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Why New Mutual Funds Are Better

Mutual funds that have been around for only a couple of years are better investments than older peers, a new study says.

By MARK HULBERT

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Scott Pollack

Looking to rejuvenate your stock portfolio? Mutual funds that are only a couple of years old are more likely to beat the market than those that have been around for a decade or more.

That is the provocative conclusion of a study released this month by finance professors Lubos Pastor of the University of Chicago's Booth School of Business and Robert Stambaugh and Lucian Taylor of the University of Pennsylvania's Wharton School. It was published by the National Bureau of Economic Research in Cambridge, Mass., a nonprofit group that also officially dates the beginning and end of U.S. recessions.

This new study doesn't mean you should now ignore all other factors that previously have been found useful when choosing a fund, such as recent performance and expenses. But it does mean that when weighing two funds you otherwise find equally attractive, you should go with the younger one, Mr. Pastor says.

The study didn't find a specific age threshold that separated "old" and "young" funds; instead, it found that performance declines steadily and consistently as funds get older.

The researchers focused on actively managed U.S. stock mutual funds between 1979 and 2011—a total of more than 3,000 individual funds—and compared each fund to an appropriate benchmark.

For example, a so-called small-cap value fund was compared with a small-cap value benchmark, while a large-cap growth fund was compared with an index of stocks in that style category.

They found that, when funds were less than three years old, they beat their respective benchmarks by significantly more than funds that were 10 or more years old beat theirs—by an average of about one percentage point a year more, in fact.

While the average fund between three and six years old did less well than those even younger, they still did better than the oldest funds.

Not only is that one percentage point statistically significant, Mr. Pastor says, it also could make a huge difference to an investor over the long term. "Even relatively small return differences should be of interest to investors in today's low-rate environment," he says.

Newer funds have a competitive advantage, Mr. Pastor says, because they are more likely to pursue the latest strategies, which have a better chance of beating the market. By contrast, the strategies that long-established funds began using many years ago may have lost their edge as they are adopted by a lot of other managers.

"My M.B.A. students who will be fortunate enough to manage a mutual fund will have the benefit of the latest academic research into what works in the market," Mr. Pastor says. "The mutual fund managers who got their M.B.A.s several decades ago were taught what was the cutting edge then, but the cutting edge has moved up a lot since then."

A manager who got his M.B.A. in the 1980s, for example, was taught he could beat the market only by investing in risky small-cap stocks or stocks with low ratios of price-to-book value, a measure of net worth. Since then, Mr. Pastor points out, "academia has identified many other potential ways to beat the market, such as by following strategies based on accruals, momentum or stock profitability"—even though, needless to say, there is no guarantee that these new strategies will always work.

Furthermore, he says, today's M.B.A. students are learning many complex econometric tools that weren't available a few decades ago.

Why can't the older managers take advantage of the same latest research as the younger managers? They can, and some do, Mr. Pastor says. But he and his co-authors found that, on average, that "isn't strong enough to overcome the additional competition from the new kids showing up with the latest skills."

To be sure, it can be easier to beat the market when there are fewer assets under management, since it then becomes possible to invest in much smaller-cap companies without adversely affecting their stock prices. Similarly, newer mutual funds don't suffer under the dead weight of the legacy positions that older funds bought in years past—which may not deserve to be sold but yet wouldn't be bought today by a fund starting out fresh.

Yet Mr. Pastor says that this can't explain his and his co-researchers' results: The same conclusions emerged even after controlling for fund size.

Would a younger manager be more likely to incur huge risks in his newer fund in the hopes of making a name for himself? The evidence doesn't seem to support this concern.

Glenn Ellison, an economics professor at the Massachusetts Institute of Technology who also has studied mutual-fund performance, says that—with the possible exception of the tiniest mutual funds—younger managers actually tend to be more conservative than older ones. One big reason, he says: They are much more likely to be terminated for poor performance than an older manager.

Each of the following seven mutual funds can be invested in without any sales charge and has a minimum initial investment of no more than $3,500, at least $15 million in assets and an expense ratio of no more than 1.5%, or $150 per $10,000 invested.

Among all funds that meet these criteria, according to Lipper, these seven are those with the best 12-month returns—each gaining in excess of 30% over the past 12 months, versus the S&P 500's dividend-adjusted return of 22%.

The first two— Columbia Active Portfolios Multi-Manager Growth and RiverPark Large Growth —focus on large-cap growth stocks, or those of the largest companies that trade for relatively high price/book ratios. The third, Lyrical US Value Equity, also focuses on large-cap stocks, but doesn't confine itself to just growth stocks. A fourth fund, ASTON/LMCG Small Cap Growth, falls in the small-cap growth category, while the remaining three are midcap growth funds, which means they focus on growth stocks of midsize companies: Christopher Weil & Co. Core Investment, TCW SMID Cap Growth and the Tarkio Fund.

In addition to showing that younger funds have an advantage over older ones, the new research also illustrates how difficult it is to beat the market. Though today's M.B.A. students will have the latest skills and be the beneficiaries of the latest research, in several years they in turn will be at a competitive disadvantage to the "new M.B.A.s who will be showing up then, who will be at their cutting edge," Mr. Pastor says.

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