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A Quarterly Newsletter for PDV Clients and Friends

How to Pick Stock Mutual Funds

By Che H. Lee
President

With thousands of stock mutual funds in the marketplace, how should you go about picking superior funds? This has become a critical question, as millions rely on the vehicle of mutual funds to secure their retirement.

News About PDV Staff

We are pleased to announce that Ms. Louisa Ho was recently promoted to the position of ***Portfolio Analyst***. Louisa graduated with high distinction from UC Berkeley, with B.A. degrees in both Economics and Statistics. Now in her third year as a valued member of the PDV team, Louisa is equally proficient with conducting investment research and dealing with operational matters. Louisa is a tremendous asset to PDV and our clients, and we look forward to Louisa being an integral part of our team for years to come. **Congratulations, Louisa!**

This is a highly complex question, without a magic formula to guide us. Since no investment professional will do well all the time, using a quantitative screen to search for equity mutual funds that outperform all the time or every year is both futile and unrealistic.

To help answer this question, we turn to investment legend, David Swensen, Chief Investment Officer of Yale University. When Swensen speaks, we should listen carefully. He handles one of the largest university endowments in the world, and has demonstrated a superlative long-term investment record as the primary steward of Yale's assets. His role at Yale includes evaluating and finding superior investment managers to help him manage Yale's endowment.

In his book "***Unconventional Success: A Fundamental Approach to Personal Investment***" (Free Press 2005), Swensen helps individual investors evaluate equity mutual funds. Much of what he looks for in superior stock funds focus on the personality traits of their managers. In our view, these desirable traits are relevant and important for investment professionals managing equities outside the mutual fund setting as well. Long-time readers of ***Observations*** and PDV clients will recognize that many of the factors Swensen favors are the same ones we preach and strive to practice on behalf of our clients.

Swensen comes out swinging, declaring that marketing is more important to the mutual fund industry than generating reasonable investment results as a fiduciary. He bluntly states that *only several dozen* of the thousands of mutual funds deserve investors' trust and assets. He believes most mutual funds fail to live up to their fiduciary duties. Among the negatives, he lists excessive management and sales fees, high portfolio turnover and trading costs, bloated asset bases and investment results that fail to beat the market over time. He says the massive resources devoted to attracting assets increase the mutual fund companies' bottom line. However, this causes mediocre or poor investment results, because it becomes increasingly difficult to produce superior results on an ever-expanding asset base.

Swensen likes to see the fund manager eat "her own cooking" by having substantial personal assets invested in her own mutual fund. In Swensen's view, by investing her own money in the fund, the fund manager is transformed from agent to principal, aligning her interests with that of the other fund shareholders.

Inside This Issue:

- How to Pick Stock Mutual Funds p.1
- The New Roth 401(k) p.3

Another very important trait which Swensen looks for is the fund manager's ability to rise above criticism and doubters and pursue with integrity what he describes as "uncomfortable policies that tend to lead to generation of superior investment returns." These policies include the courage and conviction to invest in a ***concentrated*** group of ***out-of-favor*** equities that flaunt conventional wisdom, likely inviting short-term doubt and criticism from clients. That is why they are "uncomfortable."

Swensen also favors equity funds run by managers who are absolutely passionate about what they do and how they do it. He even goes as far as to suggest that a level of obsession would be helpful, as would a competitive nature to generate superior results within an environment filled with other highly intelligent, hard-working and resourceful professionals.

Swensen is interested in funds that can beat the market ***over time***. He is untroubled by and expects lagging periods from time to time, which he considers inevitable and a natural part of the investment process. To beat the market over time, he feels the investment manager must be willing to invest money over just a limited number of attractive investment opportunities whose characteristics vastly differ from that of the general market.

As we have explained on many prior occasions, the market is defined and influenced by the vast majority of market participants and what they are doing from time to time. This means to produce different, and hopefully better, results than the market over time, your mutual fund manager must own a collection of investments that differ from what most other people own. Investing this way is by necessity a solitary exercise requiring a lot of conviction and self-confidence, but it is exactly these maverick, convention-busting fund managers whom Swensen favors. In our view, these types of managers are willing to look foolish and wrong in the short run, at least judged by conventional herd-following standards, as long as they can achieve long-term gain and out-performance for the benefit of their clients.

