

Selecting 401(k) Investments

Selecting Your 401(k) Mutual Fund Lineup

Selecting a 401(k) investment lineup can be overwhelming. With over 8,000 mutual funds in existence, many business owners, HR professionals, and Finance executives feel overwhelmed with the responsibility for selecting a quality, diversified lineup for their employees to invest.

To complicate matters according to *The Wall Street Journal* article, “Mutual Funds' Five-Star Curse”, **only 14% of 5-star funds after 10 years maintained their 5-star rating and half were ranked 3 stars or lower by Morningstar** ([read more](#)).

Picking the right funds for the long-term can be extremely difficult and involves more than picking funds that have performed well recently. Money Intel recommends focusing on low-cost index funds as the cornerstone of your employees' investment portfolios and suggests using an intensive screening process that analyzes more than performance and includes:

- ✔ What are the fund's investment objectives and how closely does it adhere to them?
- ✔ How long are the tenures of the fund managers and is their investment process repeatable?
- ✔ Has the fund demonstrated value over the fund's benchmark in terms of performance?
- ✔ How does the fund perform in down markets? Does the manager juice returns by taking on excess risk, or does s/he really add value to risk adjusted returns?
- ✔ What does the fund's analytical rankings, such as alpha, beta, R-squared, and standard deviation, look like? How do they compare to peers?
- ✔ Are the fund's expenses reasonable? Does the expense ratio justify the value added by the portfolio manager and his/her team?
- ✔ Is the fund's size appropriate to accommodate the assets of the plan and its anticipated needs for liquidity?
- ✔ Has the fund's parent organization or fund family demonstrated value over time and do they meet all applicable legal requirements?
- ✔ What does the future outlook of the fund look like considering the fund manager(s), portfolio structure, and investment style?

THE WALL STREET JOURNAL.

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit <http://www.djreprints.com>.

<http://www.wsj.com/articles/how-funds-with-5-star-morningstar-ratings-10-years-ago-have-fared-1410120116>

JOURNAL REPORTS: WEALTH MANAGEMENT

Mutual Funds' Five-Star Curse

Most Top-Rated Funds Lose Their Crown. Here are Seven Lessons for Investors.



DAN PAGE

By **JAVIER ESPINOZA** And **SIMON CONSTABLE**

Sept. 7, 2014 4:01 p.m. ET

5, 4, 3, 2, 1.

Take a list of the top-rated mutual funds from years ago—those with five-star ratings from Morningstar Inc.—and look at them now. The sobering fact: You'll see many once-proud, five-star funds have dropped to four stars, three stars or worse. And there are lessons to be learned from that.

JOURNAL REPORT

- Insights from **The Experts**
(<http://blogs.wsj.com/experts/category/wealth-management/>)
- Read more at **WSJ.com/WealthReport**
(<http://online.wsj.com/public/page/journal-report-wealth.html?mg=inert-wsj>)

MORE IN INVESTING IN FUNDS & ETFS

- **U.S.-stock funds rose 3.8% in August**
(<http://online.wsj.com/articles/despite-angst-stock-funds-advanced-3-8-in-august-1410120119>)
- Leaving a Roth behind for your heirs
(<http://online.wsj.com/articles/should-i-leave-a-roth-to-my-heirs-1410120116>)
- **Fund scandal, a decade later: What has changed?** (<http://online.wsj.com/articles/mutual-fund-scandal-ripples-even-a-decade-later-1410120105>)

WSJ Radio

Javier Espinoza tells WSJ's Mathew Passy what to look for when choosing mutual funds.

00:00 |
08:40

Morningstar, at the request of The Wall Street Journal, produced such a list of the top-rated stock and bond funds and what has become of them. Analysts at the investment-research company found the vast majority of the biggest five-star funds from five and 10 years ago no longer have a top rating.

For investors, it isn't necessarily terrible if their fund drops a notch; of funds that had a five-star overall rating as of July 2004, 37% had lost one star 10 years later. But 31% lost two stars, 14% dropped three, and 3% lost four. Two of the top-rated funds from 10 years ago, Columbia Marsico International Opportunities Fund and Fairholme Fund, went from having five stars for July 2004 to having just one star and two, respectively, for July 2014. Only 58, or 14%, of the 403 funds that had five stars in July 2004 carried the same rating through July 2014, Morningstar says.

