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A Warning for Investors

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Ninety million investors own mutual funds. And according to a recent study by Yale professors Antti Petajisto and Martijn Cremers, that means that about 30 million are paying too much to do so.

Am I one of the 30 million?
Who's overpaying? It's the folks who pay up for active management of their investment dollars but end up with a portfolio that trails the index because of the high fees that get deducted from the account. That unfortunate reality was true of funds that controlled approximately 30% of mutual fund assets in 2003, according to a recent article in *The Wall Street Journal*. The *Journal* called these "closet index funds." Our own fund guru and *Champion Funds* advisor Shannon Zimmerman calls them good funds gone bad.

Clever names aside, funds like these are a real danger to your investment dollars. That's because high fees not only hurt your returns each year, but by removing money from your account, they mute the long-term effects of compounding -- where the real money is made.

The best and the worst funds
The study calls out the once-famous and recently maligned **Fidelity Magellan**(FUND:FMAGX) as a poster child of passive active management. (To be fair, the study is using data from the period before Fidelity installed Harry Lange as the new head of Magellan.) Simply put, less than 40% of Magellan's portfolio differed from the S&P 500 in 2002. Yet Magellan still charged investors 40 basis points more than the Vanguard index offering. What's worse, Fidelity lost out to the index by 1.6 percentage points that year. In other words, the few bets it made contrary to the index didn't work out anyway.

Outperformance, however, did correlate with the most active funds, which beat the index by approximately 1.4 percentage points per year from 1990 to 2003. Consider the model case of **Fidelity Low-Priced Stock** (FLPSX), which posted an "active share" (a measure of how different the fund is from its benchmark) of approximately 90% in 2002. Not coincidentally, the fund shredded the index to the tune of 16 percentage points. Its 10-year annualized return is an even more impressive 15.8%, which puts its nearly 10 percentage points ahead of the S&P 500. Current top holdings include **Petroleo Brasileiro**(NYSE:PBR), **DR Horton**(NYSE:DHI), **Safeway**(NYSE:SWY), **Oracle** (NASDAQ:ORCL), **UnitedHealth**(NYSE:UNH), and **Chesapeake Energy**(NYSE:CHK).

The least active funds, on the other hand, trailed the index by about 1.4 percentage points.

But do you have to pay up for quality?
Unfortunately, the most active funds also correlate with the highest expense ratios -- they charge about 1.5% per year on average.

So what's the key to getting the most bang for your investing dollars? Find the most active funds with the lowest expense ratios. For instance, Fidelity Low-Priced, which is closed to new investors, charges just 0.94%.

Since Petajisto and Cremers' methodology is new, you can't find their measure of "Active Share" on Fool.com, **Morningstar**, or **Yahoo!** Finance. You can, however, find a fund's R-squared score, which measures how closely a fund's movements track those of its benchmark. While it's not a perfect measure, it can also be a helpful clue in determining whether your fund is a "closet index."

Additionally, there are a few other traits that might help you identify the market's best funds:

1. Long-tenured management.
2. A market-beating track record that the current team has earned.
3. Managers who invest in their own funds.

The Champs
These are all characteristics that Shannon searches out to identify the best mutual funds -- let's call them the *next* Fidelity Low-Priced -- for members of his *Champion Funds* investing service. If you'd like to see what he's recommending, you can join the service free for 30 days with no obligation to subscribe. Click here for more information.

After all, if you have a "closet index" on your hands, you're best served getting rid of it and putting a Champ in your portfolio instead.

Tim Hanson does not own shares of any company mentioned. UnitedHealth is a Stock Advisor *and* Inside Value *recommendation. No Fool is too cool for disclosure.*

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