



The Street

Try Jim Cramer's
Action Alerts PLUS

Investing

Return to Article

Top Stocks Picked by S&P 500 Slayers

Frank Byrt

03/16/11 - 06:00 AM EDT

BOSTON ([TheStreet](#)) -- Being labeled a "closest indexer" is akin to wearing the scarlet letter in the mutual fund industry.

The moniker implies that a manager is shadowing his fund's benchmark index in portfolio makeup and performance rather than proving his stock-picking ability and earning the advisory fee charged to investors.

Funds that are benchmarked to the **S&P 500 Index** are the easiest to identify. The tell-tale signs include a three-year return within a percentage point or two of its benchmark; a portfolio of several hundred stocks, which makes it hard to outperform an index but enables a fund to keep up with it; and top holdings that overlap with those of the benchmark.

Many investors are paying too much for performance that's, at best, average. That may be particularly true this year, as analysts expect U.S. stocks to accelerate last year's gains as global economic growth quickens. In so-called up years, closet indexers underperform those who actively manage funds. In down years, closet indexers tend to shine, as their funds don't lose as much money.

Japan's nuclear crisis has pushed stocks lower in recent days, punishing stocks around the world and boosting Treasuries. Still, investors including Robert Auer, manager of the **Auer Growth Fund (AUERX)**, and James Paulsen, chief investment strategist at **Wells Fargo's (WFC)** asset-management unit, say the stock-market decline is overdone.

The slide in stocks "maybe sets us up at a later time to rally," Paulsen said.

If so, investors would be wise to consider funds overseen by stock pickers in the vein of Peter Lynch and Ken Heebner.

Many people, especially those with long-term retirement and 401(k) holdings that include closet index funds, may hang on to them because they get lulled into a false sense of security by comparing the fund's returns each year to its benchmark, without considering fees, which over the years can be substantial.

A pair of Yale professors developed an analytical tool to identify such and concluded after a review of 3,000 actively managed funds from 1980 through 2003 that 31% fit their closet index profile. What's more, they found that after subtracting fees, the most active funds beat their benchmarks by an average of 1.26% per year, while the close index funds lagged.

A recent update of that study by one of the professors, Antti Petajisto, now at New York University's Stern School of Business, found that about a third of active-fund managers were closet indexers at the end of 2009, presumably motivated by the desire to keep up with their benchmark after the stock market's collapse in 2008.

But it's not all cut and dried in trying to ferret out the closet indexer, Morningstar fund analyst Russ Kinnel said. The number of funds that fit the "closet indexer" profile hasn't risen significantly over the past few years, although "more funds have become conformist" because of the markets' increased volatility and the prevalence of foreign holdings.

And some fund manager may be using the strategy to limit their downside risk or mitigate portfolio volatility in a difficult period and may revert to more aggressive investing in a rising market, whereas others cling to quantitative-analysis strategies to try to outperform their benchmark.

But it's clear that some fund managers track their benchmark's holding to protect their reputations, income or even their jobs. That's because if a fund is consistently below its benchmark, it will hurt their bonuses as many managers get the biggest part of their pay from outdoing their benchmark. If a fund's performance significantly lags that of its peers, it's a red flag for personal investment advisers who are quick to move their clients' money around.

Kinnel adds that in their defense, some fund managers are following a mandate they clearly describe in their fund prospectus, and that may mean mimicking a particular index, while trying to add value in some form. "There are multiple reasons for it, some are legitimate and some aren't," he said of closet indexing.

But what investors should keep an eye on is a fund that's performing in lock-step with its index but carrying a hefty expense ratio. An average actively managed mutual fund's advisory fee is between 0.08% to about 1% on its assets, Kinnel said.

As a basis for comparison, the bellwether of large-cap index funds, the \$110 billion **Vanguard 500 Index Investor(VFINX)** charges a management fee of 0.17%. It holds 504 stocks and has an annual portfolio turnover of 5%. Over the past three years, the fund has an average annual return of 2.5%, right on the S&P 500 Index's 2.49%.

Even more enticing for those seeking to trim management fees but get S&P 500 returns are the **Vanguard S&P 500 ETF (VOO)**, and the **iShares S&P 500 Index Fund(IVV)**.

The 10 biggest stocks in the S&P 500 and in the top holdings of large-cap closet indexers are **ExxonMobil(XOM)**, **Apple (AAPL)**, **Microsoft(MSFT)**, **General Electric(GE)**, **Chevron(CVX)**, **International Business Machines(IBM)**, **Procter & Gamble(PG)**, **AT&T(T)**, **Johnson & Johnson(JNJ)** and **JP Morgan Chase(JPM)**.

