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Small Traders Lose Big In Currency Casino

Page 17

SPECIAL ISSUE
MUTUAL-FUND QUARTERLY

THE AMERICAN WAY

After years of heavy outflows, American Funds goes its own way, betting on big growth stocks and shunning emerging markets. Will it work?

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Barron's/Lipper Quarterly

Mutual Funds: New Frontiers

Market Week

Cover Illustration
John MacDonald for *Barron's*

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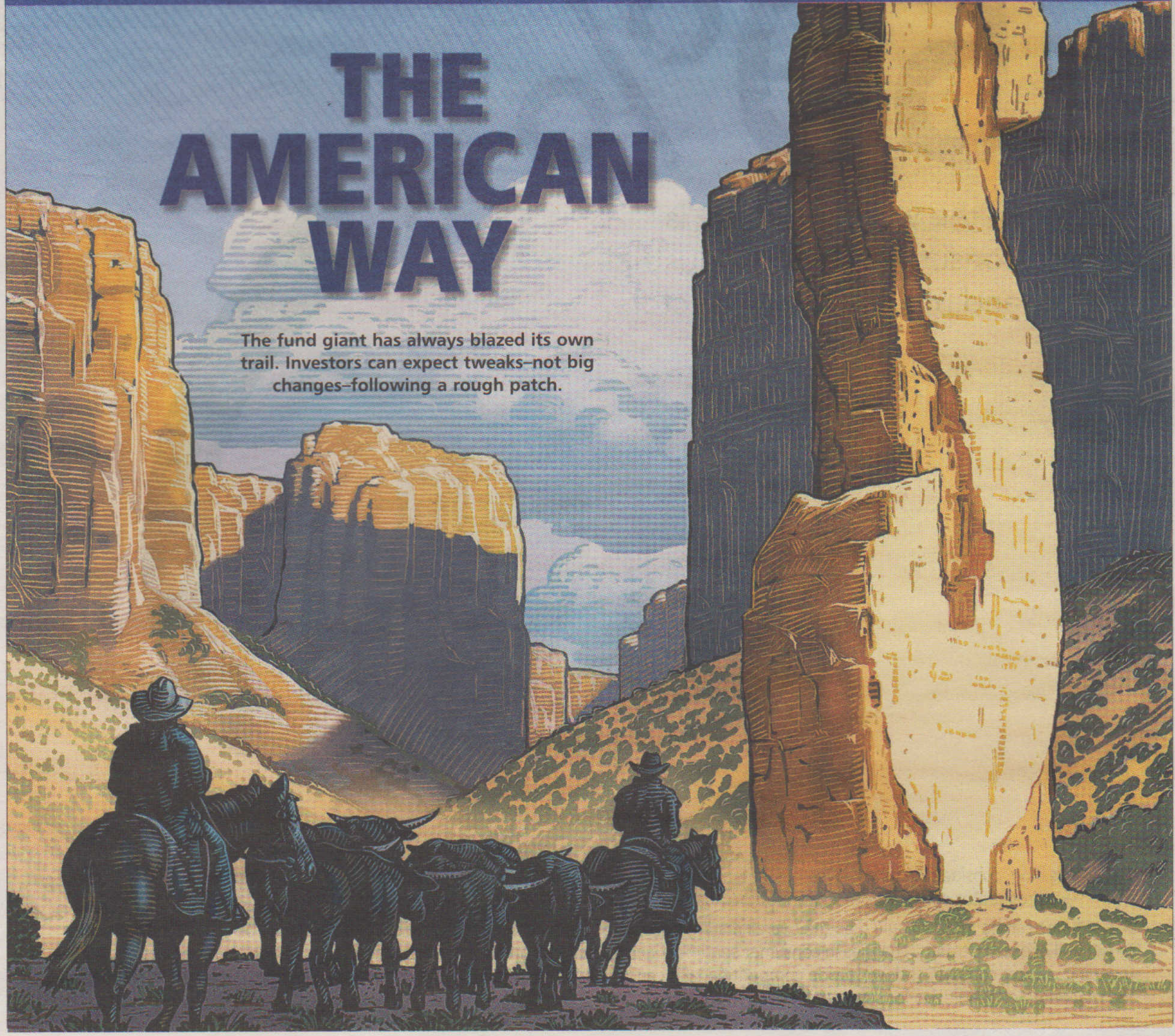
Jan. 1 through March 31, 2011
Plus Weekly Data



