)

But there's good news, too. First of all, understanding why it's so hard to find a good fund will help you become a more intelligent investor. Second, while past performance is a poor predictor of future returns, there are other factors that you can use to increase your odds of finding a good fund. Finally, a fund can offer excellent value even if it doesn't beat the market—by providing an economical way to diversify your holdings and by freeing up your time for all the other things you would rather be doing than picking your own stocks.

THE FIRST SHALL BE LAST

Why don't more winning funds stay winners?

The better a fund performs, the more obstacles its investors face:

Migrating managers. When a stock picker seems to have the Midas touch, everyone wants him—including rival fund companies. If you bought Transamerica Premier Equity Fund to cash in on the skills of Glen Bickerstaff, who gained 47.5% in 1997, you were quickly out of luck; TCW snatched him away in mid-1998 to run its TCW Galileo Select Equities Fund, and the Transamerica fund lagged the market in three of the next four years. If you bought Fidelity Aggressive Growth Fund in early 2000 to capitalize on the high returns of Erin Sullivan, who had nearly tripled her shareholders' money since 1997, oh well: She quit to start her own hedge fund in

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[2] The research on mutual fund performance is too voluminous to cite. Useful summaries and links can be found at: www.investorhome.com/mutual.htm#do, www.ssrn.com (enter "mutual fund" in the search window), and www.stanford.edu/~wfsharpe/art/art.htm.

2000, and her former fund lost more than three-quarters of its value over the next three years.[3]

Asset elephantiasis. When a fund earns high returns, investors notice—often pouring in hundreds of millions of dollars in a matter of weeks. That leaves the fund manager with few choices—all of them bad. He can keep that money safe for a rainy day, but then the low returns on cash will crimp the fund's results if stocks keep going up. He can put the new money into the stocks he already owns—which have probably gone up since he first bought them and will become dangerously overvalued if he pumps in millions of dollars more. Or he can buy new stocks he didn't like well enough to own already—but he will have to research them from scratch and keep an eye on far more companies than he is used to following.

Finally, when the $100-million Nimble Fund puts 2% of its assets (or $2 million) in Minnow Corp., a stock with a total market value of $500 million, it's buying up less than one-half of 1% of Minnow. But if hot performance swells the Nimble Fund to $10 billion, then an investment of 2% of its assets would total $200 million—nearly half the entire value of Minnow, a level of ownership that isn't even permissible under Federal law. If Nimble's portfolio manager still wants to own small stocks, he will have to spread his money over vastly more companies—and probably end up spreading his attention too thin.

No more fancy footwork. Some companies specialize in "incubating" their funds—test-driving them privately before selling them publicly. (Typically, the only shareholders are employees and affiliates of the fund company itself.) By keeping them tiny, the sponsor can use these incubated funds as guinea pigs for risky strategies that work best with small sums of money, like buying truly tiny stocks or rapid-fire trading of initial public offerings. If its strategy succeeds, the fund can lure public investors en masse by publicizing its private returns. In other cases, the fund manager "waives" (or skips charging) management fees, raising the net return—then slaps the fees on later after the high returns attract plenty of customers. Almost without exception, the returns of incubated and fee-waived funds have faded into mediocrity after outside investors poured millions of dollars into them.

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[3] That's not to say that these funds would have done better if their "superstar" managers had stayed in place; all we can be sure of is that the two funds did poorly without them.

Rising expenses. It often costs more to trade stocks in very large blocks than in small ones; with fewer buyers and sellers, it's harder to make a match. A fund with $100 million in assets might pay 1% a year in trading costs. But, if high returns send the fund mushrooming up to $10 billion, its trades could easily eat up at least 2% of those assets. The typical fund holds on to its stocks for only 11 months at a time, so trading costs eat away at returns like a corrosive acid. Meanwhile, the other costs of running a fund rarely fall—and sometimes even rise—as assets grow. With operating expenses averaging 1.5%, and trading costs at around 2%, the typical fund has to beat the market by 3.5 percentage points per year before costs just to match it after costs!