One encouraging finding: While the 10 largest five-star funds (see chart) may not all have kept their five stars after 10 years—only one did as of July—all outperformed their peers.

Still, a separate study suggests it is even more difficult for a leading fund to stay at the top: S&P Dow Jones Indices analyzed 715 top-performing mutual funds, focusing on U.S.-stock funds for the past four years through March, and found that only two stayed in the top 25% through a four-year period.

A lot of advisers, of course, think everyone should put their money in low-cost index funds because managers can't beat the market over the long term. For those who are looking for more-active managers, though, the Morningstar data offer lots of lessons.

We asked experts and fund managers to look at the data, and tell us what lessons investors can glean.

Yesteryear's Stars Go Down a Notch (or More)

The 10 biggest five-star mutual funds from 2004, and their ratings now

FUND	STAR RATING IN 2004	RATING NOW
American Funds' Growth Fund of America	★★★★★	★★★
Pimco Total Return (institutional class)	★★★★★	★★★★
American Funds' Income Fund of America	★★★★★	★★★
Fidelity Contrafund	★★★★★	★★★★
American Funds' American Balanced	★★★★★	★★★★
Dodge & Cox Stock	★★★★★	★★★★
Fidelity Low-Priced Stock	★★★★★	★★★★
Vanguard Wellington Fund Investor	★★★★★	★★★★★
American Funds' Capital World Growth & Income	★★★★★	★★★
Vanguard GNMA Fund Investor	★★★★★	★★★★★

Source: Morningstar

The Wall Street Journal

1. Don't buy in to the all-powerful manager.

Sometimes investors are drawn by funds that have a strong presence at the helm. The allure is irresistible: to invest in a fund in which one person calls the shots, especially if the fund is doing particularly well.

David Snowball, publisher of the Mutual Fund Observer website, highlights the Marsico and Fairholme funds

as examples of funds that were top performers under charismatic managers— Tom Marsico and Bruce Berkowitz, respectively—and have faltered. “[Marsico] was a family very much focused on Tom Marsico and his bold take on investing,” Mr. Snowball says. The same is true of Fairholme, he says, “which has been struggling in a number of ways lately.”

Mr. Berkowitz couldn't be reached for comment. A spokesperson at Marsico said: “The investment team is 100% focused on finding unique investment ideas and generating above average investment performance for our clients. One example of our team's progress towards that goal is the Columbia Marsico Global Fund's top 3% ranking in its category over five years.”

2. High volatility, high returns?

Think again. Many of the top-rated mutual funds in the Morningstar data that have been producing consistent returns actually have low volatility and reduced exposure to risk.

Six of the 10 largest funds with five stars 10 years ago had a 10-year standard deviation less than their category average through July 2014, and three had deviations that were close to their category average, according to the data produced by Morningstar.

As many as 19% of the 58 funds that retained a five-star rating over a 10-year period, including through the financial crisis, were in the conservative- and moderate-risk-allocation categories. One such fund is Vanguard Wellesley Income, a conservative-allocation fund that also grew throughout that time to more than \$38 billion in assets



Fairholme Fund, once a top five-star performer under a charismatic manager, Bruce Berkowitz, now is down to a two-star rating. *MELISSA GOLDEN FOR THE WALL STREET JOURNAL*

from nearly \$10 billion.

"Every conservative-allocation fund [in the Morningstar data] remains a good investment today," says Mr. Snowball. Sometimes being boring pays.

3. Watch for growing pains.

Some mutual funds aren't good at adapting their strategy to their growth, says Russel Kinnel, director of fund research at Morningstar.

As investors move their cash to successful funds, the managers have to figure out how to

HOW ALL THE FUNDS RANK, THEN AND 10 YEARS LATER

View a table of five-star mutual funds from 10 years ago, sorted by size, and their July 2014 ratings.