Here are four large-cap mutual funds that have the S&P 500 as their benchmark with performances that fit the mold of closet-index funds, followed by four funds that also use that benchmark but are outperforming due to managers' stock-picking acumen:



The **Nuveen Enhanced Core Equity A Fund(NEEAX)** has a 99.55% correlation to the S&P 500 Index over the past three years. Its chart, a comparison of the fund's performance to the S&P 500, tells its story as well as that of other alleged closet-index funds.

The mutual fund carries a 0.74% management charge.

The 479-stock fund has an annual portfolio turnover of 52%, suggesting a modicum of activity by managers, but you can't tell that from its top holdings.

Its largest holding, at 4.8% of the fund, is the **SPDR S&P500 Fund(SPY)**, an S&P index fund.

The top 25 holdings include 18 of the stocks in the S&P index's top 25 holdings, led by iPad and iPhone maker Apple, oil giant ExxonMobil and telecommunications giant AT&T. Those stocks not in the fund's top 25, but in the index's top 25, all show up in the fund's next 25 holdings.

Nuveen Enhanced Core Equity has a return of 3.6% through March 14 versus the S&P 500 Index's 3.5% gain. Over three years, the fund's annualized return is 1.8% compared to the index's 2.49%.

With a fund that can't keep up with the S&P 500 Index, long-term, you have to wonder what gets "enhanced," as its title suggests.

According to Nuveen's description of the fund, its strategy "is driven by fundamentals and heavily grounded in quantitative techniques and seeks to produce long-term capital appreciation."

A Nuveen spokesman didn't return a call seeking comment.

The three-year performance of the \$1 billion **Principal Large Cap Blend II Institutional Fund**(PLBIX) correlates with that of the S&P 500 by 99.68%, according to Morningstar data.

T. Rowe Price and ClearBridge Advisors are the managers of the fund.

A look at the 484-stock portfolio quickly shows why, as its top holdings are in the footsteps of the index's holdings.

Its largest holding, at 3.7%, is the **E-Mini S&P**(ES), an equity futures index contract tied to the S&P 500.

The fund's second-biggest position is ExxonMobil, at 3.2%, exactly that of the S&P 500 Index's, and that's followed by Apple, at 2.77%, versus the S&P 500's 2.59% weighting.

Six of the fund's top 10 are also in the top 10 of the S&P 500 Index with similar weightings.

Principal Large Cap Blend holds 24 of the top 25 stocks in the S&P 500 Index in its 75 biggest holdings, most clustered in the top 25.

The fund, which charges a 0.76% management fee, has a performance that tracks that of the S&P 500 as well. It's up 3.24% this year through March 14, versus 3.5% for the index; and 13.4% over the past 12 months versus the index's 15% gain.

More telling is its three-year performance: the fund is up 2.95% for the period while the S&P 500 is up 2.49%.

Principal Financial Group(PFG) is one of the largest providers of 401(k) retirement benefits, with \$280 billion in assets under management. According to the fund's agenda, it invests in stocks with both growth and value characteristics and it "has approximately the same industry weightings as compared to the S&P 500 index."

The \$163 million **SSgA IAM Shares Institutional Fund**(SIAMX) carries a 99.76 % correlation with the S&P 500 Index over the past three years and for that it charges a fee of 0.53%. It has a portfolio of 368 stocks, and an annual portfolio turnover of a tiny 2%.

State Street Global Advisors, owned by **State Street**(STT), is the manager. The firm didn't comment on its performance.

Comparing the index to the fund's holdings, you find that other than two passive investment choices, the top eight stocks are the same, and in the same order as the index. And only one stock in the S&P 500's top 25 holdings isn't among the fund's 29 biggest positions.

Not surprisingly, the fund's returns are virtually the same as that of the S&P 500. Through March 14, the SSgA fund has a 3.63% return this year versus 3.51% for the index; over one year, the fund's return is 14.46% versus the index's 14.99%; and over a three-year period, the fund has risen an average of 2.54% to the index's 2.49%.

According to the fund's agenda, it seeks to maximize total returns by investing at least 80% of net assets in securities of companies that have entered into collective-bargaining agreements with the International Association of Machinists and Aerospace Workers or affiliated labor unions, or are listed in the S&P 500 Index, and haven't been identified as having non-union sentiment.

The \$494 million **Schroder North American Equity Fund**(SNAEX) has a 99.63% correlation to the S&P 500 over the past three years and for that it charges a fee of 0.39%.

This 489-stock large blend fund's returns are quite similar to those of the S&P 500 Index and to that of the SSgA IAM Shares Institutional fund (see above).

The fund has climbed 4.29% this year through March 14, to the S&P 500's 3.51%; over the past year, it's 14.13% for the fund and 14.99% for the index; and over a three-year period, it has an annualized return of 2.52% to the S&P 500 Index's 2.49%.