Sheepish behavior. Finally, once a fund becomes successful, its managers tend to become timid and imitative. As a fund grows, its fees become more lucrative—making its managers reluctant to rock the boat. The very risks that the managers took to generate their initial high returns could now drive investors away—and jeopardize all that fat fee income. So the biggest funds resemble a herd of identical and overfed sheep, all moving in sluggish lockstep, all saying "baaaa" at the same time. Nearly every growth fund owns Cisco and GE and Microsoft and Pfizer and Wal-Mart—and in almost identical proportions. This behavior is so prevalent that finance scholars simply call it herding.[4] But by protecting their own fee income, fund managers compromise their ability to produce superior returns for their outside investors.

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[4] There's a second lesson here: To succeed, the individual investor must either avoid shopping from the same list of favorite stocks that have already been picked over by the giant institutions, or own them far more patiently. See Erik R. Sirri and Peter Tufano, "Costly Search and Mutual Fund Flows," *The Journal of Finance,* vol. 53, no. 8, October, 1998, pp. 1589–1622; Keith C. Brown, W. V. Harlow, and Laura Starks, "Of Tournaments and Temptations," *The Journal of Finance,* vol. 51, no. 1, March, 1996, pp. 85–110; Josef Lakonishok, Andrei Shleifer, and Robert Vishny, "What Do Money Managers Do?" working paper, University of Illinois, February, 1997; Stanley Eakins, Stanley Stansell, and Paul Wertheim, "Institutional Portfolio Composition," *Quarterly Review of Economics and Finance,* vol. 38, no. 1, Spring, 1998, pp. 93–110; Paul Gompers and Andrew Metrick, "Institutional Investors and Equity Prices," *The Quarterly Journal of Economics,* vol. 116, no. 1, February, 2001, pp. 229–260.

FIGURE 9-2 The Funnel of Fund Performance

Looking back from December 31, 2002, how many U.S. stock funds outperformed Vanguard 500 Index Fund?

One year:
1,186 of 2,423 funds (or 48.9%)

Three years:
1,157 of 1,944 funds (or 59.5%)

Five years:
768 of 1,494 funds (or 51.4%)

Ten years:
227 of 728 funds (or 31.2%)

Fifteen years:
125 of 445 funds (or 28.1%)

Twenty years:
37 of 248 funds (or 14.9%)

Source: Lipper Inc.

Because of their fat costs and bad behavior, most funds fail to earn their keep. No wonder high returns are nearly as perishable as unrefrigerated fish. What's more, as time passes, the drag of their excessive expenses leaves most funds farther and farther behind, as Figure 9.2 shows.[5]

What, then, should the intelligent investor do?

First of all, recognize that an index fund—which owns all the stocks

[5] Amazingly, this illustration *understates* the advantage of index funds, since the database from which it is taken does not include the track records of hundreds of funds that disappeared over these periods. Measured more accurately, the advantage of indexing would be overpowering.

in the market, all the time, without any pretense of being able to select the "best" and avoid the "worst"—will beat most funds over the long run. (If your company doesn't offer a low-cost index fund in your 401(k), organize your coworkers and petition to have one added.) Its rock-bottom overhead—operating expenses of 0.2% annually, and yearly trading costs of just 0.1%—give the index fund an insurmountable advantage. If stocks generate, say, a 7% annualized return over the next 20 years, a low-cost index fund like Vanguard Total Stock Market will return just under 6.7%. (That would turn a $10,000 investment into more than $36,000.) But the average stock fund, with its 1.5% in operating expenses and roughly 2% in trading costs, will be lucky to gain 3.5% annually. (That would turn $10,000 into just under $20,000—or *nearly 50% less* than the result from the index fund.)

