



The Fundamentalist

BY JASON ZWEIG

Proof that chasing hot funds will make you dizzy, not rich

Ordinary investors aren't the only ones who find mutual funds fascinating. Over the past 10 years or so, finance professors have crunched zillions of numbers and published dozens of studies on fund risk and performance. But even the best of this research can be put to the wrong use by people who want to get their mitts on your money.

Thus I want to tell you about a remarkable new study—and warn you about how it may be misused. Lu Zheng, a Yale Ph.D. who is about to join the finance faculty at the University of Michigan Business School, has written a paper that will be published later this year in the prestigious *Journal of Finance*. It's called "Is Money Smart?" ("Money" refers not to a certain personal-finance magazine but to fund investors' dollars). And it's one of the most thorough and rigorous analyses of fund investors' real-life results ever done.

Zheng wanted to find out whether investors have beaten the market by choosing the mutual funds that would perform best in the future. She looked at the returns of all the diversified U.S. stock funds that existed at any time from January 1970 through December 1993—1,800 in all. Then she determined how investors in those funds fared, by adjusting the returns for all the money that they added and subtracted along the way.

What did Zheng learn? At first glance, one of her findings is electrifying: In this 24-year period, you could have beaten the broad stock market by up to 2.4 percentage points a year if you had

zeroed in on small no-load funds (median assets: \$41 million) that were attracting new cash from investors.

I suspect that after Zheng's work is published, newsletter writers, TV talking heads and "financial advisers" who frequently shuffle funds will declare that her research "proves" that you can beat the market by short-term trading in hot funds. Better yet, many of them will add, for a mere \$139, you can buy their newsletter or software program to benefit from this powerful new discovery—or they may suggest that you have them manage your money for, say, 1% of your assets a year.

My response: Hang on to your wallet, and use both hands. That's because, as Zheng readily admits, her discovery may not be practical for ordinary investors. Her method calls for buying and selling up to 100 funds every three months—or as many as 400 a year! If you hold on to your funds for even as long as 12 months, the extra return fades away to nothing. And whether you buy and sell that giant jumble of funds every quarter or every year, once you pay taxes on your smidgen of "excess" return, you won't be beating the market; it will be beating you.

In my opinion, what really makes Zheng's paper important is a discovery the fast-money folks won't bother telling you about: Over the 24-year period Zheng analyzed, the typical fund underperformed the broad stock market by an average of 0.55 percentage points a year—but the aver-

age fund investor did even worse, underperforming the market by 0.7 points annually. Concludes Zheng: "There is no significant evidence that active [fund] investors in general can beat the market."

How can the average fund investor possibly do worse than the average fund? Your own return would match a fund's total return only if you put in every penny on Day One and left it there until the last day of the measurement period. In reality, all too many fund buyers behave like frantic butterfly collectors, flitting from one fund to the next in the never-ending pursuit of the portfolio with the top performance. That often means buying high, selling low and locking in losses—even on a money-making fund. That's why fund investors who are just passing through, instead of holding on for the long run, often earn much lower returns than their funds do. As MONEY documented in April 1997, Dreyfus Aggressive Growth earned 20.7% in 1996, but its average investor lost 34.9%; similarly, Van Wagoner Emerging Growth gained 26.9%, while its typical shareholder lost 20%.

Instead of chasing fleeting numbers, pick a fund that has low expenses, invests with a level of risk you can stomach and complements the funds you already own. Then hang on to it year after year; sell only if you need the money or if your fund falls well behind its

peers (see "The Art of Selling" on page 101). That way you won't make yourself dizzy chasing after the latest butterfly of performance, and you'll stand a better chance of netting the results you deserve.