Name	Ticker	Morningstar Category	Fund Size Then	Rating Then	Current Fund Size	July 2014 Morningstar Rating
American Funds Growth Fund of Amer A	AGTHX	US OE Large Growth	78,768,740,353	5	143,050,293,211	3
PIMCO Total Return Inst	PTTRX	US OE Intermediate-Term Bond	74,042,676,501	5	223,132,047,847	4
American Funds Inc Fund of Amer A	AMECX	US OE Moderate Allocation	44,903,045,659	5	95,102,803,723	4
Fidelity® Contrafund®	FCNTX	US OE Large Growth	37,528,914,363	5	106,346,292,886	4
American Funds American Balance A	ABALX	US OE Moderate Allocation	37,519,939,719	5	75,628,434,235	4
Dodge & Cox Stock	DODGX	US OE Large Value	35,550,912,870	5	57,247,204,440	4
Fidelity® Low-Priced Stock	FLPSX	US OE Mid-Cap Value	30,380,326,757	5	48,808,708,199	3
Vanguard Wellington™ Inv	VWELX	US OE Moderate Allocation	30,066,420,684	5	85,665,586,090	5
American Funds Capital World QI A	CWGIX	US OE World Stock	24,379,214,874	5	89,425,389,796	3
Vanguard GAMA Inv	VFIX	US OE Intermediate Government	23,398,553,300	5	26,148,915,624	4
Vanguard Health Care Inv	VHCIX	US OE Health	21,011,766,343	5	39,006,438,058	4
Franklin Income A	FKINX	US OE Conservative Allocation	20,270,920,794	5	96,105,104,786	5
Templeton Growth A	TEPLX	US OE World Stock	17,824,735,479	5	18,785,650,476	2
Fidelity® Diversified International	FDIVX	US OE Foreign Large Blend	17,369,365,793	5	26,154,554,450	4
Dodge & Cox Balanced	DODBX	US OE Moderate Allocation	17,269,043,201	5	15,051,205,948	4
Templeton Growth Inc A	EAA DE Global Large-Cap Value Equity	15,661,138,833	5	18,785,650,476	3	
American Funds AMCAP A	AMCPX	US OE Large Growth	15,583,708,437	5	41,484,266,391	3
PIMCO Low Duration Inst	PTLDX	US OE Short-Term Bond	14,287,423,151	5	22,384,467,510	4
Columbia Acorn Z	ACRNX	US OE Mid-Cap Growth	11,680,311,043	5	18,911,460,602	3
PIMCO Real Return A	PRTNX	US OE Inflation-Protected Bond	11,377,453,714	5	15,392,992,580	3
Hartford Capital Appreciation HLS IA	HCACX	US OE Large Blend	11,289,425,475	5	7,348,920,247	3
T. Rowe Price Mid-Cap Growth	RPMDX	US OE Mid-Cap Growth	11,025,915,325	5	24,091,289,277	5
Vanguard Wellesley® Income Inv	VWINX	US OE Conservative Allocation	9,992,147,722	5	38,420,787,448	5

invest the money. Some can feel they need to invest it quickly, which could cause the manager to make the wrong investment.

Mr. Kinnel highlights Thornburg International Value, a fund that has gone from managing assets of \$2.1 billion at the end of 2004 to more than \$18 billion at the end of 2007—and has seen its five-star rating drop to a two.

“They’ve had tremendous success, but they’ve gotten too big and that has impacted the performance,” says Mr. Kinnel.

Bill Fries, the fund’s co-manager, says getting bigger hasn’t caused the trouble.

“I would concede, it is easier to manage a small portfolio than a large portfolio,” he says. “Our performance over the past year and a half has been more about not being in the right place at the best time,” he says, meaning not making the right bet on European stocks when the region began to recover.

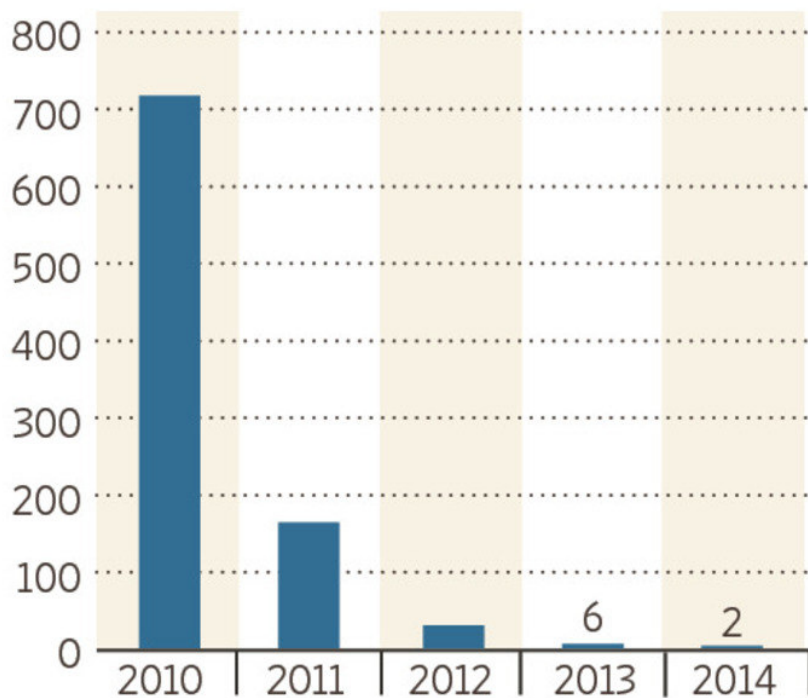
He says he believes the fund has turned a corner.