Index funds have only one significant flaw: They are boring. You'll never be able to go to a barbecue and brag about how you own the top-performing fund in the country. You'll never be able to boast that you beat the market, because the job of an index fund is to match the market's return, not to exceed it. Your index-fund manager is not likely to "roll the dice" and gamble that the next great industry will be teleportation, or scratch-'n'-sniff websites, or telepathic weight-loss clinics; the fund will always own every stock, not just one manager's best guess at the next new thing. But, as the years pass, the cost advantage of indexing will keep accruing relentlessly. Hold an index fund for 20 years or more, adding new money every month, and you are all but certain to outperform the vast majority of professional and individual investors alike. Late in his life, Graham praised index funds as the best choice for individual investors, as does Warren Buffett.[6]

[6] See Benjamin Graham, *Benjamin Graham: Memoirs of the Dean of Wall Street,* Seymour Chatman, ed. (McGraw-Hill, New York, 1996), p. 273, and Janet Lowe, *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (John Wiley & Sons, New York, 1999), p. 273. As Warren Buffett wrote in his 1996 annual report: "Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals." (See www.berkshirehathaway.com/1996ar/1996.html.)

TILTING THE TABLES

When you add up all their handicaps, the wonder is not that so few funds beat the index, but that any do. And yet, some do. What qualities do they have in common?

Their managers are the biggest shareholders. The conflict of interest between what's best for the fund's managers and what's best for its investors is mitigated when the managers are among the biggest owners of the fund's shares. Some firms, like Longleaf Partners, even forbid their employees from owning anything but their own funds. At Longleaf and other firms like Davis and FPA, the managers own so much of the funds that they are likely to manage your money as if it were their own—lowering the odds that they will jack up fees, let the funds swell to gargantuan size, or whack you with a nasty tax bill. A fund's proxy statement and Statement of Additional Information, both available from the Securities and Exchange Commission through the EDGAR database at www.sec.gov, disclose whether the managers own at least 1% of the fund's shares.

They are cheap. One of the most common myths in the fund business is that "you get what you pay for"—that high returns are the best justification for higher fees. There are two problems with this argument. First, it isn't true; decades of research have proven that funds with higher fees earn *lower* returns over time. Secondly, high returns are temporary, while high fees are nearly as permanent as granite. If you buy a fund for its hot returns, you may well end up with a handful of cold ashes—but your costs of owning the fund are almost certain *not* to decline when its returns do.

They dare to be different. When Peter Lynch ran Fidelity Magellan, he bought whatever seemed cheap to him—regardless of what other fund managers owned. In 1982, his biggest investment was Treasury bonds; right after that, he made Chrysler his top holding, even though most experts expected the automaker to go bankrupt; then, in 1986, Lynch put almost 20% of Fidelity Magellan in foreign stocks like Honda, Norsk Hydro, and Volvo. So, before you buy a U.S. stock fund, compare the holdings listed in its latest report against the roster of the S & P 500 index; if they look like Tweedledee and Tweedledum, shop for another fund.[7]

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[7] A complete listing of the S & P 500's constituent companies is available at www.standardandpoors.com.

They shut the door. The best funds often close to new investors—permitting only their existing shareholders to buy more. That stops the feeding frenzy of new buyers who want to pile in at the top and protects the fund from the pains of asset elephantiasis. It's also a signal that the fund managers are not putting their own wallets ahead of yours. But the closing should occur before—not after—the fund explodes in size. Some companies with an exemplary record of shutting their own gates are Longleaf, Numeric, Oakmark, T. Rowe Price, Vanguard, and Wasatch.

They don't advertise. Just as Plato says in *The Republic* that the ideal rulers are those who do not want to govern, the best fund managers often behave as if they don't want your money. They don't appear constantly on financial television or run ads boasting of their No. 1 returns. The steady little Mairs & Power Growth Fund didn't even have a website until 2001 and still sells its shares in only 24 states. The Torray Fund has never run a retail advertisement since its launch in 1990.

What else should you watch for? Most fund buyers look at past performance first, then at the manager's reputation, then at the riskiness of the fund, and finally (if ever) at the fund's expenses.[8]

The intelligent investor looks at those same things—but in the opposite order.

