Reprinted by permission of Morningstar, Jan. 24, 2013 • OPP-92079

Buy the Unloved 2013

Using fund flows as a contrarian indicator can be an effective strategy.

Fund Spy | 01-24-13 | by Katie Rushkewicz Reichart, CFA

Each year we look at the equity categories that have experienced the greatest outflows and inflows to gauge which areas of the market are unloved or overheated. The idea is to use fund flows as a contrarian indicator, buying into categories that have seen investors leaving in droves while trimming exposure to those that have experienced a lot of interest. This strategy can work either as a small part of a portfolio or to give investors an idea of where to add and where to trim.

Morningstar has followed this strategy since the early 1990s, using annual net cash flows to identify each year's three most unloved and loved equity categories, which feed into two separate portfolios (unloved and loved). We track the average returns for those categories for the subsequent three years, adding in new categories each year and swapping out categories after three years are up. We've found that holding a portfolio of the three most unpopular equity categories for at least three years is an effective approach: From 1993 through 2012, the "unloved" strategy gained 8.4% annualized to the "loved" strategy's 5.1% annualized. The unloved strategy has also beaten the MSCI World Index's 6.9% annualized gain and has slightly beat the Morningstar US Market Index's 8.3% return.

According to Morningstar fund flow data, the most popular equity categories in 2012 were diversified emerging markets (inflows of $23.2 billion), foreign large value (inflows of $4.6 billion), and real estate (inflows of $3.8 billion). Those looking across asset classes might want to be cautious on sending new money to intermediate-term bond (inflows of $112.3 billion), short-term bond (inflows of $37.6 billion), and high-yield bond (inflows of $23.6 billion), particularly as interest rates have nowhere to go but up.

The most unloved equity categories are also the most unpopular overall: large growth (outflows of $39.5 billion), large value (outflows of $16 billion), and large blend (outflows of $14.4 billion). These categories have seen outflows despite posting double-digit gains in 2012. The money leaving from these categories reflects a broader trend of investors fleeing equity funds while piling into fixed-income offerings and passive ETFs. Some of these categories have endured outflows for awhile: Large growth has had annual net outflows since 2004, large value since 2007, and large blend since 2010. Below we'll look at some fund picks in these categories that could serve as good long-term holdings.

LKCM Equity (LKEQX) is a tiny $169 million fund most investors haven't heard of, mostly because it comes from a shop that doesn't market its funds. (The bulk of its business focuses on institutions and high-net-worth individuals.) But that's no reason to avoid it. Since the fund's late-1995 start, manager Luther King has amassed a peer-beating record with below-average volatility. It's not a pure growth fund but has skewed that way in recent years.

Investors looking for higher growth might instead opt for PRIMECAP Odyssey Growth (POGRX). This Gold-rated fund often invests in small- and mid-cap stocks and makes sector bets, so it can look out of sync from peers at times, but it has a stellar long-term record.

Vanguard Growth Index (VIGAX) is a low-cost, passive way to gain access to large-growth stocks. A recent change in index (from the MSCI US Prime Market Growth Index to the CRSP US Large Cap Growth Index) means there could even be more cost savings for investors down the road.

On the large value side, **Sound Shore (SSHFX)** is a good choice. Despite a middling three-year record, it has generated an enviable record under its management team, which has been in place for more than 25 years.

Dodge & Cox Stock (DODGX) is also proving that it's worth sticking with; after its financial stake hurt results in 2011, it was back in top form in 2012.

Large-blend investors might opt for Gold-rated FMI Large Cap (FMIHX), which has comfortably beaten the S&P 500 Index and nearly all peers

Reprinted by permission of Morningstar, Jan. 24, 2013 • OPP-92079

during the past decade. The portfolio is relatively concentrated in just under 30 stocks, but a focus on durable, high-quality businesses has kept volatility in check during down markets. Patrick English, who has been with employee-owned FMI since 1986, leads a team of comanagers who also serve as analysts. This collaborative structure has helped retain talent and keep the research team stable.

Vanguard Dividend Growth (VDIGX) is another standout. It unsurprisingly looked relatively sluggish in 2012's market, instead leading the way in more risk-averse environments such as 2011. But its long-term prospects remain good, with a proven process and manager. The fund is also one of the cheapest actively managed dividend-focused funds around.

Katie Rushkewicz Reichart is a senior fund analyst on the active funds research team with Morningstar.

This article is not intended to provide investment advice.