ON THE MONEY

Mutual funds and managers to avoid

Barry Ritholtz

ON INVESTING

How are your retirement investments doing these days?

For many people, that's a loaded question. U.S. markets are up more than 100 percent from their 2009 lows, yet many investors are not thrilled by their returns. That's quite telling and suggests that someone is doing something wrong.

Many factors determine how well your investment returns do. The big ones are (1) how your holdings are allocated among asset classes, (2) whether you are an active or passive investor, and (3) your approach to risk management.

Today, I want to focus on active investors — meaning those of you who primarily employ mutual funds where equity managers select stocks for you. Let's talk about active fund managers and, more specifically, which ones to avoid.

I've written before about knowing when you should fire your mutual fund manager. Today's question is more basic: What are the characteristics of the managers you shouldn't hire in the first place?

As always, we begin with a caveat: If you are going the active route, you must accept that during some years, your fund manager — indeed, any manager — will not meet his benchmark. In any given year, a majority of active managers fall short of their target. Each year, Standard & Poor's releases a study that tracks the performance of active fund managers vs. passive ETF holders. In 2011, most managers — 84 percent — missed their benchmarks. As S&P put it, "the only consistent data point we have observed over a five-year horizon is that a majority of active equity and bond managers in most categories lag comparable benchmark indices."

Of course, underperformance alone may not be the basis for replacing a manager. There are times when a manager underperforms for a good reason: Sometimes a manager's sector or style falls temporarily out of favor. Value stocks or emerging markets may be strong one year, but out of favor the next. Those managers will perform poorly relative to the S&P 500 that year.

Also, there is good old-fashioned mean reversion. This simply means that all "hot hands" eventually go cold. Every style, sector, region that takes off eventually sees that momentum fade. After a few good years, managers mean revert and see their performance numbers (however temporary the reversion is) suffer.

So, how can you steer clear of those who are likely to underperform over the long term — for reasons beyond those mentioned above?

Manager types and funds to avoid:

Policy wonks: The policy wonk appears to be a deep thinker. He writes long missives about the Federal Reserve and the demise of the dollar. His specialty is esoteric history of some obscure corner of finance. They often wax eloquent in their monthly commentary to investors about the coming crisis in "_____."

The main problem with the policy wonk is that he imagines a theoretically possible scenario and then expresses your investment dollars toward that hypothetical. Unless his exact forecast comes true — and gets the timing right — the investment is likely to be a loser. That's a problem for you, the home investor.

The wonk may be brilliant and insightful, but he is utterly ill-suited to be managing other people's money.

Closet indexers: The primary reason to buy an active fund — despite the higher costs than a passive index — is the stock-picking acumen of the manager. Generally speaking, if most of their major holdings outperform their benchmark's average, the fund itself should do better as well.

Where this theory breaks down is when the manager has so many holdings that he might as well be an index. Let's say your fund holds Apple, up about 50 percent over the past six months. If it is one of a hundred holdings in the portfolio, the impact is de minimis.

The investor is getting a closet index — all of the benefits of passive investing, only with all of the costs of active investing. No thanks. The investor would have been much better off with the Index ETF.

The "schtick" fund: I am not at all a fan of the funds that seem to be designed by the marketing department instead of the fund manager.

A few years ago, the "vice" funds did well — until they fell from favor. Then came the socially responsible funds, which outperformed for a while — until that stopped. In the late 1990s, there were a few "open funds" that ran money transparently — until they blew up, losing most of their investors' money. And the latest gimmick seems to be appealing to people's faith by marketing via biblical parables from the Gospel of Matthew. The Wall Street Journal reported that there's even a registered investment fund called "Matthew 25."

Investing is challenging enough without having to adhere to some specific gimmick or schtick driving the stock selection. When the focus is on some gimmick, rather than returns, stay away.

If you are going the active route, you must accept that during some years, your fund manager — indeed, any manager — will not meet his benchmark.

The excess fees fund: The rise of Web sites such as Morningstar and Yahoo Finance have made it increasingly difficult to hide excess fees from the investing public. Yet, some fund families still are managing to charge hefty carrying costs for mutual funds.

There are A-Class shares with loads as high as 5.75 percent. Then there are the internal expense ratios — the actual costs of managing the funds — that can range from 50 basis points to more than 200 (or ½ to 2 percentage points). And don't forget the 12b-1 fees. These are what the fund families charge for marketing the funds, as well as payments made to brokerage firms for steering you, dear investor, into these funds. Each year, investors pay about $10 billion in 12b-1 fees.

Studies have overwhelmingly proven that high fees are a drag on performance. Compound them over time, and they take a huge bite out of your retirement monies. Investors who manage to avoid these high fees guarantee themselves an extra percent or two per year, risk free.

Sports team/super yacht owner: Over the past few years, a string of managers have made some very high-profile purchases of "big boy toys." Some have bought professional sports teams in the NBA, NFL or MLB. (You can still get a good deal on a soccer team in Britain). Others bought record-setting 170-foot yachts.

Now, I am all in favor of fund managers having outside interests. A broad knowledge base can only be helpful; all work and no play makes for a bored and error-prone asset manager. And it isn't too bad for the economy for them to be engaging in all of this discretionary spending.

