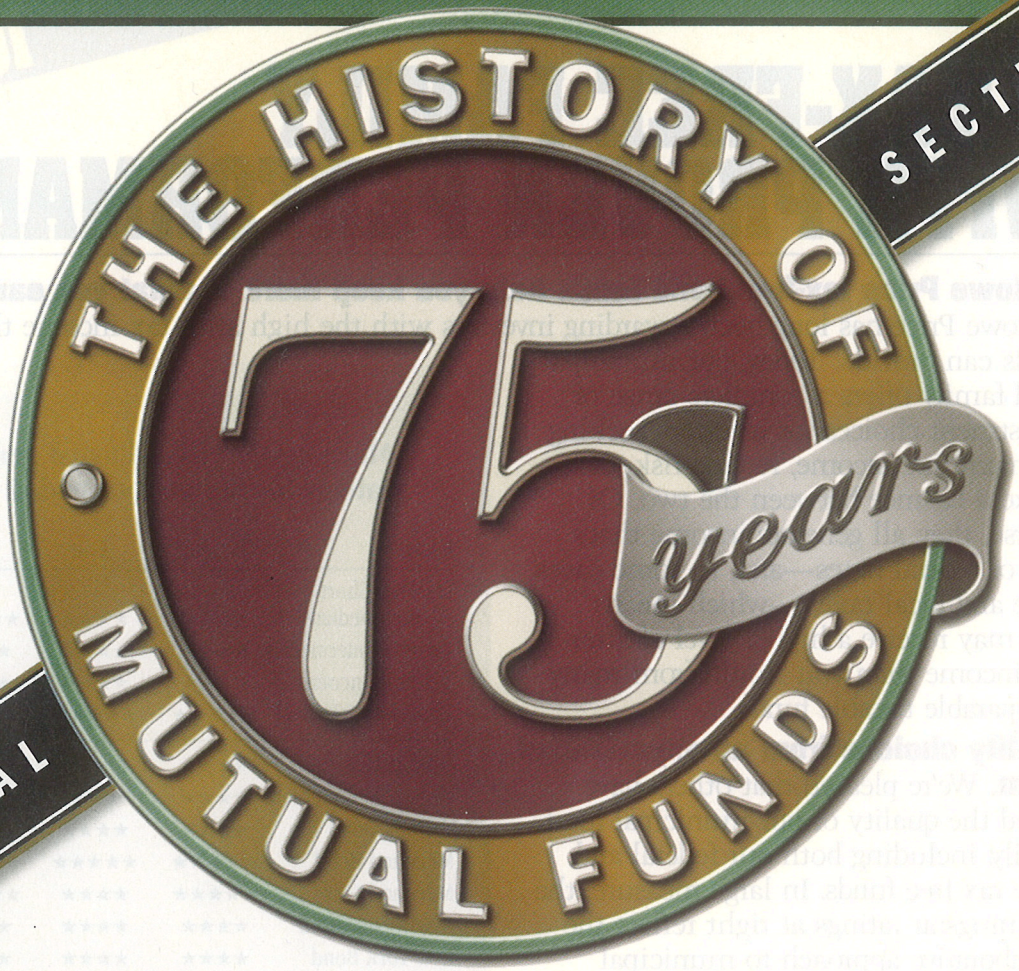



# LOOK BACK AND LEARN

IF YOU WANT TO understand what investing would be like without mutual funds, you need only look back to 1924. In those days, if you were a small investor who wanted your money run by a professional, you had to buy an "investment trust" for more than the value of its portfolio. Then you'd shell out a 10% sales charge and fork over up to 12.5% of your profits for the manager's annual fees. And your "trust" would probably refuse to tell you what stocks and bonds it held. ■ All that changed on March 21, 1924, when Edward G. Leffler launched Massachusetts Investors Trust, the world's first open-end mutual fund. For the first time, investors could sell their shares back to the fund company at any time and at a known price. The minimum investment: just $250, plus a 5% sales charge—all told, only $2.50 less than than the cost of a new, economical Ford Model T runabout.

The fund industry has since gone on to bring nearly 70 million Americans relatively low-cost, low-risk portfolios they could seldom afford (or would rarely dare) to assemble on their own: everything from blue chips, foreign stocks and money-market accounts with free checking to junk bonds and the shares of U.S. companies too small and obscure for most investors to research by themselves. By making investing easy and affordable for almost anyone, funds have given average Americans a stake in the economy that was inconceivable 75 years ago. Funds have helped transform our political democracy into an economic one as well.

But the history of mutual funds is not all sunshine and light—and the past is full of useful lessons. While researching this feature, I was struck again and again by how the booms and busts, the fashions and binges, that have marked recent fund history all have clear precedents in the past—and I

BY JASON ZWEIG



LOGO BY ALAN KIKUCHI

was reminded of the old saying, "Every time history repeats itself, the price goes up." Here, then, are the overriding lessons I've gleaned from studying 75 years of fund history.