This could be considered a particularly passive fund as its largest allocation is a 7.4% weighting to a money market fund.

After that, its top 25 holdings are a virtual carbon copy of the S&P 500's, with the top three stocks in the same order and almost the same weightings as that of the index: ExxonMobil, at 2.6%; Apple, at 2.3%, and Microsoft, at 1.8%.

The top 10 stocks in the fund are also the top 10 of the index, although in slightly different order.

The fund's top 25 holdings don't include three stocks that are in the S&P 500 Index's top 25 holdings, but they show up in the next 12 stocks in the portfolio.

Surprisingly, it has an 88% portfolio turnover rate, according to Morningstar which suggests active management.

According to its quantitative strategy, the fund "is very deliberately positioned to deliver a very modest amount of performance above the index and is not meant to be an unconstrained active fund," said Jennifer Manser, a Schroder spokeswoman, in an e-mail response to questions about the fund.

"(It) is managed as an 'enhanced index fund' which seeks to outperform the S&P 500 by only 0.75% with a tracking error of less than 1.5%. Individual stock positions are managed to be the same as the benchmark index (plus or minus) 0.5% and sector positions are limited to the benchmark index (plus or minus) 2.5%," said the firm.

On the following pages are recommended mutual funds that don't stick to their benchmark and generate outperformance.

Marsico Flexible Capital(MFCFX), the antithesis of a closet-index fund, gets a five-star rating from Morningstar, its highest, for years of outperforming its benchmark, the S&P 500 Index.

Its expense ratio is 0.75%, so it's below the industry average, yet it has a three-year average return of 16.2% versus the 2.49% of the S&P 500.

The \$390 million fund holds only 36 stocks with 44% of assets in its top 10 holdings. Portfolio turnover is a very active 146%.

It's got a big, 15% allocation to cash, but its top 25 holdings don't include any of the S&P 500 Index's stocks.

Its largest stock pick is **Sensata Technologies Holdings(ST)**, at 4.5% of the fund. The Netherlands-based firm makes sensors and controls. It sells thermal circuit breakers for aircraft, pressure sensors used in automotive systems, and current and temperature control devices for electric motors. Its shares are up 6.7% this year, giving it a market value of \$5.7 billion.

U.S. Bancorp(USB) is the next largest holding, at 3.8% of the portfolio. Its territory stretches from the West Coast to the Midwest. Its shares are down 0.37% this year.

Morningstar says in a research the company is a "conservative, customer-focused bank where profitability has been shielded by two strong sources of fee income. Poised with a strong capital position, this company is taking full advantage of today's banking crisis."

A recent addition to the fund's top five stocks is **Targa Resources Investments(TRGP)**, up 20% this year. It's in the business of gathering, compressing and selling natural gas. Its shares are up 20% this year.

T. Rowe Price New America Growth([PRWAX](#)), which gets a five-star rating from Morningstar, handily outperformed its S&P 500 benchmark over the past three years with an 8.8% return versus the index's 2.49%. It's running about even with the index this year.

Its management expenses are a relatively low 0.83%. The \$1.6 billion fund carries 115 stocks and has 60% annual portfolio turnover.

Although Internet search engine **Google**([GOOG](#)) and Apple are its top two stocks, fund manager Joseph Milano goes his own way after that.

The fund shows a penchant for agriculture with its next two holdings, seed and weed-killer maker **Monsanto**([MON](#)) and **Potash Corp. of Saskatchewan**([POT](#)), which produces fertilizer. Both have piddling returns so far this year.

Online auctioneer **eBay**([EBAY](#)), up 10.5% this year, is the next largest holding, followed by **Adobe Systems**([ADBE](#)), the maker of Photoshop, Illustrator and Acrobat software.

Potash is up 12% over the past three months while Adobe is up 21%.

A recent fund addition is **Tim Hortons**([THI](#)), which is as ubiquitous in Canada as Dunkin' Donuts is in the Northeast U.S. It's making inroads into the U.S., and Morningstar says "the company's franchised structure means it receives a steady stream of revenues, shielding it from rising coffee bean prices."

Oakmark Select(OAKLX) is another fund that has benefited from getting out of lock-step with its index. It has a three-year annualized return of 9.6% versus the 2.49% increase of its benchmark, the S&P 500. It's up 5.5% this year versus the index's 3.5%.

Its expense ratio is 1.08%, and the fund has assets of \$2.5 billion.

Fund manager William Nygren makes **Discovery Communications(DISCK)** his top pick, at 8.4% of the fund. Discovery provides original and purchased programming to more than 170 countries. Its network includes the Discovery Channel, TLC, Animal Planet, Discovery Kids and a 50% interest in OWN, a new joint venture with Oprah Winfrey.

