Mutual funds are ranked chiefly on their past performance, but a new measure may offer investors another way to pick winners and losers.

The main way investors have to compare mutual funds is to look at their past performance against a set benchmark such as the S&P 500-stock index, analyzing how well funds have done over a set period, say three or five years. The new method takes a different approach: It compares the fund return against returns of its past holdings. It looks at statistics including stock trades and transaction costs in an effort to calculate how skilled the manager is at picking good investments.

The method also tries to weigh the impact of internal-fund workings not readily observable by investors, such as the exact timing of stock trades, along with transaction prices and costs.

Mutual funds are already taking an interest in the method, outlined in a study by Marcin T. Kacperczyk of the University of British Columbia, and Clemens Sialm and Lu Zheng of the Stephen M. Ross School of Business at the University of Michigan in Ann Arbor.

Based on an analysis of monthly return data for more than 2,500 U.S. equity funds, the study covers the period from 1984 to 2003. It hinges on the notion of a return gap, which is the difference between a fund's current returns to investors and returns on a "holdings portfolio," which is the same fund's previously disclosed holdings, usually reported several months before. In calculating the return gap, the method subtracts expenses from the holdings portfolio.

"Many mutual-fund studies use holdings data to analyze the performance and strategies of mutual funds," wrote the study authors. "We show that a large amount of information is lost by only considering the holdings. The return gap between investor and holdings return is persistent and helps predict future performance."

The authors are in the early stages of presenting the study at academic conferences on finance, and "we are starting to talk with different companies now," Mr. Sialm says. Mr. Kacperczyk said he had had interest from fund managers at big firms in the U.S. and Canada, including an informal conversation with Vanguard Group.

The study looks at holdings in a given portfolio at the beginning of a quarter. From those
holdings, the authors extrapolate a hypothetical portfolio.

"Suppose the manager goes to a Caribbean island for a vacation, and doesn't trade at all in the quarter but continues to hold on to those previously disclosed holdings," said Mr. Sialm. "Those are the hypothetical returns."

In reality, however, the manager may well have bought and sold stock in the fund. "Say the fund has only two stocks, 50% in Google and 50% in Krispy Kreme," said Mr. Sialm. "After a month, the manager sells Krispy Kreme and buys Apple. Then the performance of the fund depends on the performance of those stocks and trading costs. How we judge the fund manager is pretty much how they deviate from this hypothetical portfolio."

The approach is different from a measure of fund performance used by investors, Morningstar Inc.'s star ratings -- which assigns a fund between one and five stars based on past performance adjusted for risk and sales charges. The firm makes disclaimers that past performance shouldn't be used to predict the future.

But Mr. Sialm and his colleagues say their measure of the return gap can be used for just that purpose. "It indicates how cheaply a portfolio manager can trade, and how well he is able to identify undervalued stocks. You would expect that those are consistent," he said.

Russel Kinnel, director of mutual-fund research at Morningstar, said he thinks the measure "sounds pretty flawed" because the authors are looking primarily at short-term trading results.

Says Mr. Sialm: "We don't say long-term performance is irrelevant; we just say that the return gap, which captures short-term performance, is very important."

Write to Arden Dale at arden.dale@dowjones.com1

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Hyperlinks in this Article:
(1) mailto:arden.dale@dowjones.com

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