SmartMoney

Focused Funds That Benefit From Concentration

By Rob Wherry
June 1, 2007

THE STAFFERS AT Blankinship & Foster, an investment shop in Solana Beach, Calif., know their mutual fund managers inside and out. Probably more so than their contemporaries, since the 33-year-old firm favors focused funds, a category of offerings that has the potential to take investors on a wild ride. "We get nervous when managers shoot at everything," says Rick Brooks, one of B&F's advisors. "We like the ones who put all their money in their best ideas."

Focused funds feature portfolios with just a few dozen investments. While most funds will devote a percentage point or two to a particular stock, these concentrated portfolios aren't afraid to put 5% or 10% of their assets into one holding. That means a few bad picks can spell disaster. Obviously, the opposite is true, too. Some investors like focused funds because they have the potential to post outsized returns when a manager hits his stride. Indeed, a $10,000 bet at the 1999 inception of the **Fairholme fund** (FAIRX[1]), an offering that holds just 21 stocks, would now be worth around $34,000 while that same investment in an S&P 500 index fund would have grown to just $11,400.

To narrow down our candidates for this week's SmartMoney.com fund screen we defined focused funds as those with 50 or so stocks. We then tightened some of our usual criteria. Because focused funds can be volatile, we decided to limit our candidates to the cream of the crop in terms of performance. Only those with three- and five-year track records in the top 20% of their peer groups were considered. (We usually place the cutoff at 40%.) We also followed a page from B&F's playbook and looked for funds whose managers had been at the helm for longer than five years. "We tell our clients we want managers with gray hair or no hair," jokes Brooks. "They have to have been around the block a few times. You don't want someone coming into a year like 2000 seeing it for the first time."

In this week's Fund Insight[2] we told you about enhanced index funds, a group of funds that were trying to outdo their traditional index counterparts. Focused funds are at the opposite end of the spectrum, but they are waging the same battle. The average actively managed portfolio has around three times the number of positions as a focused fund. But the managers running the show at these concentrated portfolios think they can beat their bigger brethren with savvy stock picking. Index funds — and to a certain extent the enhanced ones, too — are perfect for the centerpiece of your portfolio. While B&F's Brooks thinks focused funds can serve a similar role, most advisors would devote a smaller percentage of assets to these funds. We think that's smart advice. "If you want to use 5% of the Las Vegas part of your portfolio that would be OK," says a skeptical P.J. DiNuzzo, president of DiNuzzo Investment Advisors in Beaver, Pa.

We usually don't dwell on funds that don't make our cuts. But this week we would be remiss if we didn't explain the absence of two top funds. **Longleaf Partners** (LLPFX[3]), a multicap offering that won Morningstar's domestic equity fund manager of the year in 2006, is closed to new money, a detail that violates our screen. And even though it ranks in the top 4% of its peer group over the last decade, recent performance, especially in 2004, puts it in the bottom half of its category over the trailing three-year period, according to Lipper. The $6 billion **Oakmark** (OAKMX[4]) fund, a well-respected offering run by Bill Nygren, has also hit a rough patch in recent years. We would still recommend both funds.

One offering that did make our cut was **Permanent Portfolio Aggressive Growth** (PAGRX[5]). Manager Michael Cuggino, who has been at the helm since 1991, looks for stocks in up-and-coming sectors that have above-average growth prospects. He also favors companies that have pricing power or new products that can steal market share from competitors. Once he finds a potential winner, he holds on. This portfolio of 36 stocks — top holdings include **Frontier Oil** (FTO[6]), **Hewlett-Packard** (HPQ[7]) and **Morgan Stanley** (MS[8]) — has a tiny turnover of just 2%. That means Cuggino — and investors, too — must have some patience. That was particularly the case last year when the fund turned in a respectable 9% return, but trailed the broader market by almost seven percentage points. However, year-to-date he is up 10.4%, about 1.6 percentage points ahead of the S&P 500. That up-and-down ride could lead some managers to make a knee-jerk reaction. But, says Cuggino, "We haven't been doing anything different."

The Criteria

We defined focused funds as having 50 or so stocks. These concentrated portfolios had to have performance track records over the three- and five-year performance time periods that put them in the top 20% of their peer groups. These no-load funds also had to have a manager who had been running it for longer than five years. In addition, the funds had to be open to new money, require a minimum below $5,000 and charge an expense ratio under 1.5%.

Funds With Focus

Company	Classification	Expense Ratio (%)	Assets ($ millions)	3-Year Average Annual Return (%)	5-Year Average Annual Return (%)	Manager Tenure
CGM Focus (CGMFX[9])	Midcap Growth	1.02	2597	25.4	17.6	10
Columbia Marsico Focused Equities (NFEPX[10])	Large-Cap Growth	0.97	1276	12.0	7.8	10
Fairholme (FAIRX[11])	Midcap Growth	1.00	4896	20.1	16.7	8
FBR Small Cap (FBRVX[12])	Small-Cap Growth	1.38	1666	20.1	22.5	10
Marsico Growth (MGRIX[13])	Large-Cap Growth	1.26	2841	11.4	8.2	10
Permanent Portfolio Aggressive Growth (PAGRX[14])	Multicap Core	1.34	31	19.7	12.8	16
TCW Focused Equities (TGFVX[15])	Large-Cap Core	1.38	34	15.3	10.5	6
Westport (WPFRX[16])	Multicap Core	1.49	37	17.2	12.7	10

Source: Lipper
Note: Data as of May 31, 2007

Links in this article:
[1]http://www.smartmoney.com/cfscripts/Director.cfm?searchString=FAIRX
[2]http://www.smartmoney.com/fundinsight/index.cfm?story=20070531
[3]http://www.smartmoney.com/cfscripts/Director.cfm?searchString=LLPFX
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