Supplementary Reading for

**<u>Chapter 14　The Mutual Fund Mess</u>**

# A Green Light For Blue-Chip Funds

***Returns have been off lately, but funds investing in big-cap stocks are set to rebound***

*By Lauren Young*

Big is back. In the past six years large-cap stocks have toiled while smaller companies led the markets higher amid an economic rebound. Many mutual-fund statements reflect this discrepancy: The typical small-cap value fund soared an annualized 15% in the past five years, while the average large-cap growth fund is among the worst fund performers, with an annualized loss of almost 9%. But don't let such dismal numbers scare you away. Many financial advisers, such as Adam Bold, president of the Mutual Fund Store in Overland Park, Kan., say the time is right to invest in funds that own blue chips with market caps above $10 billion because they have more earnings momentum than small caps in the later stages of an economic cycle. Bold is overweighing his clients' portfolios in large-cap growth funds. "From a valuation and market cycle standpoint, large caps look really good right now," he says. But with so many laggards among large-cap growth funds since 2000, how do you sift through the rubble to find the right one?

*BusinessWeek*'s Mutual Fund Scoreboard ranks funds by their five-year track records and adjusts them for downside risk. Each fund is given an overall grade from A to F. We update the list every month at BusinessWeek Online.

We also rate funds against their peers. Among the 62 large caps we grade, we've looked at the 24 A-rated large-cap growth funds and checked on the fund managers to see how they're tuning their portfolios for a large-cap turnaround. The managers have different strategies -- some focus on mega caps like Microsoft, (MSFT) General Electric, (GE ) and Citigroup (C ), while others see the best buys in the smaller "big" companies such as Google, the online giant; EnCana (ECH ), an energy producer; and Pulte Homes (PHM ), a homebuilder.

Although their game plans are different, the managers agree that large-cap stocks offer good bargains overall. "Names that used to be the hallmark of growth are scoring well on growth and value characteristics," says James P. O'Shaughnessy, manager of the $400 million Dreyfus Premier Alpha Growth Fund, (BSFAX) who uses computer screens to identify stocks to buy. "That's really unusual."

Look at the $11 billion T. Rowe Price Growth Stock Fund: (PRGFX ) Its top holdings feature market giants, including Intel (INTC ) and Wal-Mart Stores (WMT ). On average, the portfolio is trading at 16 times 2006 earnings. That's half the price-earnings ratio the group sported five years ago. At the same time, the stocks in the fund are expected to post average earnings growth of 12% to 14% annually. Yet in many cases those stocks have barely budged since 2000.

In addition to the bargain price tags, Robert Smith, manager of the T. Rowe Price Growth Stock Fund, likes mega-cap companies because they offer the most varied mix of business units with a combination of domestic and international exposure. "As the growth rates stop accelerating and we start to have more normal growth, people will begin to pay for that diversification," Smith says.

Such diversity in business as well as geography means that something is usually working right for big companies. One example is First Data (FDC ), a recent addition to the concentrated Jensen Fund. (JENSX ) More than half of the company's operating income comes from its rapidly growing flagship Western Union unit, which provides electronic money transfers. The company has some 220,000 locations worldwide and is looking to double that presence as more people come from remote villages to work in cities. "Whether it's China, India, or Brazil, workers need a way to move money back to their families," says Robert Millen, co-manager of the $3 billion Jensen fund. At the same time, First Data processes credit- and debit-card transactions, which is a lucrative business. Its credit-card issuance division is suffering, but First Data's other units are picking up the slack, Millen says.

**Eye On Innovation**

To identify stocks for the $49 billion Fidelity Contrafund, (FCNTX ) manager Will Danoff is focusing on smaller, more innovative large companies with cutting-edge products and services. His research has led him to Genentech (DNA ), a biotech which has delivered promising results with cancer drug Avastin as well as Lucentis, which treats blindness.

Another top holding is Google, which Danoff purchased in the initial public offering last year. "Google (GOOG ) has a very powerful business model. They have the smartest engineers, and the company is growing like a weed," Danoff says. Google is poised to benefit from an uptick in online advertising: Americans spend 12% of their media time surfing the Internet, but online media currently accounts for 4% of the advertising industry's revenue, Danoff says.

Like Danoff, Bill Kornitzer, co-manager of the $50 million Buffalo Large Cap Fund (BUFEX )(he also subadvises the AFBA Five Star Large Cap Institutional Fund), seeks smaller large caps. In the past six months, Kornitzer and his team have shifted the fund away from giant companies. Some 20 companies in the Standard & Poor's (MHP) 500-stock index have market capitalizations above $100 billion, but the stocks in the Buffalo fund have a median market cap of about $30 billion. In the health-care group, Kornitzer likes Baxter International, (BAX )which isn't facing major patent expirations, and Abbott Laboratories, (ABT ) which has a good product pipeline, rather than industry heavyweight Pfizer (PFE ).

An added feature that large caps typically bring is staying power. Enron and WorldCom aside, "you get the insurance policy that large-cap companies won't go out of business in your lifetime or mine," says Bold, the financial adviser. You can't say that about many small caps.

**Questions for discussion:**

1. How did small-cap funds make their performance in the market in the past six years? What about the large-cap stocks?
2. What are the opinions of the financial advisers to the current market? What do they suggest and why?
3. “From a valuation and market style standpoint, large caps look really good right now.” Please cite examples for further explanation.
4. How does *Mutual Fund Scoreboard* rate the variety of funds? How often is the list updated?
5. Can you give some examples to show different strategies adopted by the fund managers in tuning their portfolios for a large-cap turnaround?
6. What are cutting-edge products and services? Why do many fund managers focus on more innovative companies with them?
7. For what reasons have Bill Kornitzer and his team shifted the fund away from giant companies?
8. Generally, what are advantages large caps companies have over small ones?