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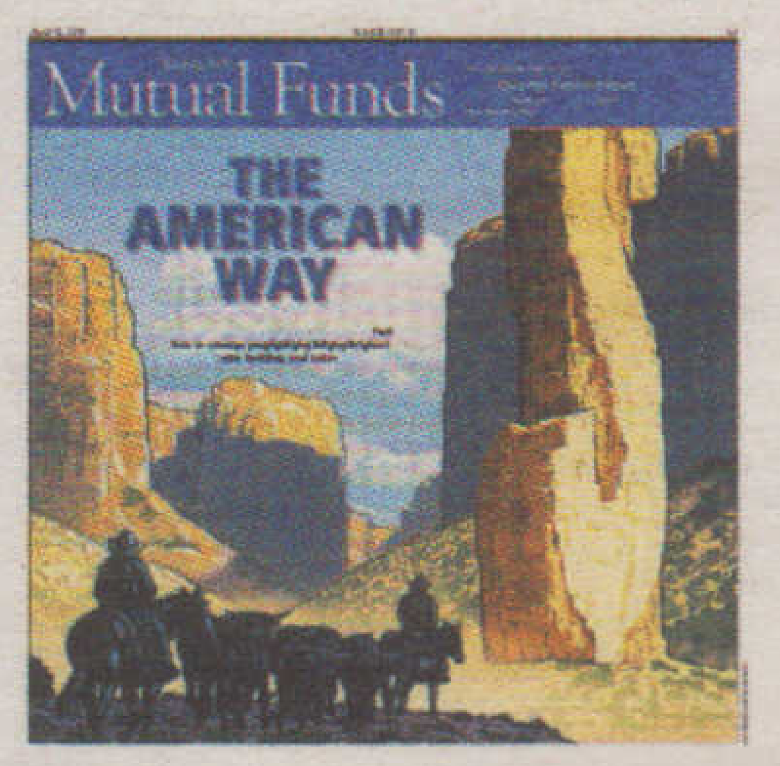
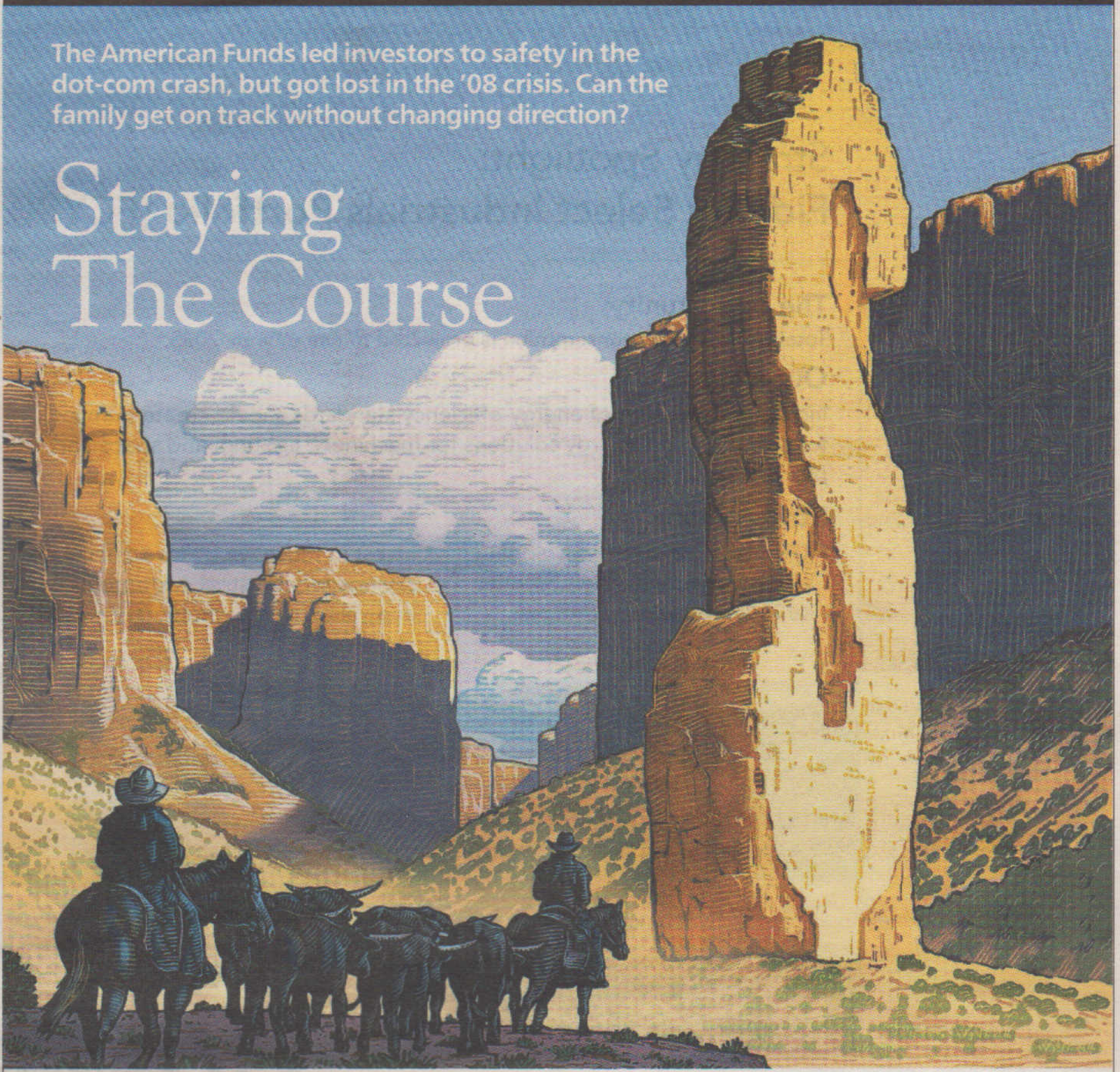




