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## **When Funds Turn Cold, Do You Sell?**

How to decide whether to stay or go when top-performing mutual funds turn into laggards

BY MICHAEL A. POLLOCK

In unsettled markets, many investors look to their mutual-fund managers to chart a course through the storm. But even once-stellar performers sometimes turn into disappointments.

Take Bruce Berkowitz. The manager of [Fairholme Fund](#) had an impressive run through most of the 2000s. For the 10 years through 2009, his fund's annualized return was about 13%, or 14 percentage points better than the Standard & Poor's 500-stock index. Fund researcher Morningstar Inc. ranked Fairholme at the top of its Large Value category for the decade and last year named Mr. Berkowitz its domestic equity manager of the decade.

But Fairholme this year has fallen nearly to the bottom of its Morningstar category, hurt by the financial stocks it holds.

Mr. Berkowitz has bounced back before, but some shareholders aren't waiting to see if he can do it again. In the four months through June, the fund saw net redemptions of about \$3.5 billion, or a drop of more than 17% in assets since February.

When a once-high-flying fund runs into turbulence, shareholders and financial advisers who manage investments for clients must make a stay-or-go decision. If a big portion of a nest egg is invested in one poorly performing fund, it may make sense to exit sooner rather than wait, says Harvey Rowen, chief executive at Starmont Asset Management LLC, in San Ramon, Calif. But if a fund on a losing streak is a modest part of a well-diversified portfolio, many advisers prefer to wait at least a year—and sometimes quite a bit longer—to see whether a fund manager can pull out of a funk.

It isn't unusual for even top managers to have reversals of one year or longer. A study by Tucson, Ariz.-based Davis Advisors, managers of the Davis Funds, found that 93% of 192 large-cap managers who ranked in the top quarter of their peer group for the decade of the 2000s had spent at least one three-year stretch in the bottom half of their category. The analysis looked at managers at a range of fund firms and was based on a ranking by Atlanta-based data provider eVestment Alliance.

Financial adviser Stephen Craffen offers advice on monitoring your mutual-fund portfolio and deciding whether to sell a one-time star that's gone cold. Photo courtesy AP.

Sunit Bhalla, a financial planner in Fort Collins, Colo., likes to scrutinize fund-manager commentary to see how management explains results. An intellectually honest manager who makes a mistake will take responsibility and "hopefully learn from it," Mr. Bhalla says.

What follows are examples of how financial advisers have reacted to major stumbles by some fund managers with stellar long-term records. Knowing how these advisers think may give individual investors insights that could be helpful as they try to make their own informed decisions.

### **Fairholme Fund**

Fairholme Fund left most peers in the dust during the 2000s. But this year, through July, the fund has a minus 12.6% return and ranks in the bottom 2% in its grouping. That's because a big bet by Mr. Berkowitz on financial issues such as [American International Group](#) Inc., [Bank of America](#) Corp. and [Morgan Stanley](#) so far hasn't succeeded.

The fund's performance also has been hurt by its holding in [St. Joe](#) Co., a WaterSound, Fla., real-estate concern. St. Joe said in a recent regulatory filing it was the subject of a Securities and Exchange Commission investigation into issues including company compliance with reporting rules by owners of more than 5% of its common shares; such owners include Fairholme Capital Management LLC. Mr. Berkowitz is currently chairman of St. Joe and heads Fairholme Capital Management. He did not respond to requests for comment.

Mr. Rowen of Starmont recently began reducing his clients' holdings in the fund because of a view that the economy is too unsettled for financial shares to rally much in the near future.

But Starmont will keep some client money in the fund "to play the long-term prospect of a meaningful return," Mr. Rowen says.

### **Keeley Small Cap Value**

[Keeley Small Cap Value](#), which focuses on smaller companies, sizzled in the mid-2000s. A 33% total return in 2004 beat its category average by 14 percentage points, putting it in the top 1% of its group.

## Do You Sell Lagging Funds?

### Questions to ask about a lagging fund

- If the manager is sticking with a stock or sector that is out of favor, do you agree with that position?
- Has the fund grown to the point that the manager can't operate as he or she used to?
- Did you fully understand the fund's approach to begin with?
- If the manager invests very differently from a benchmark, can you tolerate performance that is sometimes much better but sometimes much worse?
- Do you want to trim your exposure to this type of fund? Or, alternatively, are there competing funds that are more attractive?
- What has the manager said about the recent results in shareholder reports and other commentary?
- Has the manager veered away from the strategy described in the fund's prospectus?