▶ SINCE 1926, when returns were first tracked, the average stock fund has beaten Standard & Poor's 500-stock index in just 35 out of 73 years. In 28 of those 35 years, small stocks outperformed large ones. And that—not the skills of fund managers—holds the key to beating the market. Since funds have always favored companies smaller than the ones that make up the S&P 500, funds are most likely to beat that index when small stocks do better than big ones. **THE LESSON:** Until large stocks slow down, most funds will keep underperforming. If you expect otherwise, you're kidding yourself.

▶ IN 1966, celebrity manager Gerald Tsai's new Manhattan Fund raised a then record $247 million. In 1967, Manhattan returned a market-stomping 39.4%—but it went on to lose 76.3% by the end of 1974. From 1991 through 1993, the American Heritage Fund was the hottest in the country, gaining an annual average of 48.9%. Then, over the next five years, it lost 71.2%. More recently, Lexington Strategic Investments and Dreyfus Aggressive Growth, among many others, have flamed out after short hot streaks. **THE LESSON:** Before you buy a hot fund, ask yourself how you'll feel when it turns cold—because it surely will.

▶ LATELY, technology funds have been on fire. The Internet Fund, for instance, was up 196.1% in 1998. But this is the third time tech funds have been hot—and you'd better hope this time works out a lot better than the last two.

In the 1950s, investors sank hundreds of millions of dollars into funds like Television-Electronics; Atomic Development Mutual; Nucleonics, Chemistry & Electronics; and Missiles-Rockets-Jets & Automation. These funds held such "stocks of tomorrow" as Lithium of America, Pronto Uranium Mines and Consolidated Electrodynamics. Despite the bull market of the 1950s and the U.S. economy's huge leaps in technology, only a few tech stocks made money, and many went bust.

In 1982, tech got hot again. Fidelity Select Technology shot up 38.4%, then 29.9% more in 1983, thanks to stakes in "upstart space-age firms" like Silicon Systems, Watkins-Johnson and GenRad. But the next year, Fidelity Select Technology lost 16.9%; the average tech fund fell 11%. Fifteen years later, even after gaining 51.8% in 1998, tech funds still haven't caught up with the S&P 500. **THE LESSON:** Sector funds have a chronic history of overpromising and underdelivering.

▶ EVERY FEW YEARS fund companies pump out gimmicky new "products" that promise higher returns. In 1968, "go-go" portfolios like Mates Investment Fund produced returns of up to 72% while the S&P 500 gained *only* 24%. But Mates was loading up on privately issued "letter stock," then arbitrarily marking up the value of those shares and including the markup in its total return. When the Securities and Exchange Commission put a stop to this stunt, Mates lost 22% in a matter of months. Likewise, in the mid-1980s, giant firms like Putnam and Dean Witter offered "plus" funds that purported to wring extra income out of government bonds. Funds owning bonds with 9% interest miraculously "enhanced" that yield to 11%. Over the next few years, as interest rates dropped, these funds lost billions of dollars. **THE LESSON:** Ignore promises of outsize returns and "unique" strategies. Stick to plain funds with understandable strategies.

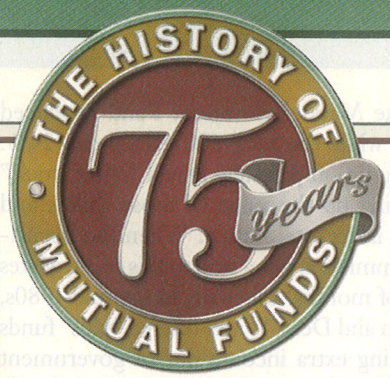
▶ AN AMAZING amount of the time, the experts' forecasts have been wrong. When Vanguard launched its first stock index fund in 1976, Columbia University finance professor Roger F. Murray called index funds "an idea whose time has passed," and an executive at fund manager National Investors Corp. proclaimed that "indexing is a sure path to mediocrity." Since then, Vanguard 500 Index has consistently trounced its rivals.

**BOOMS AND BUSTS, FASHIONS AND BINGES, HAVE BEEN PART OF THE MUTUAL FUND EXPERIENCE ALMOST SINCE THE BEGINNING.**

Fund managers themselves are feckless forecasters. One of the easiest ways to measure managers' views of the future is to count their cash; when funds hold 10% or more of their assets in reserve, they are bearishly waiting for stocks to turn cheaper. When cash is low, at 5% or less, bullish managers have already spent most of it on stocks.

Over time, you can use fund managers' cash positions to forecast the market's returns with remarkable accuracy—as long as you do the exact opposite of the managers. In 1951, for example, cash balances in stock funds set their all-time record high of 15%; over the next decade, stocks grew at 16.4% annually, among the biggest gains the U.S. market has ever produced. And when did cash positions hit their record low? In 1972, when they shrank to just 4.2%; that's the most optimistic fund managers have ever been. Over the next two years, U.S. stocks lost 37% of their value, the worst loss since the Great Depression. So what are cash levels telling us now? At the end of 1998, they stood at 4.8%, the lowest level since 1972. **THE LESSON:** Unless fund managers have suddenly become far better forecasters, this is an excellent time to be a cautious investor.