The American Funds led investors to safety in the dot-com crash, but got lost in the '08 crisis. Can the family get on track without changing direction?

Staying The Course

John MacDonald for *Barron's*

by Michael Shari

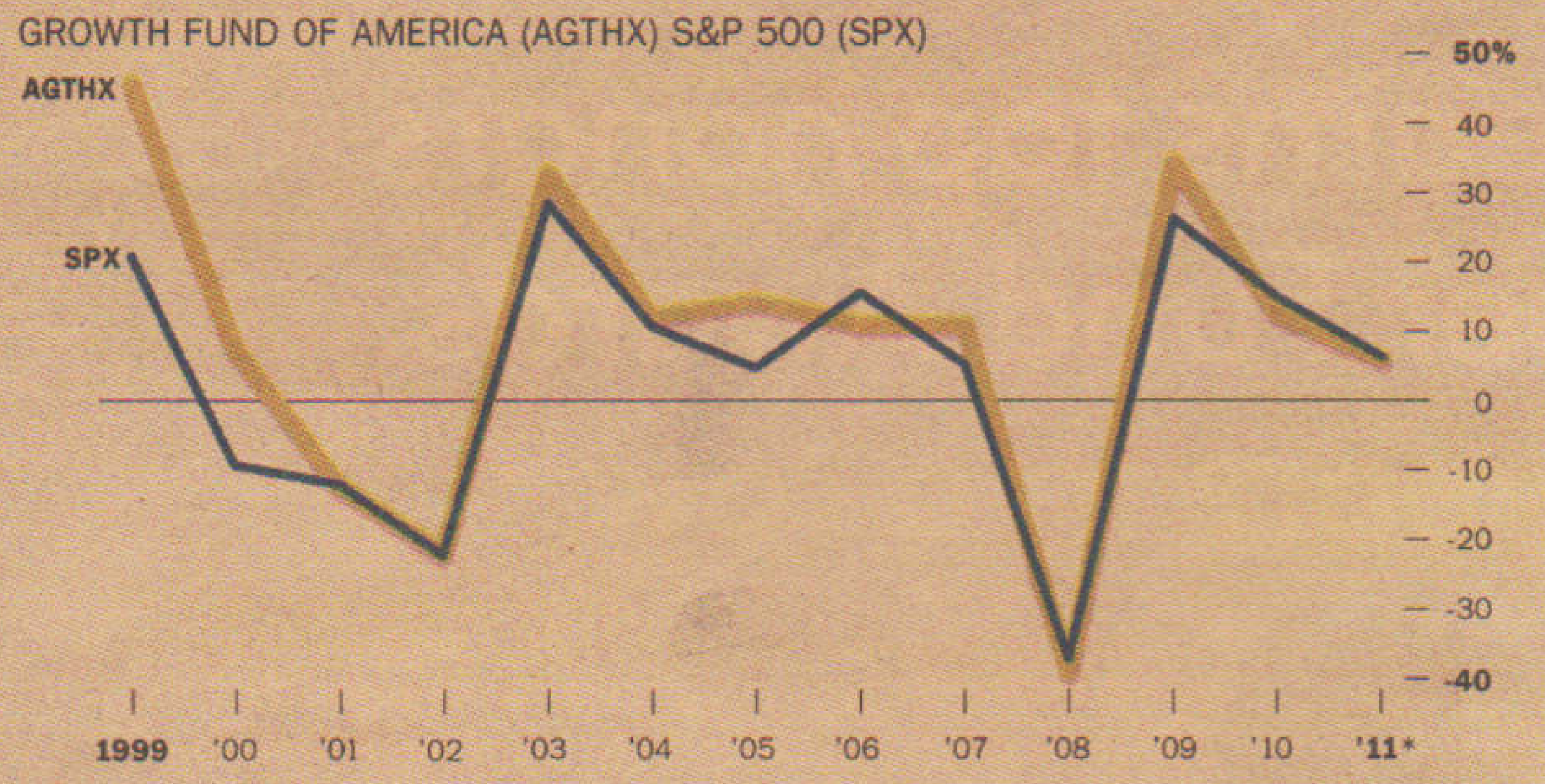
"OUR FLOWS WERE MASSIVE. WE KNEW THAT WOULD NOT LAST, and we were correct," says Jim Rothenberg, the gruff 64-year-old chairman of the executive committee at Capital Research and Management. He's talking about the flood of money that started rolling into the firm's American Funds family about a decade ago. These days, the hope is that outflows of cash don't last as long as the inflows did.