Tyco(TEL) is the second-largest holding, at 6.8%. Its electronics unit, comprising 72% of its sales, makes components used in automobiles, computers and medical devices. Its network-services segment (17% of sales) supplies infrastructure components to the telecommunications and energy markets.

Liberty Media(LINTA) and **Comcast(CMCSK)** are top-five holdings, showing Nygren's penchant for media stocks.

Liberty Media tracks the performance of a subset of Liberty Media's business units, including the QVC home-shopping network, which makes up more than 90% of Liberty Interactive's revenue, and several small online retailers.

Comcast is the nation's largest cable-TV operator, reaching 52 million households, with 23 million customers signing up for at least basic cable service. The firm also offers high-speed Internet access and phone service.

Comcast's shares are up 11% this year and 41% over the past 12 months.

Wells Fargo Growth Inv CL(SGROX) has Apple and Google in its top 10 holdings, but that's where the similarities with its benchmark, the S&P 500 Index, ends.

Alexion Pharmaceuticals(ALXN), **Praxair(PX)**, **Tractor Supply(TSCO)** and **Mettler-Toledo International(MTD)** are among its eclectic top 10 holdings.

Alexion, up 22% this year, specializes in the development and marketing of drugs for life-threatening medical conditions, such as hematologic diseases, autoimmune disorders and various types of cancer.

Praxair is the largest industrial gas supplier in North America and South America. Its shares are up 3% this year.

Tractor Supply is the biggest operator of retail farm and ranch stores in the U.S. The company targets recreational farmers and ranchers, and has very little exposure to commercial and industrial farm operations. Its shares have gained 11% this year and 86% over the past 12 months.

Mettler-Toledo International supplies weighing and precision instruments to customers in the life sciences, industrial and food-retail industries. Its shares are up 12.7% this year.

The fund carries a 103-stock portfolio with an annual turnover of 72%. The \$ 3.7 billion fund has a hefty 1.4% expense ratio.

The fund has gained 25.6% over the past year versus the S&P 500 index's 15%, and 7.6% over the past three years, compared to the index's 2.49%.

Readers Also Like:

[Goldman's 8 New Conviction Stock Buys](#)

[5 Defensive Stocks to Protect Your Money](#)

Visit TheStreet for more great features

THESTREET PREMIUM SERVICES

From the action-oriented investing ideas of *Action Alerts PLUS* by Jim Cramer to the expert technical trading strategies of Helene Meisler's *Top Stocks*, TheStreet.com offers a range of premium services to help boost your portfolio's performance. [View now.](#)

EXPERT ADVISORS ALERTS DELIVERED TO YOUR INBOX

Action Alerts PLUS: Cramer's personal portfolio, emails before he acts.
RealMoney: 70+ experts share their top investing ideas and analysis.
Stocks Under \$10: Alerts identify undervalued stocks with profit potential.

FREE NEWSLETTERS

Get an edge on the market with the help of free email newsletters like Jim Cramer's *Daily Booyah!*. Learn about the day's major market events, companies that sizzled or fizzled and lots more that can help you make more profitable investing decisions. [Sign up.](#)

Sponsored Links

Penny Stock Soaring 3000%

Sign up for Free to find out what the next 3000% Stock Winner Is!
www.PennyStocksUniverse.com

Lean Six Sigma Online

Top Ranked Villanova -100% Online. Six Sigma Training & Certification!
www.VillanovaU.com/SixSigma

(Amex:LPH) Hot Oil Stock!

Undiscovered Growth Stock Giving \$500M Revenue Guidance for FY11
www.LongweiPetro.com

[Buy a link here](#)

Brokerage Partners



[TheStreet Corporate](#) | [Home](#) | [About Us](#) | [Advertise](#) | [Customer Service](#) | [Employment](#) | [Privacy Policy](#) | [Sitemap](#) | [Topic Archive](#) | [Video Archive](#) | [Stock Quotes Online](#) | [Terms of Use](#)

TheStreet's enterprise databases running Oracle are professionally monitored and managed by [Pythian Remote DBA](#).

Quotes delayed at least 20 minutes for all exchanges. Market Data provided by [Interactive Data](#). Company fundamental data provided by [Morningstar](#). Earnings and ratings provided by Zacks. Mutual fund data provided by Valueline. ETF data provided by Lipper. [Terms & Conditions](#). Powered and implemented by [Interactive Data Managed Solutions](#).

TheStreet Ratings updates stock ratings daily. However, if no rating change occurs, the data on this page does not update. The data does update after 90 days if no rating change occurs within that time period.

IDC calculates the Market Cap for the basic symbol to include common shares only. Year-to-date mutual fund returns are calculated on a monthly basis by Value Line and posted mid-month.

*Oil Data in Market Overview is Brent Crude Pricing

The Street

© 1996-2011 TheStreet.com, Inc. All rights reserved.