All the lessons of fund history, then, boil down to fairly basic rules. Chasing hot returns leads to nothing but heartbreak. And the most powerful tools for successful fund investing are the simplest: prudence and patience.




# RISKS AND RICHES

Over the full sweep of time, mutual funds have shown that they are probably the greatest contribution to financial democracy ever devised. ■ But like every democratic structure, they are far from perfect. ■ Failing to beat the market, as 90% of all funds have done for the past four years running, is a longstanding pattern (see the chart below). ■ When regulators leave the least loophole, fund companies will pile through it—and investors will end up sorry (see the events of 1954, 1967, 1986, at right). ■ And if a fund idea is trendy, it's probably bad for you (see 1929, 1968, 1983, 1991).

BY

JASON ZWEIG

## '20s

**HOT: closed-end funds**
**NOT: closed-end funds**

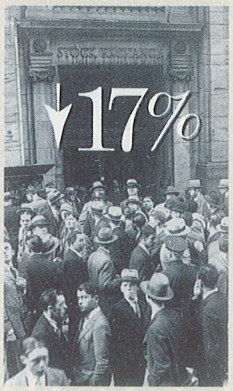
◀**1924: Edward G. Leffler** invents the world's first open-end fund, Massachusetts Investors Trust. The day the fund is founded, March 21, the Dow closes at 95.87. After one year, MIT has 200 shareholders and $392,000 in assets.

**1924:** The entire fund industry, consisting of a few closed-end funds, has less than $10 million in assets. ■ **Paul Cabot** co-founds State Street Investment Trust, the second open-end fund, four months after MIT. These two funds are the first ever to allow investors to sell their shares back to the fund company at any time.

**1925: Edgar Lawrence Smith** founds Investment Trust Fund A, which invests according to the precepts of his book, *Common Stocks as Long Term Investments*, the first major work to argue that stocks will outperform bonds and cash over time.

**1927: Closed-end funds** (then called investment trusts) spring to life on Wall Street. From March to August alone, they multiply from 49 trusts with $350 million in assets to 97 trusts holding $750 million.

▶**1928:** Boston money manager **Scudder Stevens & Clark** creates the first no-load fund, First Investment Counsel Corp. (now Scudder Income Fund).




◀**1929:** Investors bid up closed-end shares to absurd levels, shooting total assets past $3 billion. Sales charges of 10% are common, expenses run up to 12.5% and many funds refuse to disclose their holdings. On Oct. 29, **"Black Tuesday,"** the Dow crashes, dropping 12%. By year-end the index is at 248.48, off 17%, and the Great Depression has set in.

FUNDS 21 AS OF 12/31/29 — ASSETS 134 MILLION

## '30s

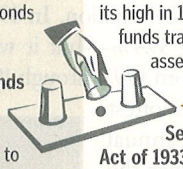
**HOT: government crackdowns**
**NOT: stock funds**

**1931:** Edgar Lawrence Smith's **Investment Trust Fund** has lost an estimated 75% of its value since its 1925 launch.

▶**1931: Jonathan B. Lovelace** founds Capital Research & Management, parent of the American Funds, today's third largest fund family.

**1932: Merrill Griswold**, chairman of MIT, founds the fund industry's first research department to ensure that an analyst studies every stock before the fund buys it. ■ The Dow hits rock bottom at 41.22, or **89% below** its high in 1929. Many closed-end funds trade at 10% of their asset value.

▼**1933:** Group Securities, the first family of **sector funds**, offers aviation; home building; agriculture; distillery and brewing; chemical; electronics and electrical-equipment portfolios.



◀**1933: Securities Act of 1933** requires funds to be sold with a prospectus disclosing their potential risks.


**1934: Benjamin Graham** publishes *Security Analysis*, the bible of professional stock pickers.

**1936:** Paul Cabot and Merrill Griswold, who had rescued F.D.R.'s sons from a boating mishap, get him to back **new tax rules** for funds when Cabot yells, "Mr. President, this is a damn outrage!"

▼**1936:** The Securities and Exchange Commission is created to regulate the markets. **Joseph P. Kennedy**, father of J.F.K. and a notorious stock manipulator, goes straight as the SEC's first chairman.

◀**1937: Thomas Rowe Price** founds an investment firm in Baltimore. His long-term goal: to find "new businesses which will develop with the growth of the Air Age."

FUNDS 67 AS OF 12/31/39 — ASSETS 532 MILLION

## NECK AND NECK

**Since 1926, when data for both stocks and funds begin,** funds have almost always moved in lockstep with the market as a whole. And the belief that in "the good old days" funds regularly beat the market is simply a myth: Overall, stock funds have topped the market just half the time. Their only sustained hot streak, from 1975 through 1983, overlapped precisely with the best years for smaller stocks, which funds tend to favor.