But in 2008, its performance slid dramatically. Its average return of minus 2.5% a year for the three years through July places the fund in the bottom 4% of its Morningstar category for that period.

The fund appears to be a victim of its earlier success, says Stephen Craffen, an adviser in Fair Lawn, N.J. From around 2005 to 2007, it remained open to new shareholders, even as assets ballooned to more than \$3 billion from around \$300 million.

As funds swell, their managers have to take larger and larger positions to make a difference in overall portfolio performance.

Mr. Craffen, founder of Stonegate Wealth Management LLC, says he is gradually pulling clients' money out of Keeley, selling shares whenever he needs cash to rebalance portfolios. "Its performance hasn't lagged as much in the past nine months, but I am fearful just because of its size," he says.

Fund manager John Keeley Jr. says the growth in his fund's assets didn't hurt its performance. The decline in returns after 2007, he says, stems from a focus on industrials, materials, energy and companies undergoing restructuring, shares that were battered during the financial crisis as credit dried up.

But Mr. Keeley says his strategy hasn't shifted. He says that the portfolio is well-diversified and that he is reluctant to liquidate holdings that have appreciated in price but continue to have strong prospects.

He adds that the Keeley family is a substantial shareholder in the fund and hasn't sold shares.

## **CGM Focus**

[CGM Focus](#) aims to beat the broader market by investing in a select group of stocks, typically fewer than two dozen. The approach worked well for manager Ken Heebner in the past—his fund's 10-year average annual return of more than 10% is almost eight percentage points above Morningstar's Large Growth category average, putting the fund at the very top of the group for that decade.

But returns have been volatile over that period, probably making the fund a poor choice for individual investors who want more stability. For example, after a nearly 80% positive return in 2007, the fund's return slid to minus 48% in 2008.

For the past three years, the fund ranks at the very bottom of its category, with a minus 13.5% average annual return.

San Francisco-based adviser and fund manager Malcolm Gissen early last year pulled "a couple million" dollars of client money out of the fund, he says. This was partly because of lackluster returns, Mr. Gissen says, and partly because of concern about the fund's holding of automotive shares such as [Ford Motor](#) Co., despite the economic hurdles the industry faced.

Still, Mr. Gissen advises, "Don't abandon a good fund just because it has had a bad year. You have to give managers an opportunity to perform."

Mr. Heebner says returns have suffered recently because he was overly optimistic about the strength of the economic rebound—for example, making a "premature" move into financial stocks.

But if the economy is poised for better performance, he says, "I think I am positioned to participate."

## **Hussman Strategic Growth**

[Hussman Strategic Growth](#) was among the first mutual funds to adopt hedging techniques similar to those used by institutional investors to try to achieve more consistent returns. Manager John Hussman, who holds a Ph.D. in economics, invests in individual stocks that he believes have good potential for long-term appreciation and also uses derivatives such as options on broad market indexes to try to limit downside risk.

On a 10-year basis, the fund's average annual return of 4.9% beat the average for Morningstar's Long-Short Equity category by more than three percentage points. But performance has lagged since 2009, including last year's minus 3.6% return.

Lou Stanasolovich, chief executive of Legend Financial Advisors in Pittsburgh, continues to like the fund, which he says is useful in reducing the volatility in a broader portfolio.

In 2008, when the S&P 500 index fell nearly 40%, the fund's return was minus 9%.

But Jody Team, an adviser in Abilene, Texas, this year took client funds out of the fund. Among other things, he was concerned about website commentary by Dr. Hussman that seemed to suggest the manager was having difficulty adjusting his approach for the unprecedented events of the past couple of years.

Dr. Hussman says that the fund's objective is to outperform the S&P 500 over a complete market cycle and that investors with shorter horizons may at times be frustrated with returns. But he says he has made significant revisions in the computer models he uses to gauge risk and return prospects, and now includes many more indicators and possible scenarios.

Recent criticism of Hussman Strategic Growth's performance is "well-deserved," he says. "But we have come out of this period with an approach that I think deals with the uncertainty we are likely to continue to see ahead."

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