'Focused' Funds and Risk: Less Is Less

FUND TRACK

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The less diversified your mutual-fund portfolio, the more risky it should be—but the opposite is proving true with the growing breed of "focused," or concentrated, mutual funds.

The average U.S. diversified mutual fund holds 132 stocks, reports fund-tracker Morningstar Inc. in Chicago, and scores no better on standard risk measurements than funds holding 35 stocks or fewer.

"Holding more stocks makes a portfolio incrementally more risky," says Scott Schoelzel, manager of the **Janus Twenty Fund**, which has $35.3 billion in assets. "There's no way you can know 100 things as well as 10 or 15."

Janus Twenty's performance underscores Mr. Schoelzel's views. The fund has gained 78% during the past 12 months, beating the average large-capitalization fund's performance by 40 percentage points. While it has been closed to most new investors since April, Janus Twenty has been one of this year's best-selling funds.

The fund's performance and huge asset growth have attracted dozens of newcomers to the concentrated school of investing during the past 18 months. Some represent big players in the mutual-fund business, including **Bear Stearns**, **Legg Mason**, **Merrill Lynch** and **Liberty Financial**'s Stein Roe Funds. Others are obscure start-ups like **Fairholme Funds** in Short Hills, N.J., **Meehan Mutual Funds** in Washington and others now awaiting regulatory approval.

Turner Top 20 Fund, launched in July, is among those that have had immediate success. Turner is up 95% since inception and ranks fifth among 472 multi-cap core funds. Tom Marsico, Mr. Schoelzel's predecessor at Janus Twenty, opened another focused large-cap fund—**Marsico Focused Fund**—in December 1997. It is up 48% since then, compared with gains averaging 34% for its peers.

Superior returns of the focused funds are challenging the basic tenet of portfolio diversification. Too many stocks in a portfolio can result not just in diversification, but in diminished returns, says Dave Haywood, a fund analyst for Financial Research Corp., in Boston. "How can any one stock contribute to the portfolio when it makes up such a small percentage of it?"

Some say a perfectly diversified portfolio can be constructed with 15 to 25 stocks. "Once you hit that critical point of 20" stocks, portfolio risk is reduced "in very small increments," says Bryan Olson, director of Charles Schwab & Co.'s Center for Investment Research in San Francisco.

But Mr. Olson says investors shouldn't invest everything in one focused fund. Better to diversify investments among several focused funds, he says, or to make an indexed mutual fund your "core" holding and "explore" the hotter investment areas by using focused funds or sector funds.

For portfolio managers of focused funds, risk is "offset because you know your companies so well," says Jon Essen, chief executive of **Jundt Associates**, which manages $340 million in mutual-fund assets. The Minneapolis company, known for its concentrated, high-cost funds, will start two no-load focused funds next year. One, American Eagle Twenty Fund, will resemble the existing **Jundt Twenty-Five Fund**, likely holding similar stocks, mostly technology companies.

Most successful focused-fund managers have bet heavily on the narrow band of trophy stocks that has been driving the market: **Intel, Cisco Systems, Microsoft, General Electric, EMC, MCI WorldCom, Citigroup, American International Group, Merck** and **Fannie Mae**, according to Morningstar.

Jeffrey Van Harte, manager of the **Transamerica Investment Services** Premier Equity Fund, says concentrated investing is a natural extension of the changing economy. Only a handful of expert companies bubble to the surface as clear leaders, says Mr. Van Harte. However, "it's hard to know which ones are going to be the winners," he says.

Mr. Van Harte has about $300 million invested in 30 stocks. He bought **Qualcomm** two months ago—"a little late," he says; the stock was up 11-fold since January. But it has doubled since he bought it.

"If you're astute, you do far better," says Robert E. Torray, a nine-year veteran fund manager. "If you aren't, you do much worse." Mr. Torray, president of a Bethesda, Md., money-management firm that bears his name, has $4 billion under management in the firm, including $1.9 billion in Torray Fund, a "value," or bargain-hunting, portfolio that concentrates on about 30 large-capitalization stocks. It is up 19% this year, twice the average of its peers, and has an impressive long-term record, up an annualized 21% since December 1990. It is a rare bird, a value fund with a healthy long-term record.

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VANGUARD GETS SOCIAL: Vanguard Group, the nation's second-largest mutual-fund company, announced it is filing to launch a "socially responsible" index fund. The fund, to be known as Vanguard Calvert Social Index Fund, will mirror the holdings of the Calvert Social Index, an index that screens for companies with desirable social and environmental policies. The Calvert index avoids companies that are involved with tobacco, alcohol, gambling and nuclear power, as well as firms that violate fair labor practices and equal-opportunity standards.

Calvert Group, which runs Calvert Social Index, also plans to launch its own fund to track the index, a spokeswoman said. Unlike Vanguard's fund, which will be sold directly to investors, the Calvert fund will be sold through intermediaries.

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