However, once most managers have acquired so much wealth as to allow them to broadly indulge themselves, one suspects their heart isn't in it anymore. Their focus tends to wane, and their performance falters.

I am not suggesting managers need to live like Warren Buffett. One of the wealthiest men in the country, he still drives the same junker car he had 20 years ago and lives in the same house he bought more than 30 years ago. Sure, he bought NetJets, a private jet company — but that was for Berkshire Hathaway.

Buffett is on one end of the spectrum and the Master of the Universe/Yacht Captain/Ballclub Owner at the other. Do you want to guess which one is paying closer attention to your money?

Note: This tends to happen more often — but not exclusively — among hedge fund than mutual fund managers.

Investors considering going the active route should do their homework before putting their money at risk. Start with sites such as Morningstar, Yahoo Finance and MSN Money. There is an immense amount of easily accessible information out there on mutual funds.

There is no excuse for not knowing the fees and compositions of funds you want to invest in today, as there is a world of data and details about potential places for your cash.

Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, the Big Picture. He owns a 7-year-old, 24 foot dinghy. You can follow him on Twitter: @Ritholtz

ISTOCKPHOTO

MICHELLE SINGLETARY

Book takes a youthful stand against bad financial role models

COLOR FROM G1

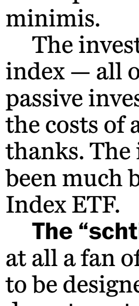
Bissonnette took his parents' struggles and his father's "lifetime of financial inattentiveness" and has used it as inspiration to do better for himself. He's also using his experience to help other 20-somethings navigate the financial world.

He delivers simple strategies and cautionary stories of athletes and pop stars to scare young adults before they get trapped in bad situations because of poor financial decisions.

The first thing Bissonnette does is address the notion that stuff equals success. "If you're going into debt to buy something you think will make you cooler, not only will you be broke, you'll be terribly unhappy to learn that 'having stuff' doesn't make you happy," he writes.

Want to be rich? Stop watching so much television, which bombards people with messages that spending equals happiness, Bissonnette says. He doesn't even own a TV.

You will find good, solid advice in this book about credit, investing and saving with a heavy and much-needed dose of cynicism. Bissonnette is annoyed — as I often am — about the constant drumbeat that your credit score is the most important number in your life.



HOW TO BE RICHER, SMARTER, AND BETTER-LOOKING THAN YOUR PARENTS
Zac Bissonnette
Portfolio, 256 pages, $17

"More important than your net worth?" Bissonnette asks. "More important than your cholesterol or body mass index? . . . Your credit score is not a measure of the strength of your financial life because your credit score does not take into account your income or your net worth."

Man, what insight. Speaking of which, I love Bissonnette's contempt for debt, especially student loans. He's says people who tell students not to be in a rush to pay off their loans are full of it. And wrong.

"It's much better to hunker down, get the debt out of your life, and then move on," he writes. "The low-grade misery of chipping away at it forever is just not a good deal."

Amen.

And he has sound advice when it comes to automobiles.

"I am part of a tiny, fringe cult of people who think we should only buy cars with cash," he writes.

Count me in that cult.

I asked Bissonnette why he wrote the book. He said: "I wanted to create something parents could give to their kids and say, 'Read this, do this, and have a better life than we had.' I think that's what every parent wants for his or her child. The idea of the book is really how to avoid the things we do with money that we think will make us happy (but won't) and show how to do the things that will make us happy."

I'm often asked to recommend a book for a recent college graduate or young adult starting out. Get this book.

I will host a live online discussion about "How to be Richer, Smarter, and Better-Looking Than Your Parents" at noon Eastern time on May 31 at washingtonpost.com/conversations. Bissonnette will join me to answer your questions.

Every month, I randomly select readers to receive a copy of the featured book, which is donated by the publisher. For a chance to win a copy of this month's book club selection, send an e-mail to *colorofmoney@washpost.com* with your name and address.

Readers can write to Michelle Singletary at The Washington Post, 1150 15th St. NW, Washington, D.C. 20071, or *singletarym@washpost.com*. Personal responses may not be possible, and comments or questions may be used in a future column, with the writer's name, unless otherwise requested. To read previous Color of Money columns, go to postbusiness.com.

STEVEN PEARLSTEIN

One-track-mind politics threaten the Silver Line

PEARLSTEIN FROM G1

What we're dealing with here is yet another example of government by hijacking. If we don't get everything we want, we'll kill the project, we'll close the government, we'll put the U.S. Treasury into default. As the infamous general said in Vietnam: We had to "destroy the village in order to save it."

In this poisonous political atmosphere, every little disagreement becomes a test of wills that must be fought until a total victory is won. It's not about what's good for the country, or the state, or the county — it's all about politics and winning.

It's just a hunch, but let me go out on a limb and say that, until this year, there weren't many county supervisors — let alone many voters — spending waking hours worrying about project labor agreements. Someone must have wanted to call attention to the issue, and in this case it was the Associated Builders and Contractors, representing mostly nonunion firms. In this effort, they have made common cause with the ideological zealots of the Republican Party who are constantly on the lookout for any opportunity to destroy the labor movement.