As an example, Swensen contrasts the 20 stocks in the Longleaf Partners Fund at the end of 2003 versus the 224 stocks in the Fidelity Magellan Fund. He thinks it is absolutely critical to judge how managers running concentrated portfolios would react during inevitable disappointing periods when such portfolios temporarily lag the market. He expects superior managers to stick to their conviction, strategies and discipline despite near-term criticism or difficulties.

Swensen also blames consultants and fund shareholders alike for abandoning superior equity funds and their managers during predictable and inevitable periods of disappointing or lagging results. As an example, he again cites Longleaf Partners Fund which he admires. Swensen recounts that after a superlative market-beating run by the Fund from 1987 (fund inception) to 1995, the Fund began lagging the market substantially, as its managers avoided the speculative bubble stocks that propelled the market higher. By early 2000, Longleaf shareholders had left the Fund in droves.

Morningstar, the well-known consultant/publisher, capitulated as well; they piled on by following the herd and downgrading the Fund, contributing to the mass exodus. Swensen describes what happened at Morningstar this way: "Yet, with perfectly-pathetic-poor timing, in December 1999, Morningstar reduced the Longleaf Partners Fund rating to a middling three stars. Just when investors needed the forward-looking vision to maintain their position, Morningstar's rearview-mirror image showed them the door." In hindsight, Swensen concludes these shareholders foolishly bolted at the point of maximum opportunity, when the Fund and its underlying undervalued securities were poised to take off again. This should not be surprising to our long-time readers or PDV clients, as we have often remarked that all investment professionals will have disappointing periods, but well-managed portfolios are likely to bounce back after slow periods.

He goes further to state "Even though Longleaf Partners Fund could no longer serve the investors that departed, the firm rewarded investors that remained for maintaining a **tough, out-of-the-mainstream** position (emphasis added). From the end of the first quarter of 2000 through the end of 2003, the Fund returned nearly 16 percent per annum, outpacing the S&P 500's negative return by 22 percentage points annually." Further, Swensen points out that loyal Fund shareholders enjoyed a massive out-performance from inception to 2005 (which was the widest progress snapshot available) over the market, notwithstanding some lagging interim years.

Swensen frames the recurring temperamental and emotional mistakes that most investors make this way: "Finally, **successful mutual-fund investors must understand themselves well enough to know if they possess the conviction to maintain fundamentally sound, yet out-of-favor positions** (emphasis added). The nearly 30 percent of assets that investors withdrew from Longleaf Partners at the peak of the market in late 1999 and early 2000 doubtlessly damaged portfolios thrice. First, exiting investors paid taxes on realized gains. Second, the leave takers suffered poor relative past performance and missed good relative prospective results. Third, departing players likely chased a recent hot-performing fund just as results were about to turn cold. Identifying a winning fund proves helpful only if the investor demonstrates sufficient staying power to reach the finish line."

Another trait which Swensen likes to see is the fund manager's willingness to be selective about the clients he takes on. Swensen likes to see the fund manager screening and limiting clients to those who share the same long time horizon, investment philosophy and patience of the manager and the fund. He explains that fickle, disloyal or impatient clients coming in and out of the mutual fund based on short-term trends hurt the other shareholders and make the job of the mutual fund manager a lot more difficult, pressuring him to sell to meet redemptions just when he would rather be buying because stock prices are low.

In summary, Swensen identifies superior equity funds by seeing whether the funds and their managers exhibit the following traits and qualities: patience, discipline and courage to pursue an unconventional and concentrated investment strategy that buys out-of-favor securities; willingness to look foolish in the short term for long-term superior gain; willingness to turn away clients and screen for committed clients who will support and stay with the strategy through inevitable disappointing periods; market-beating results over time and reasonable fees.

