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FUND OF INFORMATION

When Divergence Is Good

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INVESTORS IN SO-CALLED ACTIVELY MANAGED FUNDS, beware: There are closet index funds lurking out there.

So concludes a working paper by two finance professors at the Yale School of Management: "You don't want to get stuck in the middle," one of the paper's authors, Antti Petajisto, tells *Barron's*. "Either go with a low-cost pure index fund or with a truly active fund. The funds in the middle very closely mirror the benchmark, but charge active management fees."

Index funds, which don't have to pay analysts to find investment ideas because their portfolio holdings correspond with those in a benchmark, usually have much lower expense ratios than actively managed funds, which must pay for investment research. The professors' paper is titled "How Active Is Your Fund Manager? A New Measure That Predicts Performance."

The professors found that a fund's "active share" was a good indicator of how likely it is to beat its benchmark, both before and after fees.

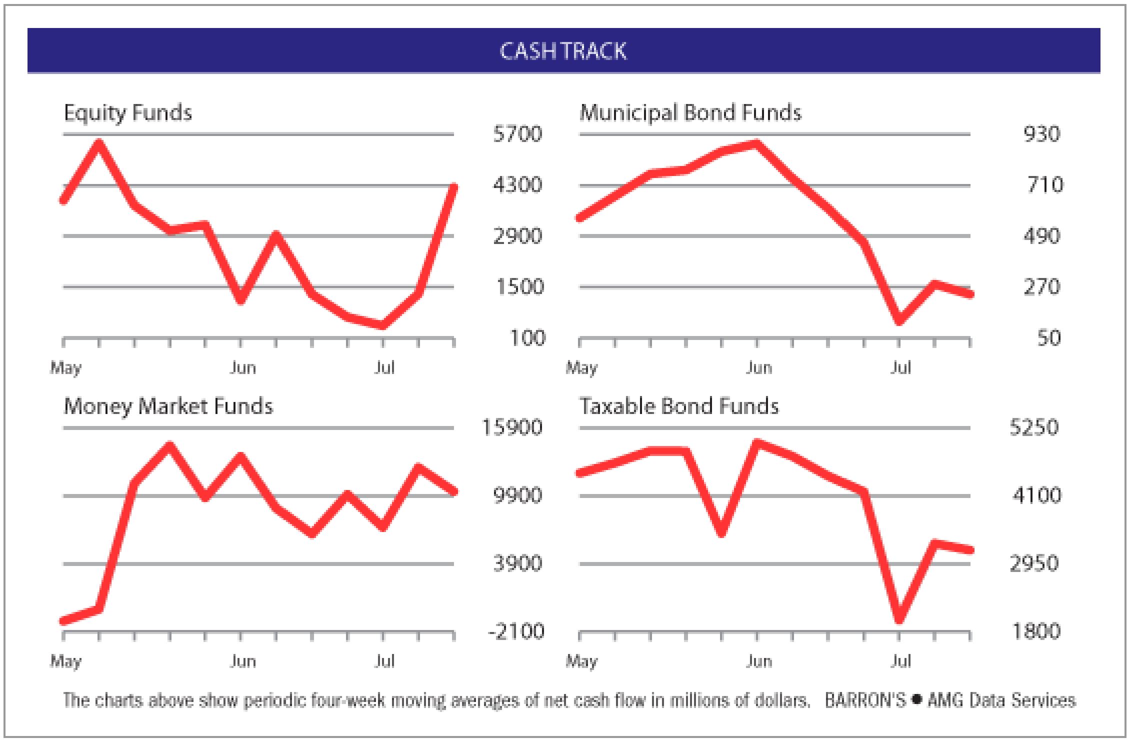
Active share is calculated by looking at how different a fund's holdings are from its benchmark. A fund with a higher active share diverges from the benchmark more than one with a lower active share.

Consider a $100 million fund benchmarked against the Standard & Poor's 500 Index and which holds half of the stocks in the benchmark. Its active share would be 50%. A fund holding only 50 stocks in the benchmark would have an active share of 90%.

Those funds ranked in the top 20% based on active share outperformed their benchmarks by 1.39 percentage points on an average annual basis from 1990 to 2003, net of fees and transaction costs. But those funds in the bottom group based on active share underperformed their benchmarks by 1.41 percentage points.

And as Petajisto and his co-author, Martijn Cremers, point out, the number of actively managed funds with closet index characteristics has increased. They consider funds with a low active share to be closet indexers. Funds with lower active share had about 30% of all mutual-fund assets in 2003, up from no share in the 1980s.

A high-profile example of a closet indexer cited by the authors was Fidelity Magellan[3] (ticker: FMAGX), under its previous manager Robert Stansky. He was replaced in late 2005 by Harry Lange, who quickly revamped the portfolio -- initially to disappointing results. However, its year-to-date return of nearly 15% ranks in the top 20% of its Morningstar peer group.



Equity Funds Increase Uptake: AMG Data's latest moving averages show that cash went into money funds at an average weekly clip of nearly $10.3 billion in the four weeks ended Wednesday. The figure was $4.2 billion for stock funds, $239 million for municipal-bond funds and $3.2 billion for taxable-bond funds.

It's important to remember that a high active-share rating doesn't always translate into superior performance. "It's not a guarantee," Petajisto affirms. An example cited in the professors' paper: Oakmark Select[4] (OAKLX), a concentrated portfolio run by longtime manager Bill Nygren, has a high active-share rating, yet the fund has struggled in recent years.

Nevertheless, Morningstar is considering incorporating the active-share metric into its analysis of funds -- in order to give investors a little more help discerning what they're getting in return for their fund costs.

Says Russel Kinnel, Morningstar's director of fund research, "It's an interesting lens to view mutual funds when you look at how active they are."

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