In 2000, American Funds' carefully-selected portfolios of mostly large-capitalization, long-term-growth stocks were the perfect destination for desperate investors fleeing flimsy dot-coms and shoddy Wall Street analysis. The Nasdaq fell 39% that year, while the firm's flagship **Growth Fund of America** (ticker: AGTHX) rose 7.5%. The suddenly popular 70-year-old firm enjoyed an astounding net inflow of $372 billion from 2002 through 2007. Over a couple of prolonged periods, American accounted for all of the new inflows into the entire U.S. mutual-fund business.

More recently, however, investors have discovered that American isn't the answer in every U.S. financial calamity. The Growth Fund of America dropped 39% during the financial crisis of 2008, even worse than the Standard & Poor's 500's 37% decline. Overall mutual-fund assets at the Los Angeles-based firm crested at $1.17 trillion at the end of 2007—before plummeting to $744 billion a year later. Although asset levels, aided by resurgent markets, have come back to about $1 trillion, the outflows continue: Investors pulled out $141.64 billion between

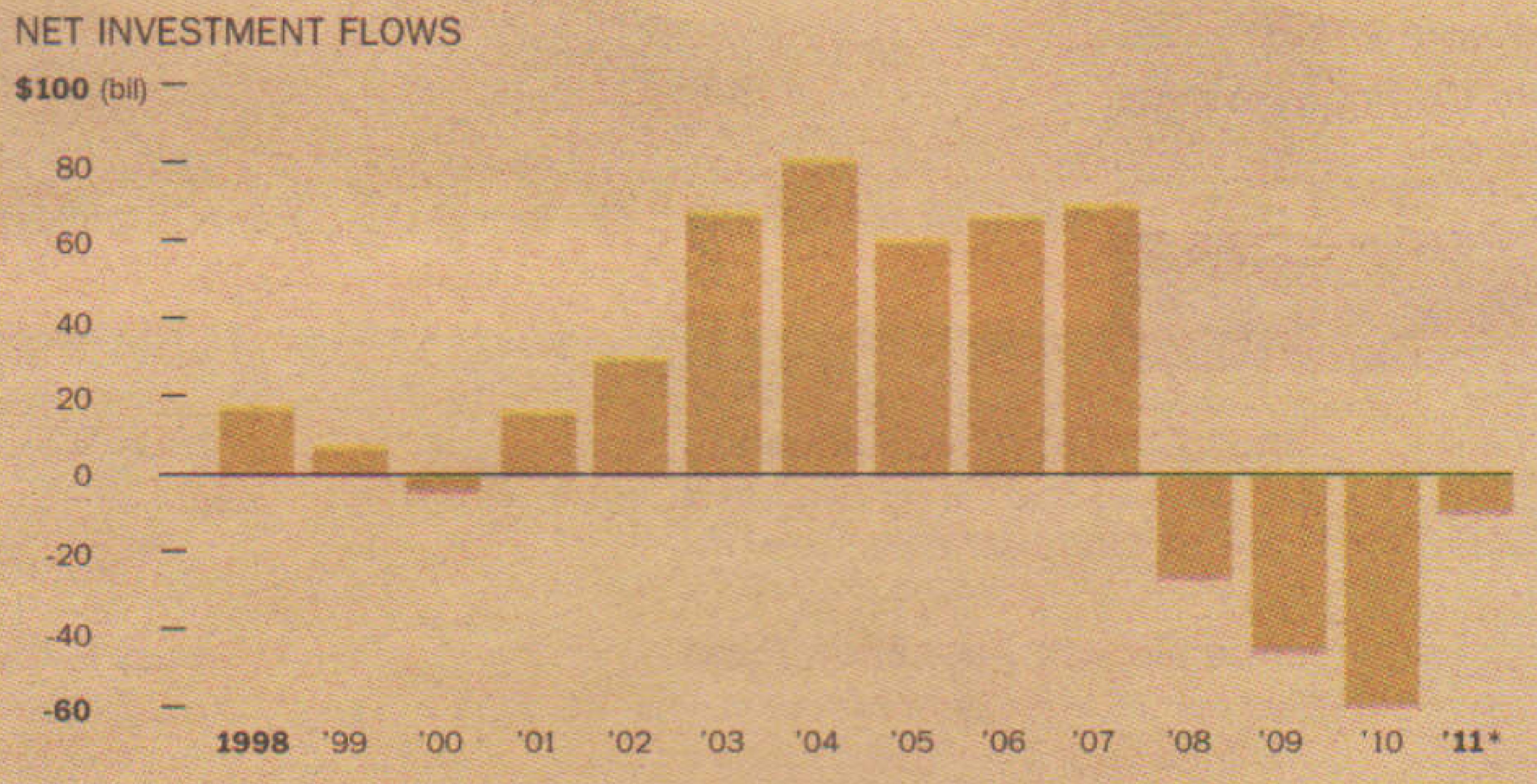
Flagging Performance Pushes Some Investors to the Exits

American Funds' flagship Growth Fund of America easily beat the Standard & Poor's 500 in the late 1990s through the early 2000s, and again in the middle of the decade. But it didn't hold up well in the financial crisis, and has been underwhelming in the last year or so.



*Through April 3. Note: All figures above are percentages, and they all reflect daily returns reinvested. Note that some of them are negative (particularly in 2000, 2001, 2002 and 2008).

More generally, the falloff in performance at a number of American funds, as well as the popularity of absolute-return funds and passive vehicles has resulted in net outflows since early 2008.



*Through Feb. 28. Note: Figures above cover every fund and every share class in the American Funds mutual fund family. All periods above are calendar years. All figures in billions of U.S. dollars. Note that some years are negative (including 2000 and every year from 2008 onward)

