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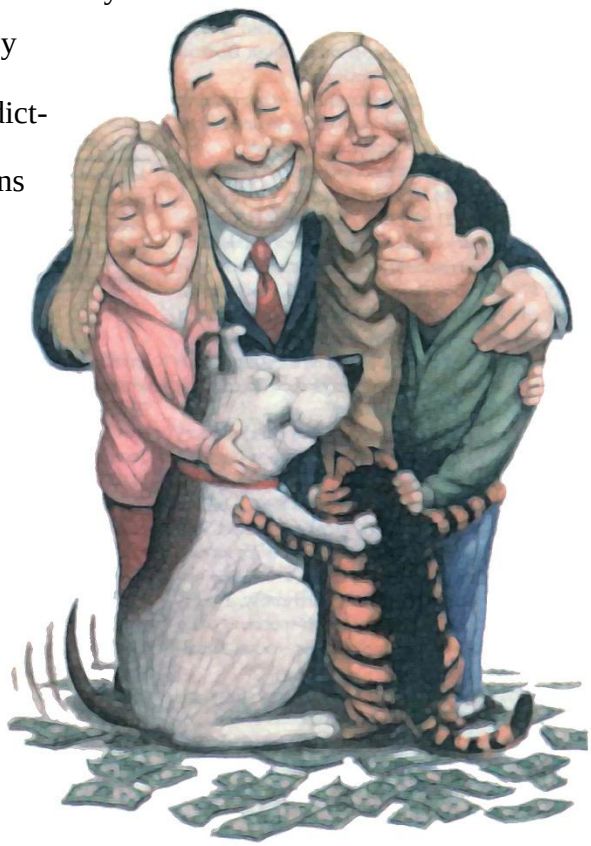
**Two straight years of strong returns have made fund investors more comfortable with risk. Just don't get too comfortable.**

# That's Better Now

**By Michael Shari** Investment success last year meant embracing risk. Certainly, it wasn't hard to find. • Following 2009's sharp rally, investors had to confront their fears about weak U.S. housing and employment, Europe's ugly sovereign balance sheets, May's violent flash crash, a sharp swing in U.S. political sentiment, deficit-ridden state and local governments and the effects of easy U.S. monetary policy in order to partake in a second-half stock-market surge that many reasonable people mistrusted. Risk was rewarded. • In such an unpredictable year, the mutual-fund families that delivered the best overall returns for their shareholders didn't take money off the table, flee to defensive stocks or hide in Treasury bonds. That made for some unusual winners in our annual ranking of the best fund families. A prime example is the leader of the *Barron's*/Lipper ranking: Dimensional Fund Advisors, a quantitative-fund group with many index-like qualities. DFA was followed by Nuveen Fund Advisors, newcomer Principal Management, Oppenheimer Funds, and Waddell & Reed Investment Management (see table, page 30). • Overall, they topped their rivals with strong returns in areas like emerging-market stocks, which were up 19.54%, small-and mid-cap growth and value plays, which gained 27.7% and 24.19%, respectively, and global high-yield funds, which rose about 3.50%, according to Lipper. • "At the highest level, it would come down to the amount of risk a fund manager took.



In general, riskier assets, lower credit quality and lower-quality companies generally outperformed less risky assets across equity, fixed income and various asset classes," says Jeremy Degroot, chief investment officer of Litman/Gregory, a firm that specializes in mutual-fund research in Orinda, California.

The strong gains have put money in the pockets of fund shareholders and the funds themselves. Publicly help **T. Rowe Price** (ticker: TROW) saw its earnings per share increase 50.2% in 2010, to $2.47, according to Keefe, Bruyette & Woods; they are expected to rise another 17.5% this year. **Waddell & Reed** (WDR) posted a 45.7% rise to $1.80 a share in 2010 profit; earnings are seen increasing by 16.7% for 2011. **Janus** (JNS), **Legg Mason** (LM), **Franklin Resources** (BEN) and **Invesco** (IVZ) all reported healthy profits, through some of them might have hoped for better investment returns.

**Can mutual-fund families** and their investors continue to dodge the raindrops for another year? Not only are the stocks at higher levels and bond yields still low, none of 2010's risks have disappeared and a new one-political upheaval across the Mideast and North Africa- has appeared. The unrest in Egypt and elsewhere is a challenge for big oil companies that depend on the region for much of their supply, says Henry Herrmann, CEO of Waddell & Reed. And the worries about U.S. states and municipalities have worsened of late, driving $13.37 billion out of municipal-bond funds in December, a trend Degroot warns could continue.

"This could be the trend in the year ahead-risk on, risk off-with people thinking 'the world is coming to an end' or 'maybe I'm missing the trend,'" observes Degroot.

Possibly a little late, retail investors seem to be getting their courage up to wade into U.S. stocks again. From Jan. 1 to Jan. 26 of the New Year, $11.82 billion flowed into U.S. large-cap growth and value equity funds, more than triple the $2.82 billion that went into international stock funds, according to Lipper. In 2010, $74.88 billion flowed out of U.S. stock funds, while $42.71 billion came into international stock funds, and a gargantuan $213.25 billion poured into taxable-bond funds.

Not everyone agrees that risk levels are rising: "The risky stuff is more stable this year," says Art Steinmetz, chief investment officer of Oppenheimer.

Of course, it's impossible to time stock-and bond-market changes and the strategy that's paid off for the best big fund families-as well as investors- is a diversified one. Our No. 1, DFA, is a global asset manager that oversees $206.5 billion in all and owns a mind-boggling 13,000 stocks, or about 70% of the world's publicly listed equities. Because DFA's investment process is purely quantitative, it doesn't have the option of succumbing to fear in the face of adversity. It certainly helped that DFA focuses much of its attention on some of last year's highest-performing equity areas-value, small-cap and emerging markets.

"What was important last year was to stay fully invested," explains David Booth, chief executive and cofounder of DFA. "We take diversification very seriously. We tend to be more global than other fund families. We emphasize small-cap and value stocks globally, and in emerging markets. Those factors paid off last year."

The privately held firm (Arnold Schwarzenegger is an investor) also is known for keeping a lid on costs that can rob shareholders of performance points, steering clear of some foreign markets where it doesn't believe funds can get a fair shake on prices. DFA's strong equity performance carried the day: It finished first in U.S. equities, 13th in world equities and 5th in mixed equities last year, according to Lipper.

Our survey weights each category of fund differently: 40.52% for U.S. equity, 14.32% for world equity, 16.46% for mixed equity, 24.52% for taxable bonds and 4.18% for tax-exempt bonds. (For our complete methodology, see Barrons.com)

The stresses caused by the financial crisis as well as the mutual-fund industry's never-ending quest for scale continues to prompt consolidation. Morgan Stanley has sold most of its Van Kampen unit to Invesco, Prudential absorbed JennisonDryden under its own brand and Wells Fargo took Evergreen under its wing.

One beneficiary was Nuveen, which picked up FAF Advisors, a strong performer in *Barron's* previous rankings. Nuveen, best known for its bond expertise, particularly in tax-exempts, has added to its skills in both U.S. and foreign equities. With pretty good strength across the board, particularly in equities, Nuveen is No.2 for 2010.

The theme that drove returns in domestic equity last year was "the return of U.S. consumer," says Tom Schreier, the former CEO of FAF who is now vice chairman of Nuveen. Those funds that picked stocks that were poised to benefit from added consumer spending did well. The $1 billion **Nuveen Equity Income** Fund