https://www.wsj.com/articles/SB1026245139176281360

Rewriting History: How Funds Hide Past Miscues With Closures

By Jonathan ClementsStaff Reporter of The Wall Street Journal

July 10, 2002 12:01 am ET

The good old days have never looked so good.

As the mutual-fund industry seeks to burnish its image, it's killing off rotten stock funds at a rapid rate. Result: These lousy performers are expunged from the historical record. That makes actively managed stock funds look like a better bet than they actually are, especially when compared to their nemesis, market-tracking index funds.

John Bogle, founder of Vanguard Group in Malvern, Pa., notes that some 6½% of stock funds are killed off each year, double the failure rate of just a few years ago. "That means that two-thirds of the funds around today will be gone in 10 years," he says. "That's an astonishing number."

When a fund is killed off, it's often merged into another fund with lower costs and a more sensible strategy. That's good for shareholders. But it's even better for fund-management companies, because they get rid of embarrassing funds that are often generating scant profit for the fund companies involved.

To appreciate how fund mergers distort the long-run record, consider the 20 years through year-end 2001.

According to Chicago's Morningstar Inc., U.S. stock funds returned an average 13.8% a year over that stretch, just a smidgen behind the 14.3% for the Wilshire 5000-index of almost all U.S. stocks. This fund average was built by stringing together the calendar-year results for funds that were around in each year, and are still around today.

If actively managed funds lag behind the index by just 0.5 percentage point a year, the case for index funds would seem rather weak. After all, if you stick with actively managed funds, you will still do pretty well, even if you end up with middling performers, and there's always that chance you could beat the market.

Keep in mind, however, that the 13.8% doesn't include all the fund industry's failures. What if you add back the funds that have since been liquidated or merged out of existence? That knocks more than a percentage point off the 20-year average, dropping it to 12.7% a year.

At that annual rate, $1,000 would grow to $10,926 after 20 years, versus $13,987 for an investor who owned an index fund that mimicked the Wilshire 5000. To generate the latter number, I knocked 0.2 percentage point off the Wilshire's 14.3% annual performance, to reflect the expenses charged by a low-cost index fund.

"With the fund industry, you end up with the sort of historical record found in the old Soviet Union," quips Scott Cooley, editor of Morningstar Mutual Funds, a newsletter. "The record isn't accurate, because the fund industry buries its mistakes."

There is a silver lining to all this. At least these rotten funds aren't around to do further damage to shareholders.

"Generally, a fund that is put out of its misery is a fund that should never have been started," says Vanguard's Mr. Bogle. "The fund company hasn't paid the price. The poor investor has paid the price."

If a fund has rotten performance, shareholders tend to flee, so that the fund is small by the time it is merged out of existence. Indeed, in most mergers, a larger fund swallows a smaller one, and the larger fund's record survives.

While it bothers me that fund companies thereby get to bury their mistakes, it seems logical that the larger fund's record should survive, because more shareholders were probably affected by that fund's performance.

But, of course, logic doesn't always prevail. Consider two recent mergers, which were brought to my attention by the folks at No-Load Fund Investor, a newsletter in Ardsley, N.Y.

This year, the $135 million-in-assets Berger New Generation Fund was merged into the $35 million Berger Mid Cap Growth Fund. Meanwhile, just before the end of April, the tiny Credit Suisse International Focus Fund suddenly became a $383 million fund, thanks to its acquisition of the $354 million Credit Suisse International Equity Fund.

Why was the larger fund merged into a smaller offering? Whatever the rationale, it certainly spruced up performance.

Over the four years through year-end 2001, Credit Suisse International Focus clocked 5.7% a year, while the now-defunct Credit Suisse International Equity lost 2.2% annually, calculates Morningstar. Similarly, the surviving Berger Mid Cap Growth boasted a four-year annualized return of 15.5%, while Berger New Generation lost 3.2% a year.

"There is some difference [in performance], but that wasn't our motivating factor," insists Berger spokeswoman Sally Carleton. She says Mid Cap Growth was chosen as the surviving fund because its strategy was more suitable for shareholders who wanted a core portfolio holding.

What about Credit Suisse? A spokeswoman declined to comment.

The Securities and Exchange Commission has occasionally nixed such mergers. For instance, in 1999, the SEC opposed the merger of the large, but lackluster Stein Roe Capital Opportunities Fund into Stein Roe Growth Investor Fund, a far smaller fund.

But the SEC doesn't always object to such minnow-swallows-the-whale mergers. Under SEC guidelines, the surviving fund is allowed to use the record of whichever predecessor fund it most closely resembles.

What does "closely resembles" mean? Put it this way. If a fund company wants to bury a large fund's lousy record, it seems there's plenty of room to maneuver.

And, frankly, I encourage fund-company executives to mess with performance. The more games they play, the more disgusted stock-fund investors will become -- and the more likely they are to make the sensible choice, which is to buy no-frills, market-tracking index funds.