After these folks first raised the issue earlier in the year, officials of the Metropolitan Washington Airports Authority, which manages the Silver Line construction, went to Richmond and hammered out a compromise. A project labor agreement would not be required, but bidders who had one would get extra points in the evaluation scheme. The airport authority was led to believe this compromise was acceptable to Gov. Robert McDonnell, who took a personal interest in the issue, and Virginia Secretary of Transportation Sean Connaughton. The attorney general's office also said it complied with a new state law rushed through the legislature by the contractors lobby.

When the contractors balked, however, the governor and the secretary renounced the deal and demanded that all reference to the labor agreement be removed, setting that as a condition for Virginia's continued participation in the project, with a majority of the Loudoun supervisors joining in. To drive home the point, they rammed through the special session of the legislature yet another law outlawing any consideration whatsoever of a labor agreement in the awarding of contracts.

False assumptions

Dip into this debate and you'll quickly confront assertions that project labor agreements will add 10 to 15 percent to the cost of Silver Line construction. It's pure malarkey. All firms doing work on a project with federal money have to pay at least the same minimum wages. In Phase 1, the union firms have wound up paying 3 percent above that minimum. Non-union subcontractors also paid 3 percent above the minimum. In other words, no difference.

What's so silly about this controversy is that there are only a dozen firms that are big and experienced enough to manage a transit project of this size and complexity, and all of them are giant national and international firms that are either union shops or have long since learned to operate in both union and nonunion environments. The opportunity for local contractors is to bid on subcontracts that are explicitly not required to sign on to project labor agreements. And yet in Phase 1, 80 percent of the nonunion subs have done so voluntarily.

So what are we arguing about here? Politics. Ideology. Certainly nothing that is worth risking the most important economic development project in the region.

At $600 million for the two stations within Loudoun's borders, it's also the most important economic development project for the county. Robert Charles Lesser & Co., a consulting firm, recently updated an earlier study for the county estimating the fiscal impact of the Metro extension on the county's finances. It concluded that the project would add about $425,000 a year in net revenue, largely because of increased development and property values within walking distance of the two Loudoun stations.

That number seemed awfully low, so I dug into the fine print and found that it was based on an assumption that the arrival of Metro would have no impact on property values or housing construction beyond a half-mile radius of the two stations. The authors cite a number of mostly academic studies that have been done on the subject. But does that make sense?

Do you think that, given the commuting nightmare that is the Dulles Toll Road or I-66, people living a mile or two from one of the Loudoun Metro stations might want to arrange a ride to and from the station each day, or drive a car and park it in one of the adjacent garages? Tens of thousands of people, in fact, do it every day at the Franconia, Vienna, Shady Grove and New Carrollton stations — so many, in fact, that some of these garages fill up by 7:45 a.m. And — what do you know? – about half of those parkers live within a three-mile radius of the station. Indeed, that perhaps explains why there are plans to build parking garages at both Loudoun stations, with combined parking for 5,000 cars.

Okay, now that we have established that such people exist, ask yourself whether the availability of Metro might have some impact on their desire to live, or continue living, in Loudoun — and, if so, on their willingness to pay a bit more for property in Loudoun even after paying the parking fee and the subway fare. If your answer is yes, then it follows logically that the arrival of Metro will likely increase the value of homes in Loudoun County that are farther than a half-mile from the station.

The 'Metro premium'

Certainly that has been the experience of local officials and real estate agents. Ryan Davis, for example, the city assessor in Falls Church, estimates the "Metro premium" to be somewhere between 5 percent and 7 percent for properties within one to three miles of a station. Closer than that, the premium jumps to nearly 15 percent.

Davis's father, a real estate broker, thinks that estimate may be low. Rick Davis says he is aware of investors who bought homes a mile or two from the proposed station in Reston, expecting to capture a significant Metro premium once the station is open.

So let's do some back-of-the-envelope calculations for Loudoun: The total assessed value of residential property on the east side of Loudoun County, in neighborhoods that are within a reasonable driving distance of the proposed Metro stations, is about $32 billion. A 5 percent increase in the value of those existing properties would translate into a $1.6 billion Metro premium.

In addition, let's assume that the arrival of Metro makes Loudoun sufficiently more attractive and that it induces construction of 4,500 new homes — a 5 percent bump from the current base. At today's average prices, that translates into another $1.6 billion in residential property value.

What would that mean for the residents of Loudoun County? For current homeowners in those neighborhoods, it works out to a one-time $18,000 increase in the value of the average home, now assessed at $355,000. And for a county with a residential tax rate of $1.25 for each $100 of valuation, that works out to an extra $40 million a year in property tax revenue — enough to cover the $30 million that Loudoun would be required to shell out each year for its share of Silver Line operating and construction costs.

Are these estimates too optimistic? Maybe. But at least they raise the kind of questions that Loudoun officials and voters ought to be focused on when thinking about the Silver Line, rather than allowing themselves to get caught up in ideological tong wars over project labor agreements.

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