Source: Lipper

Jan. 1, 2008 and the end of February of this year—about $55 billion of it in 2010.

While the outflows aren't life-threatening, they do reflect mediocre performance, which has been a jolt to a privately held firm that champions its active-management principles above all else. Its founder, financier Jonathan Bell Lovelace, bought a fund company in 1932 that was invested in just three stocks, **General Electric** (GE), Westinghouse, and S.S. Kresge (now dissolved into K-Mart). Not long afterward, Lovelace advised Walt Disney to take his cartoon company public, which he did early in the Great Depression.

Ever since, American Funds and its parent, Capital, have promoted investment research that seeks long-term values; it let analysts oversee client portfolios decades before the practice became popular at other money managers, and has compensated them according to their long-term picks. It's a serious business at American, where everyone starts as an associate, and successful analysts tend to embrace the team culture and stay for decades. One researcher recalls getting reprimanded by a more senior colleague for referring to a long-term stock recommendation as a "play on natural gas" in a meeting.

From its West Coast roots, American has always gone its own way, and Rothenberg insists the firm has no intention of changing its old-school approach. American, which sells exclusively through financial advisors, runs just 44 funds, versus Vanguard's 170. It has eschewed asset-allocation and long-short funds as well as exchange-traded and index vehicles. American doesn't offer an emerging-markets fund, even though it's one of the leaders in international institutional management and it never closes funds, leading to the creation of several huge, cumbersome entities that are unpopular with some advisors. Growth Fund of America now weighs in at $164 billion, and the **EuroPacific Fund** (AEPGX) at $109 billion.