Since a fund's expenses are far more predictable than its future risk or return, you should make them your first filter. There's no good reason ever to pay more than these levels of annual operating expenses, by fund category:

• Taxable and municipal bonds:	0.75%
• U.S. equities (large and mid-sized stocks):	1.0%
• High-yield (junk) bonds:	1.0%

[8] See Noel Capon, Gavan Fitzsimons, and Russ Alan Prince, "An Individual Level Analysis of the Mutual Fund Investment Decision," *Journal of Financial Services Research,* vol. 10, 1996, pp. 59–82; Investment Company Institute, "Understanding Shareholders' Use of Information and Advisers," Spring, 1997, at www.ici.org/pdf/rpt_undstnd_share.pdf, p. 21; Gordon Alexander, Jonathan Jones, and Peter Nigro, "Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information," OCC working paper, December, 1997, at www.occ.treas.gov/ftp/workpaper/wp97-13.pdf.

- U.S. equities (small stocks): 1.25%
- Foreign stocks: 1.50%[9]

Next, evaluate risk. In its prospectus (or buyer's guide), every fund must show a bar graph displaying its worst loss over a calendar quarter. If you can't stand losing at least that much money in three months, go elsewhere. It's also worth checking a fund's Morningstar rating. A leading investment research firm, Morningstar awards "star ratings" to funds, based on how much risk they took to earn their returns (one star is the worst, five is the best). But, just like past performance itself, these ratings look back in time; they tell you which funds were the best, not which are going to be. Five-star funds, in fact, have a disconcerting habit of going on to underperform one-star funds. So first find a low-cost fund whose managers are major shareholders, dare to be different, don't hype their returns, and have shown a willingness to shut down before they get too big for their britches. Then, and only then, consult their Morningstar rating.[10]

Finally, look at past performance, remembering that it is only a pale predictor of future returns. As we've already seen, yesterday's winners often become tomorrow's losers. But researchers have shown that one thing is almost certain: Yesterday's losers almost never become tomorrow's winners. So avoid funds with consistently poor past returns—especially if they have above-average annual expenses.

THE CLOSED WORLD OF CLOSED-END FUNDS

Closed-end stock funds, although popular during the 1980s, have slowly atrophied. Today, there are only 30 diversified domestic

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[9] Investors can search easily for funds that meet these expense hurdles by using the fund-screening tools at www.morningstar.com and http://money.cnn.com.

[10] See Matthew Morey, "Rating the Raters: An Investigation of Mutual Fund Rating Services," *Journal of Investment Consulting,* vol. 5, no. 2, November/December, 2002. While its star ratings are a weak predictor of future results, Morningstar is the single best source of information on funds for individual investors.

equity funds, many of them tiny, trading only a few hundred shares a day, with high expenses and weird strategies (like Morgan Fun-Shares, which specializes in the stocks of "habit-forming" industries like booze, casinos, and cigarettes). Research by closed-end fund expert Donald Cassidy of Lipper Inc. reinforces Graham's earlier observations: Diversified closed-end stock funds trading at a discount not only tend to outperform those trading at a premium but are likely to have a better return than the average open-end mutual fund. Sadly, however, diversified closed-end stock funds are not always available at a discount in what has become a dusty, dwindling market.[11]

But there are hundreds of closed-end bond funds, with especially strong choices available in the municipal-bond area. When these funds trade at a discount, their yield is amplified and they can be attractive, so long as their annual expenses are below the thresholds listed above.[12]

The new breed of exchange-traded index funds can be worth exploring as well. These low-cost "ETFs" sometimes offer the only means by which an investor can gain entrée to a narrow market like, say, companies based in Belgium or stocks in the semiconductor industry. Other index ETFs offer much broader market exposure. However, they are generally not suitable for investors who wish to add money regularly, since most brokers will charge a separate commission on every new investment you make.[13]

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[11] Unlike a mutual fund, a closed-end fund does not issue new shares directly to anyone who wants to buy them. Instead, an investor must buy shares not from the fund itself, but from another shareholder who is willing to part with them. Thus, the price of the shares fluctuates above and below their net asset value, depending on supply and demand.

