What a Mutual Fund Is Really Worth to You

A new way to look at fund expenses shows that you could be paying almost 10 times more than you think

Whether you're shopping for a car or a mutual fund, the two questions you must answer are "What will it cost me?" and "What's it worth to me?" You need information about price *and* value to see if you're getting a good deal. You can get a decent idea of what a mutual fund will cost you by checking its expense ratio, which shows what percentage of your total investment will be eaten up each year in overhead. But how can you figure out what a fund is worth to you?

That's a tricky question. A fund's value depends largely on whether its manager can beat a benchmark like Standard & Poor's 500-stock index without taking too much risk. That's because you can automatically earn the benchmark return by investing in an index fund that mimics the benchmark. If you do, you'll pay as little as $1 out of every $1,000 you invest—less than a tenth of what more "active" funds charge. So it's no wonder that Vanguard 500 Index has become the world's largest mutual fund.

Champ or Chimp?

Ross Miller, a risk consultant and former finance professor at Boston University, has devised a clever way to help you figure out what a fund manager is worth. Miller kills two birds with one stone: First he confronts the fact that luck looms large in stock picking. Then he zeroes in on funds that barely bother trying to beat the market. There's not much value in either a lucky or a half-hearted fund.

You might be impressed hearing a fund manager brag on CNBC about how he's beaten the market three years running—but you shouldn't be. It's just a matter of basic probability. On average, if eight blindfolded chimpanzees threw darts at the stock pages of the *Wall Street Journal* for three years, one of them would end up beating the market. Humans and chimps share roughly 98% of the same genes, but that doesn't make it a good idea to give your money to a stock picker who munches on bananas and termites. Our chimp isn't a great investor—he's just lucky. Most human stock pickers on a hot streak are just lucky too. You wouldn't want to buy their funds right before their luck runs out. So Miller adjusts returns for the risk the managers took to earn them, a time-tested way to correct for dumb luck.

Meanwhile, many managers are so afraid of lagging the market that they end up copying it, owning similar proportions of the stocks that carry the most weight in the index. The five top holdings in the S&P 500 are ExxonMobil, General Electric, Microsoft, Citigroup and Pfizer—and sure enough, most funds specializing in big U.S. stocks have them

Bargains Galore!

After adjusting for their managers' investment styles, these funds still have low expense ratios.

FUND NAME (TICKER)	3-YEAR RETURN[1]	EXPENSES[1]	"ACTIVE" EXPENSES[1]
Parnassus Equity Income (PRBLX)	6.8%	0.95%	2.54%
Fidelity Equity-Income II (FEQTX)	7.2	0.64	2.89
Fidelity Growth & Income (FGRIX)	2.3	0.69	2.91
TIAA-CREF Growth & Income (TIGIX)	1.6	0.43	2.92

They Want How Much?

These funds closely mimic the market. You'd be better off in an index fund.

FUND NAME (TICKER)	3-YEAR RETURN[1]	EXPENSES[1]	"ACTIVE" EXPENSES[1]
Strong Growth & Income (SGRIX)[2]	1.9%	1.40%	9.94%
Dreyfus Growth & Income (DGRIX)	0.5	1.05	9.71
Russell Tax-Managed Large Cap S (RETSX)	2.6	0.94	8.50
Fidelity Stock Selector (FDSSX)	3.3	0.82	7.19

NOTES: [1]As of Dec. 31, 2004. Returns are annualized. Expenses are as a percentage of assets and are as reported by funds; "active" expenses are adjusted for portion of assets that mirror the fund's benchmark index. [2]Now Wells Fargo Advantage Growth & Income Inv. Wells Fargo acquired Strong Financial's mutual fund assets at the end of 2004. **SOURCES:** Ross Miller, Miller Risk Advisors; Morningstar.

as top holdings too. Managers call this copycat behavior "closet indexing."

How does Miller deal with that? Using some complex math, he estimates how much of the fund is imitating the market instead of trying to beat it. This, he says, "unbundles" your money into a passive portion that might as well be in a cheap index fund and a second (usually much smaller) part with which the manager is more aggressively trying to beat the market. Then Miller applies the fund's official expenses only to the active part.

This makes sense. Why should you have to pay a full management fee on the portion of your money that is not being actively managed? By Miller's adjusted measure, or the "active expense ratio," Fidelity Magellan's annual costs are not 0.7% but 5.87%—and the annual expenses on big U.S. stock funds average around 7%. with another sheeplike fund that charges you as if the manager were a lone wolf doing something original.

The Bottom Line

Unsurprisingly, people in the fund business think Miller is off the wall. Brian Reid, chief economist at the Investment Company Institute, the fund industry's trade association, says Miller takes a "really unrealistic view of what fund managers can accomplish" by giving them no credit for controlling risk. After all, a fund that loses less money than average in a bear market delivers value in spades—even if its holdings may seem similar to the market's. Miller's method shortchanges funds for that.

In a statement, Fidelity says that Magellan's manager, Bob Stansky, is "aggressively looking for investment

When Miller accounts for how much a fund mirrors the market index, he concludes that **Fidelity Magellan charges more than 5% in annual expenses**—and the typical U.S. stock fund costs roughly 7%.

(All numbers used here and in the table on page 90 are as of Dec. 31, 2004.) In short, if you buy Miller's argument, many funds cost from five to nearly 10 times more than you thought. A 3% or 4% active expense ratio, coupled with solid risk-adjusted returns, is "pretty good," he says.

Magellan's sister fund, Fidelity Growth & Income, has an active expense ratio of just 2.91%. Miller's approach tends to highlight funds with fairly narrow styles, like "equity income" portfolios (which favor stocks with high dividends). So-called focused or concentrated funds, which own a relative handful of stocks, also tend to score well. Funds in these styles, being less broadly diversified, are less likely to mirror the market.

But what's so bad about that? If you're going to invest outside an index fund, you should look for something the index doesn't offer—like higher income, lower risk or a shot at outsize returns. Using Miller's score, you're less likely to end up opportunities that will allow the fund to beat the index" and that "there are many ways in which the fund's investments regularly differ from the S&P 500."

As I see it, Miller's measure isn't ready to replace the cost standard we all use; the underlying math is too unwieldy. But I do think it should prompt you to ask if your managers are earning their fees. You can view a list of how the 100 biggest funds rate on Miller's measure at money.com/funds. Also on our website, look up the "R-squared," a sign of how closely a fund tracks its benchmark. If that number is 0.95 or higher, the fund probably tries harder to ape the market than to beat it. Look for one that's more active—with an R-squared below 0.9—or buy a low-cost index fund instead. If you can't beat the market, why not just own it? **$**

E-mail Jason Zweig, editor of Benjamin Graham's The Intelligent Investor, *at* **investor@money.com**.