In a rare interview at his small office in the Bank of America tower overlooking downtown Los Angeles, Rothenberg tells *Barron's* that the 40,000 individual investors in American Funds would never understand "the modern stuff" and "the fancy things" that other fund families are marketing, and would never be able to tolerate the volatility of emerging markets. He professes not to care that much about fund flows, and is much more focused on American's long-term performance. He doesn't follow money-management fads.

"Remember what will happen to you when you own that index fund in the next crisis. It will go down a friggin' lot," says Rothenberg, a Harvard Business School grad who joined the firm in 1970 and has been its senior executive for seven years. "The hope is that all these asset-allocation programs and the like will get you protected at the right time. I would say a worse swear word to its probability of happening."

A plainspoken former analyst who tracked Xerox and Kodak, Rothenberg sees signs that large-cap stocks, the firm's forte, are coming back. American favors some multinationals that have reasonable price/earnings ratios and solid dividend yields. Most are more global than the U.S. economy because they make and sell their goods and services around the world. Since the crash of 2008, these companies have cut costs, dramatically improved earnings, and now are using the cash flow to buy back stock or pay dividends. As a result, "after a lot of years in which they were not all that exciting," some of American's biggest funds, like the $52-billion **Washington Mutual Investors** Fund (AWSHX), have begun to outperform again.

"Do you want to own a bond with less than a 3% coupon for 10 years, or do you want to own a good-quality company with a 3.5% yield and a growing dividend? To me, it's something of a no-brainer," says Rothenberg.

If you are a contrarian seeking an out-of-favor management style (active and geared to top a benchmark) focusing on an out-of-favor sector (large-caps), an American Funds' offering like Washington Mutual could be a savvy bet. If you're not, move on.

The firm remains *Barron's* top-ranked mutual-fund family over 10 years of performance across several different types of funds, according to figures compiled by Lipper ("The Best Mutual Fund Families," *Barron's*, Feb. 7). But it falls to 24th place over the shorter five-year interval, and then to 49th for 2010. *Barron's* rankings are based on a sampling of funds but a broader ranking shows the same trend. In another Lipper family ranking, it drops from the 37th percentile over 10 years to the 57th percentile for the last 12 months. Investors withdrew a net of $9.7 billion in January and February from American funds, maintaining the pace of last year. Overall, American has fallen to the No. 3 slot in mutual-fund assets, behind Vanguard and Fidelity, from No. 2 in 2007, according to Lipper.

"We disappointed people in the downturn in 2008-09, after we had done so very well in 2000-02," says Rothenberg. "We had all the raw ingredients, but somehow the chef messed up the soup."

Although reticent about discussing specific holdings, Rothenberg acknowledges that the firm underestimated the U.S. economic rebound. The funds prematurely lightened holdings of metal, mining and energy stocks in 2009. The portfolio managers were "thinking the economic recovery was going to be slow, and all that was going to be slow coming back. It didn't work out that way," says Rothenberg. Recent regulatory filings show that Growth Fund of America, of which Rothenberg is a portfolio counselor, sold its stake in **ExxonMobil** last year, missing the stock's subsequent advance.

In the midst of the crisis, Growth Fund had 6.2% of its holdings in financial-services outfits like **Fannie Mae**, **Freddie Mac** and **Wells Fargo** (WFC) at the end of May 2008. Chuck Freadhoff, a vice president of American Funds Distributors, says American's fixed-income analysts had identified subprime-mortgage problems in advance of the crisis but their views didn't carry over to the equity side.

On the fixed-income side, performance problems cropped up in the management of corporate credit, particularly in the **Bond Fund of America** (ABNDX), which lost 12.2% in 2008. "I don't think our credit research did a great job," admits Rothenberg. Although it can invest in a wide range of fixed income, it was heavily loaded with corporate bonds. "Therefore, it has tended to do well when equity markets are doing well, and it has done poorly when equity markets did poorly," says Robert Lovelace, a grandson of the founder of Capital and a member of a committee that oversees the fund.