[12] For more information, see www.morningstar.com and www.etfconnect.com.

[13] Unlike index mutual funds, index ETFs are subject to standard stock commissions when you buy and sell them—and these commissions are often assessed on any additional purchases or reinvested dividends. Details are available at www.ishares.com, www.streettracks.com, www.amex.com, and www.indexfunds.com.

KNOW WHEN TO FOLD 'EM

Once you own a fund, how can you tell when it's time to sell? The standard advice is to ditch a fund if it underperforms the market (or similar portfolios) for one—or is it two?—or is it three?—years in a row. But this advice makes no sense. From its birth in 1970 through 1999, the Sequoia Fund underperformed the S & P 500 index in 12 out of its 29 years—or more than 41% of the time. Yet Sequoia gained more than 12,500% over that period, versus 4,900% for the index.[14]

The performance of most funds falters simply because the type of stocks they prefer temporarily goes out of favor. If you hired a manager to invest in a particular way, why fire him for doing what he promised? By selling when a style of investing is out of fashion, you not only lock in a loss but lock yourself out of the all-but-inevitable recovery. One study showed that mutual-fund investors underperformed their own funds by 4.7 percentage points annually from 1998 through 2001—simply by buying high and selling low.[15]

So when should you sell? Here a few definite red flags:

- **a sharp and unexpected change in strategy,** such as a "value" fund loading up on technology stocks in 1999 or a "growth" fund buying tons of insurance stocks in 2002;
- **an increase in expenses,** suggesting that the managers are lining their own pockets;
- **large and frequent tax bills** generated by excessive trading;
- **suddenly erratic returns,** as when a formerly conservative fund generates a big loss (or even produces a giant gain).

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[14] See Sequoia's June 30, 1999, report to shareholders at www.sequoiafund.com/Reports/Quarterly/SemiAnn99.htm. Sequoia has been closed to new investors since 1982, which has reinforced its superb performance.

[15] Jason Zweig, "What Fund Investors Really Need to Know," *Money,* June, 2002, pp. 110–115.

WHY WE LOVE OUR OUIJA BOARDS

Believing—or even just hoping—that we can pick the best funds of the future makes us feel better. It gives us the pleasing sensation that we are in charge of our own investment destiny. This "I'm-in-control-here" feeling is part of the human condition; it's what psychologists call overconfidence. Here are just a few examples of how it works:

- In 1999, *Money* Magazine asked more than 500 people whether their portfolios had beaten the market. One in four said yes. When asked to specify their returns, however, 80% of those investors reported gains *lower* than the market's. (Four percent had no idea how much their portfolios rose—but were sure they had beaten the market anyway!)
- A Swedish study asked drivers who had been in severe car crashes to rate their own skills behind the wheel. These people—including some the police had found responsible for the accidents and others who had been so badly injured that they answered the survey from their hospital beds—insisted they were better-than-average drivers.
- In a poll taken in late 2000, *Time* and CNN asked more than 1,000 likely voters whether they thought they were in the top 1% of the population by income. Nineteen percent placed themselves among the richest 1% of Americans.
- In late 1997, a survey of 750 investors found that 74% believed their mutual-fund holdings would "consistently beat the Standard & Poor's 500 each year"—even though most funds fail to beat the S & P 500 in the long run and many fail to beat it in *any* year.[1]

While this kind of optimism is a normal sign of a healthy psyche, that doesn't make it good investment policy. It makes sense to believe you can predict something only if it actually *is* predictable. Unless you are realistic, your quest for self-esteem will end up in self-defeat.

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[1] See Jason Zweig, "Did You Beat the Market?" *Money,* January, 2000, pp. 55–58; *Time*/CNN poll #15, October 25–26, 2000, question 29.

As the investment consultant Charles Ellis puts it, "If you're not prepared to stay married, you shouldn't *get* married."[16] Fund investing is no different. If you're not prepared to stick with a fund through at least three lean years, you shouldn't buy it in the first place. Patience is the fund investor's single most powerful ally.