4. Keep it simple.

“We live in a financial world that idolizes complexity,” says Manisha Thakor, who runs MoneyZen Wealth

Hard to Stay on Top

Number of funds remaining in the top quartile each year



Source: S&P Dow Jones Indices The Wall Street Journal

Management in Santa Fe, N.M. But don't be impressed by fancy jargon. She says some top-performing funds "are so clearly articulated, your 12-year-old child can understand the root logic."

She highlights Dimensional Fund Advisors' U.S. Core Equity 1 Portfolio, which has more than tripled in size and gone from a three-star Morningstar rating to a five.

"This fund's simple, powerful strategy is to own a broad range of U.S. companies with a tilt toward two dimensions—small and value companies—that have historically provided higher expected returns," she says.

"Turnover is low, at 2%, making the fund index-like," Ms. Thakor says, in the way it buys and holds shares for the long run.

5. Old-fashioned is still OK.

Will Danoff, famous for his piles of financial reports and jotted notes, has been the manager of giant Fidelity Contrafund for the past 24 years. The fund, with more than \$106 billion in assets, has retained a consistently solid star rating over the decade, dropping a notch from a five to a four.

When it comes to taking a new position in a firm, "we discuss with the companies the fundamentals [of their business]," says Mr. Danoff. "The more companies you listen to, the more opportunities you see. Woody Allen says 80% of life is showing up. I am the Woody Allen of Fidelity."

6. Get the right 'balance.'

Funds with a balanced portfolio between bonds and stocks tend to retain steady ratings over time and can serve as "one-stop" shops for investors.

Of the 10 largest funds that kept their five stars for 10 years, three were balanced funds, according to an analysis by Mutual Fund Observer. And one of these success stories is Vanguard Wellington, which kept a ratio of roughly 60/40 between stocks and bonds as assets under management grew.

The other two balanced funds to make this group were American Funds Income Fund of America and American Funds American Balanced.

Todd Rosenbluth, director of ETF and mutual-fund research at McGraw Hill Financial Inc.'s S&P Capital IQ in New York, says there is a growing interest in balanced asset-allocation funds, such as Vanguard's fund, but warns that these funds have "a somewhat

different risk profile" because of their varying degrees of exposure to bonds or stocks.

"More stocks tends to be higher-risk than less stocks. But also look inside at the type of stocks and bonds," says Mr. Rosenbluth.

Moderation seems to have paid off.

7. Look forward.

When a fund drops a notch, it doesn't necessarily mean it hasn't performed well. There are other factors to consider.

Morningstar points out that a fund's star rating can change because of new categories, new funds being added to the category, funds changing categories and such. Overall ratings are a weighted average of the three-, five- and 10-year ratings.

Scott Clemons, chief investment strategist of private banking at Brown Brothers Harriman in New York, emphasizes that ratings are backward-looking and say little about what will happen next.

The same can be said of recent returns. In the S&P Dow Jones study, an investor browsing at random through the 700-plus top-performing funds would have had less than a 1% chance of picking one of the two funds that was still in the top quartile four years later. (For the curious, the two were AMG SouthernSun Small Cap and Hodges Small Cap.) The study included no index-tracking funds, exchange-traded funds, or specialized sector funds. S&P Dow Jones Indices is a unit of McGraw Hill Financial Inc.

Nevertheless, there are a few helpful questions investors can ask when looking at past performance, says Mr. Clemons. Among these: Is the same management team in place? How was the track record built? And if a fund had a great year, was it the result of "a lucky bet" or "a sign of some underlying strength?"

Mr. Espinoza is a London-based reporter for The Wall Street Journal. Email javier.espinoza@wsj.com. Twitter: @WSJEjespinoza. Mr. Constable is the host of the News Hub show at WSJ Live online. Email simon.constable@wsj.com.