Senior management had seen this problem as early as 2003, but didn't start reducing the fund's holdings in corporate and other high-yield bonds and increasing its government bonds until 2006. But the process was slow, says Lovelace. "When 2007-08 hit, we regretted that it had not been done faster," he recalls. The fund returned 14.90% in 2009, but "that snapback was not as dramatic as it has been historically," he says. Bond Fund of America returned a middling 7.3% in 2010, and investors pulled out a net $5.84 billion, according to Lipper estimates. In contrast, rivals like Pimco and BlackRock were raking in money last year. Without elaborating, Lovelace says the firm has "made some critical manager changes" since.

Some insiders believe the firm has been hurt by the great expectations created early last decade. Kevin Clifford, president of American Funds Distributors, blames financial advisors who had oversold the funds as "able to defy gravity" based on their strong performance after the crash eight years earlier, which he dismisses as "foolish."

But Don Phillips, president of fund-researcher Morningstar, counters: "American bears some responsibility for this." The firm, he says, "aggressively hired wholesalers in the early part of the past decade, and I believe they brought in a shareholder base that didn't grasp the American Funds' philosophy as well as their long-term base did. The result has been the stream of recent redemptions."

The problems are worrisome since they comprise the second round of what Lovelace calls "two crises." The first was in the group's institutional unit. Rothenberg says the firm made the "mistake" of modifying its traditional investment strategies into "customized mandates" to fit the needs of specific pension funds, endowments and other institutions. In other words, a global strategy might be executed with European stocks excluded, to meet the wishes of the investor. As of Dec. 31, the institutional business had fallen to just $150 billion from $321 billion at its peak in 2006. "We did more of what they wanted, not what we do well," says Rothenberg, who seems determined not to make that mistake again.

Aside from personnel changes, American Funds has taken steps to try to improve its overall performance. In 2008, Capital Research and Management split its research operation into two identical units, Capital World Investors and Capital Research Global Investors, in an attempt to make it easier for analysts to communicate in smaller meetings. It also helps avoid triggering takeover and poison-pill rules when a single legal entity buys too much of a company's stock, says Kevin McDevitt, an analyst at Morningstar.

The same year, in an attempt to take what Rothenberg calls "a holistic approach" to analyzing the stock and bond markets, the analysts started a new weekly conference call entitled "Connect the Dots."

American Funds also has plugged some holes in its product line with the launch of three new funds since November–the **Mortgage Fund** (MFAAX), the **Tax Exempt Fund of New York** (NYAAX), and the **Global Balanced** Fund (GBLAX). But the timing of the introductions has puzzled a few observers given some of the problems in these markets. "We would rather launch something when it does not seem like it has a lot of pizzazz, and build a track record over time," says the undeterred Rothenberg.

Despite these switches, some financial advisors complain that the firm hasn't done anything about the size of its funds. It simply refuses to close mutual funds to new investors. The resulting bulk makes it hard for the bigger American funds to buy or sell securities without affecting their market value, and can make them look more like index funds, just with higher fees. The jumbo funds also run out of stocks to buy that match their respective investing styles—a bone of contention with advisors. The advisors tend to assign funds to style boxes even though American Funds believes that investment approach is "nonsense," says Rothenberg.

A case in point is Growth Fund of America, which recently changed its prospectus to allow 25% of its assets to be invested abroad. Rothenberg explains that part of that percentage is Canada, which the fund previously had treated as part of the U.S.

Others don't see it that way. "I don't like the fact that there is style creep in there," says Steve Blankenship, a principal at Heritage Financial Planning in Grapevine, Texas, who manages about $85 million in high-net worth assets, 5% of which is invested in American Funds. "I want to stick to the fundamentals. If the problem is that you are too big, then close the fund."

Tim Armour, president of Capital Research Management, and Rothenberg's deputy, contends that the company has conducted its own studies that have found no link between fund size and performance.

The debate is basic, because it involves a basic American principle from its "multiple-portfolio-counselor system." The system was introduced in 1958 as part of the succession from founder Jonathan Bell Lovelace, known as JBL, to his son Jon Lovelace, known as JL. JBL offered to bequeath the portfolio he had managed to JL. But his son refused on grounds that it "would be nepotism," recalls JL's own son, Robert Lovelace. Instead, the assets were divided among three portfolio managers to see who could get the best results using the same strategy. Over the years, as investors deposited new money, the mutual funds would add new managers, later renamed counselors. Each counselor ran a new pool of money–rather than close to new investors.