[16] See interview with Ellis in Jason Zweig, "Wall Street's Wisest Man," *Money,* June, 2001, pp. 49–52.

CHAPTER 10

The Investor and His Advisers

The investment of money in securities is unique among business operations in that it is almost always based in some degree on advice received from others. The great bulk of investors are amateurs. Naturally they feel that in choosing their securities they can profit by professional guidance. Yet there are peculiarities inherent in the very concept of investment advice.

If the reason people invest is to make money, then in seeking advice they are asking others to tell them how to make money. That idea has some element of naïveté. Businessmen seek professional advice on various elements of their business, but they do not expect to be told how to make a profit. That is their own bailiwick. When they, or nonbusiness people, rely on others to make *investment profits* for them, they are expecting a kind of result for which there is no true counterpart in ordinary business affairs.

If we assume that there are normal or standard *income* results to be obtained from investing money in securities, then the role of the adviser can be more readily established. He will use his superior training and experience to protect his clients against mistakes and to make sure that they obtain the results to which their money is entitled. It is when the investor demands more than an average return on his money, or when his adviser undertakes to do better for him, that the question arises whether more is being asked or promised than is likely to be delivered.

Advice on investments may be obtained from a variety of sources. These include: (1) a relative or friend, presumably knowledgeable in securities; (2) a local (commercial) banker; (3) a brokerage firm or investment banking house; (4) a financial service or periodical; and (5) an investment counselor.* The miscellaneous character of this list suggests that no logical or systematic approach in this matter has crystallized, as yet, in the minds of investors.

Certain common-sense considerations relate to the criterion of normal or standard results mentioned above. Our basic thesis is this: If the investor is to rely chiefly on the advice of others in handling his funds, then either he must limit himself and his advisers strictly to standard, conservative, and even unimaginative forms of investment, or he must have an unusually intimate and favorable knowledge of the person who is going to direct his funds into other channels. But if the ordinary business or professional relationship exists between the investor and his advisers, he can be receptive to *less conventional* suggestions only to the extent that he himself has grown in knowledge and experience and has therefore become competent to pass independent judgment on the recommendations of others. He has then passed from the category of defensive or unenterprising investor into that of aggressive or enterprising investor.

Investment Counsel and Trust Services of Banks

The truly professional investment advisers—that is, the well-established investment counsel firms, who charge substantial annual fees—are quite modest in their promises and pretentions. For the most part they place their clients' funds in standard interest- and dividend-paying securities, and they rely mainly on normal investment experience for their overall results. In the typical case it is doubtful whether more than 10% of the total fund is ever invested in securities other than those of leading companies, plus

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* The list of sources for investment advice remains as "miscellaneous" as it was when Graham wrote. A survey of investors conducted in late 2002 for the Securities Industry Association, a Wall Street trade group, found that 17% of investors depended most heavily for investment advice on a spouse or friend; 2% on a banker; 16% on a broker; 10% on financial periodicals; and 24% on a financial planner. The only difference from Graham's day is that 8% of investors now rely heavily on the Internet and 3% on financial television. (See www.sia.com.)

government bonds (including state and municipal issues); nor do they make a serious effort to take advantage of swings in the general market.

The leading investment-counsel firms make no claim to being brilliant; they do pride themselves on being careful, conservative, and competent. Their primary aim is to conserve the principal value over the years and produce a conservatively acceptable rate of income. Any accomplishment beyond that—and they do strive to better the goal—they regard in the nature of extra service rendered. Perhaps their chief value to their clients lies in shielding them from costly mistakes. They offer as much as the defensive investor has the right to expect from any counselor serving the general public.