I hope it is apparent to long-time readers of ***Observations*** and PDV clients that these criteria are the same ones we have preached over the years as conducive to producing superior long-term investment results. We certainly strive to practice what we preach on our clients' behalf. For example, one of Swensen's main points is that even superlative funds go through temporary lulls and how shareholders can benefit by practicing patience during such periods. That is why we spend so much time educating and encouraging our clients to hold on when their accounts occasionally go through similar frustrating times, so they can benefit from the eventual rebound. In addition to this significant point, Swensen discusses many other criteria for you to use and follow, which will increase your odds of success when selecting superior stock mutual funds or professionals to manage your equities.

The New Roth 401(k)

By Louisa Ho
Portfolio Analyst

Beginning January 1, 2006, an employer can add a feature that allows participants to make contributions with after-tax dollars to its 401(k) plan . This new feature is called the Roth 401(k).

With this new feature, participants are allowed to make after-tax contributions to a Roth 401(k) account, which

is separate from a traditional 401(k) account that only accepts before-tax contributions. Distributions of earnings from a Roth 401(k) account will be tax-free as long as the participant has 1) held the account for at least 5 years, and 2) either reached age 59½, become disabled or died. In contrast, distributions from a traditional 401(k) account are taxed as ordinary income even when the participant has reached age 59½. However, Roth 401(k) contributions, unlike traditional 401(k) contributions, are not deductible.

Provided an employer has added the Roth 401(k) feature to its plan, all participants are eligible to make Roth 401(k) contributions. There are no income limits to participation. Contributions are irrevocable; that is, the after-tax contributions cannot be changed back to pre-tax contributions, or vice-versa. Participants can make contributions to both a Roth 401(k) account and a traditional 401(k) account, provided the combined contribution amount does not exceed the maximum contribution allowable under the 401(k) tax rules. In 2006, the contribution limits are $15,000 for participants younger than age 50 and $20,000 for those age 50 and above. Any matching contributions from the employer will, without exception, go into the traditional 401(k) account.

Roth 401(k) distributions that do not qualify for tax-free treatment will be partially taxable. Such distributions will consist of a pro-rata share of the total contributions and earnings in the account at the time of distributions. The portion related to contributions will not be taxable, but the portion related to earnings will be taxed as ordinary income and may also be subject to an early withdrawal penalty of 10% additional tax.

In addition, distributions can be rolled over to a Roth IRA or a Roth 401(k) account of another plan that accepts rollover of after-tax contributions. Whereas rollovers to a Roth IRA can be done by either a direct rollover or 60-day rollover, rollovers to a Roth 401(k) account of another plan must be accomplished through a direct rollover. If rolling into a Roth IRA, then the 5-year required holding period will be deemed to have started in the year when the first contribution to the Roth IRA was made. If rolling into another Roth 401(k) plan, then the start of the 5-year holding period will be the earliest year in which a Roth 401(k) contribution was made to either of the distributing or receiving plans.

Like traditional 401(k) accounts, the rules on required minimum distributions (RMDs) also apply to Roth 401(k) accounts — participants must take RMDs beginning in the year in which they turn 70½. However, as discussed above, participants can roll over their Roth 401(k) assets to a Roth IRA, which is not subject to any required minimum distributions. This offers participants more flexibility on the timing of withdrawals.

So is making a Roth 401(k) contribution preferable than making a traditional 401(k) contribution? The answer ultimately depends on the current and future tax rates for the participants. Since no one can predict the future tax rates with certainty, participants can contribute to both the Roth and traditional 401(k) accounts to hedge their bets on future tax rates. But in general, if a participant is currently in her peak earning years and anticipates being taxed at a lower rate at the time of distribution, she will benefit from continuing with traditional 401(k) contributions. On the other hand, if a participant expects his tax rates to be the same or higher at the time of distribution than currently, then he will generally be better off making Roth 401(k) contributions.

The Roth 401(k) feature is currently set to expire in 2010. Should it expire, no future contributions would be allowed, but assets can remain in the accounts until distribution. Further information on Roth 401(k) accounts and contributions can be found in the responses to a set of frequently asked questions on the IRS website.

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