The counselor system also is at the heart of a compensation structure that rewards investment returns, not assets under management. Money-management professionals are paid based on their performance over a composite of rolling eight-year, four-year and one-year periods. This forces them to take a long-term view, and penalizes them harshly for poor performance. "If you have a bad year, you carry it," says Rothenberg, explaining that his staff is still lugging around the damage of 2008 in their bonus packages.

Robert Lovelace argues that American's counselor system protects fund holders' interests more than the standard practice at many fund-management firms. Others will close a big fund, then launch a new one with the same strategy at a higher fee. This system allows American Funds to maintain economies of scale large enough to keep fees low, which ultimately adds to investment returns.

American charges the lowest fees of any active manager, says Ed McIlveen, director of performance analytics and research at Francis Investment Counsel. Francis Investment is a financial-advisory firm in Pewaukee, Wisc., that has invested about $130 million of its clients' money in American Funds. Financial advisors sell them in the R6 share class as retirement funds and the F2 share class as retail funds. The expense ratio for the R6 share class of the **Income Fund of America** (AMECX), for example, is only 33 basis points, while that for the F2 share class is 42 basis points.

So where does American go from here? It seems unlikely that the firm will ever enjoy the rate of growth it had at the end of the dot-com crash. It doesn't have a broad enough array or the type of funds to catch today's investment flows. Last year, $225 billion flowed into bond funds and another $40 billion went to U.S. equity exchange-traded funds. In contrast, $75 billion flowed out of U.S. stock funds, according to Morningstar. American's "current woes lie in part from being a diversified long-only equity manager in a world that currently favors passive, alternative and fixed-income strategies," says Phillips.

And what were once deemed safe active strategies—like focusing on high-quality, dividend-paying large-cap stocks that measure returns against a benchmark—are now considered risky. Increasingly, diversification is seen as the key to managing risk, says Kevin Quirk, a partner at Casey, Quirk and Associates, a fund consultant in Darien, Conn. That's why investors are flocking to absolute-return strategies, which promise a predetermined rate of return regardless of market conditions.

Some financial advisors, many of whom complain about the firm's lack of communication, believe American Funds squandered an opportunity by not using the financial crisis to diversify. "They indeed learned nothing from 2008," says Emerson Fersch of Capital Investment Advisers of Long Beach, Calif. "Any move to something new would be perceived [by investors] as weakness in their approach."

Fersch still has about $12 million of his clients' money invested in American Funds, down from $21 million at the top of the market, according to Freadhoff. Fersch says he has been moving it into competing, actively-managed funds such as the large-cap value **Fairholme Fund** (FAIRX), the large-cap-growth **Amana Trust Growth** Fund (AMAGX), and the large-cap-blend **First Eagle Overseas** Fund (SGOVX). He is also using funds managed by JPMorgan and Invesco.

Most financial advisors, however, seem willing to give American the benefit of the doubt. "We have reason to believe it will show resilience in the future," says McIlveen. "Usually, our observation is we see a return to prominence later on for those funds that have personnel and processes in place that have not changed—but for whatever reason, the market is working against their ideas en masse."

One of the reasons to believe in American Funds is the undeniable effect that its funds have achieved reliably over the decades, notes McIlveen. According to Lipper, $10,000 invested in Growth Fund of America 15 years ago would be worth $39,583 today, versus $26,687 for the same amount invested in the S&P 500. "I'm much happier with the power of compounding over 15 years than I am worrying about what went on in the last year or three," says McIlveen.

In time, there would seem to be opportunities for more radical change at American. Rothenberg, for instance, turns 65 in July. But it's not that simple. As a private firm, American doesn't have strict retirement dates. And under the portfolio-counselor system, all decisions are made by committee. In the unique corporate culture that the Lovelaces created, there is technically no CEO.

Any successor will come from inside the firm. Armour, who is 51 and started with the firm as an associate 26 years ago, is a likely candidate, as is Robert Lovelace, who is 48 and began as an intern 26 years ago. He's one of two grandchildren of the founder who remain in family business. (His older brother, James, has shown more interest in managing securities than people, colleagues say.)

In the meantime, Rothenberg and the current team will continue to hope the market turns back their way and to work to get performance back on track. As he says, "We don't always get it right. We have tried to say that over and over again. The future of active management is about us being able to earn it. Three or four years from now, come back, and we will look at the records and we'll see whether we earned it or not. If we earned it, we did a good job. My guess is that…the outside world will look somewhat different." And American probably won't. ■

MICHAEL SHARI is a free-lance writer in New York. He covers finance, politics and emerging markets.