What we have said about the well-established investment-counsel firms applies generally to the trust and advisory services of the larger banks.*

Financial Services

The so-called financial services are organizations that send out uniform bulletins (sometimes in the form of telegrams) to their subscribers. The subjects covered may include the state and prospects of business, the behavior and prospect of the securities markets, and information and advice regarding individual issues. There is often an "inquiry department" which will answer questons affecting an individual subscriber. The cost of the service averages much less than the fee that investment counselors charge their individual clients. Some organizations—notably Babson's and Standard & Poor's—operate on separate levels as a financial service and as investment counsel. (Incidentally, other organiza-

* The character of investment counseling firms and trust banks has not changed, but today they generally do not offer their services to investors with less than $1 million in financial assets; in some cases, $5 million or more is required. Today thousands of independent financial-planning firms perform very similar functions, although (as analyst Robert Veres puts it) the mutual fund has replaced blue-chip stocks as the investment of choice and diversification has replaced "quality" as the standard of safety.

tions—such as Scudder, Stevens & Clark—operate separately as investment counsel and as one or more investment funds.)

The financial services direct themselves, on the whole, to a quite different segment of the public than do the investment-counsel firms. The latters' clients generally wish to be relieved of bother and the need for making decisions. The financial services offer information and guidance to those who are directing their own financial affairs or are themselves advising others. Many of these services confine themselves exclusively, or nearly so, to forecasting market movements by various "technical" methods. We shall dismiss these with the observation that their work does not concern "investors" as the term is used in this book.

On the other hand, some of the best known—such as Moody's Investment Service and Standard & Poor's—are identified with statistical organizations that compile the voluminous statistical data that form the basis for all serious security analysis. These services have a varied clientele, ranging from the most conservative-minded investor to the rankest speculator. As a result they must find it difficult to adhere to any clear-cut or fundamental philosophy in arriving at their opinions and recommendations.

An old-established service of the type of Moody's and the others must obviously provide something worthwhile to a broad class of investors. What is it? Basically they address themselves to the matters in which the average active investor-speculator is interested, and their views on these either command some measure of authority or at least appear more reliable than those of the unaided client.

For years the financial services have been making stock-market forecasts without anyone taking this activity very seriously. Like everyone else in the field they are sometimes right and sometimes wrong. Wherever possible they hedge their opinions so as to avoid the risk of being proved completely wrong. (There is a well-developed art of Delphic phrasing that adjusts itself successfully to whatever the future brings.) In our view—perhaps a prejudiced one—this segment of their work has no real significance except for the light it throws on human nature in the securities markets. Nearly everyone interested in common stocks wants to be told by someone else what he thinks the market is going to do. The demand being there, it must be supplied.

Their interpretations and forecasts of business conditions, of course, are much more authoritative and informing. These are an important part of the great body of economic intelligence which is spread continuously among buyers and sellers of securities and tends to create fairly rational prices for stocks and bonds under most circumstances. Undoubtedly the material published by the financial services adds to the store of information available and fortifies the investment judgment of their clients.

It is difficult to evaluate their recommendations of individual securities. Each service is entitled to be judged separately, and the verdict could properly be based only on an elaborate and inclusive study covering many years. In our own experience we have noted among them a pervasive attitude which we think tends to impair what could otherwise be more useful advisory work. This is their general view that a stock should be bought if the near-term prospects of the business are favorable and should be sold if these are unfavorable—*regardless of the current price.* Such a superficial principle often prevents the services from doing the sound analytical job of which their staffs are capable—namely, to ascertain whether a given stock appears over- or undervalued at the current price in the light of its indicated long-term future earning power.

The intelligent investor will not do his buying and selling solely on the basis of recommendations received from a financial service. Once this point is established, the role of the financial service then becomes the useful one of supplying information and offering suggestions.

Advice from Brokerage Houses

Probably the largest volume of information and advice to the security-owning public comes from stockbrokers. These are members of the New York Stock Exchange, and of other exchanges, who execute buying and selling orders for a standard commission. Practically all the houses that deal with the public maintain a "statistical" or analytical department, which answers inquiries and makes recommendations. A great deal of analytical literature, some of it elaborate and expensive, is distributed gratis to the firms' customers—more impressively referred to as clients.

A great deal is at stake in the innocent-appearing question whether "customers" or "clients" is the more appropriate name. A business has customers; a professional person or organization has