InvestmentNews DAILY

September 28, 2011

American flags as standard-bearer fund sees substantial outflows

Fund firm's Growth Fund of America loses position as largest mutual fund in U.S.; earlier success likely triggered 'unrealistic expectations'

Growth Fund of America has lost its status as the largest U.S. equity mutual fund, a position it held for six years, as investors are turning away from Los Angeles-based parent Capital Group Cos. and its tradition of picking stocks.

The $139 billion Vanguard Total Stock Market Index Fund last month overtook the $137 billion Growth Fund of America, whose $3.3 billion of withdrawals in August were the most of any fund, according to data from researcherMorningstar Inc. (MORN) Investors pulled $73 billion, or 8.6 percent of the money held by American Funds, in the 12 months ended Aug. 31, the heaviest proportion among the 15 biggest fund families. (**Click on the following link to see** the fund firms advisers are most loyal to).

“We're in an environment where stock pickers haven't been adding value andAmerican Funds is a case study,” Geoff Bobroff, a mutual-fund consultant in East Greenwich, Rhode Island, said in a telephone interview.

Money is flowing out of mutual funds whose managers choose domestic stocks for a record fifth straight year as shareholders and advisers question whether it is worth paying them to try to beat the market. The firm, which has resisted offering lower- cost index funds, has been plagued since 2008 by performance it calls disappointing, including poor returns for the large- company stocks that are its specialty, and by an investor preference for bond-fund managers.

American Funds, whose redemptions are rising for the fourth year in a row, is altering its marketing while keeping its investment process intact.

Communication Efforts

The firm is trying to improve communications with the financial advisers who sell its funds by providing more frequent reports on its outlook for the global economy and markets, said Chuck Freadhoff, a company spokesman, in a telephone interview. Next year it will start using social media such as Facebook, Twitter and YouTube to make educational material available to the public.

American Funds isn't changing its research-based process for selecting investments or broadening its product line beyond active mutual funds, Freadhoff said. James Rothenberg, Capital Group's non-executive chairman, in a December 2009 interview brushed off suggestions that the firm may change the way it invests.

“I think history shows -- including all the bad stuff -- that we've delivered,” Rothenberg said then.

10-Year Records

American, which uses teams of five to 10 managers to oversee its funds, says its stock pickers base their decisions on the same type of company-focused research the firm has used since its founding in 1931. The funds emphasize long-term results, and by that standard they're still outperforming the competition.

Growth Fund of America, the firm's biggest fund, averaged annual gains of 4.5 percent in the 10 years ended Sept. 16, better than 79 percent of rivals, according to Chicago-based Morningstar, and beating the 3.1 percent annualized return of the Standard & Poor's 500 Index, its benchmark. Since it was created in 1973, the fund bested the index for large U.S. stocks by 3 percentage points a year, according to an April regulatory filing.

American's 14 stock funds with at least a 10-year record beat 76 percent of rivals, on average, Morningstar data show. The firm's 11 bond funds outperformed 53 percent of competitors.

Some of American's funds have stumbled since the September 2008 bankruptcy of Lehman Brothers Holdings Inc. roiled markets, Freadhoff said. Capital Group underestimated the impact the housing collapse and resulting credit crisis would have on financial companies, he said. Growth Fund of America dropped 39 percent in 2008, its biggest calendar-year loss, according to data compiled by Bloomberg.

'Interesting Fact'

American has opened three funds in the past two years, including the $440 million Global Balanced Fund that invests in stocks and bonds around the world. Talks on creating each began before the 2008 market decline and none represents an attempt to halt withdrawals, Freadhoff said.

"To the extent that outflows reflect disappointment among our investors, we take them very seriously," Freadhoff said this month. "But we don't care that the Vanguard fund is larger than Growth Fund of America. It's an interesting fact but it has no significance."

Several of the firm's domestic stock funds lagged behind their benchmarks in the stock-market rebound that began the next year. In the 12 months following March 9, 2009, when stocks reached a 12-year low, Growth Fund of America, the $55 billion Investment Company of America Fund and the $49 billion Washington Mutual Investors Fund each trailed the S&P 500's 72 percent gain by at least 7 percentage points.

Indexing, ETFs

American Funds had assets of $887 billion as of Aug. 31, second to Valley Forge, Pennsylvania-based Vanguard Group Inc. in U.S. mutual-fund holdings, according to Morningstar. Capital Group oversaw $1.25 trillion as of June 30, including money from institutional investors such as pension funds.

Actively run domestic stock funds have seen redemptions of $290 billion since the end of 2007, Morningstar data show, while U.S. equity index funds have attracted $96 billion. An additional $160 billion has poured into exchange-traded funds that track indexes and trade throughout the day like stocks.

Investors have redeemed $31 billion from Growth Fund of America since the end of 2007 while adding $42 billion to the Vanguard fund that tracks the MSCI U.S. Broad Market Index, according to Morningstar.

Cheaper Alternative

Too many of American's funds closely track the returns of indexes, Ed Schrotenboer, a financial planner in Bloomington, Minnesota, said in a telephone interview. Schrotenboer, who used active funds from American and others earlier in his career, now employs mainly ETFs because he no longer believes many stock pickers can outperform indexes.

"Why would I choose American Funds when I can go with a lower-cost index product?" Schrotenboer said.

Growth Fund of America charges annual fees of 43 cents to $1.53 for every $100 invested, compared with 7 to 18 cents for the biggest Vanguard index fund, according to the company websites.

At its peak in October 2007, Growth Fund of America held $202 billion in assets. It reigned as the nation's largest equity mutual fund from May 2005 until last month, according to Morningstar.

American Funds has found it hard to live up to its past success, said Burton Greenwald, a mutual-fund consultant in Philadelphia. The firm performed better than most rivals in the bear market of 2000-2002, and was untouched by a 2003 scandal in which competitors were accused of allowing improper late trading and market timing.

Broker Confidence

“There was a feeling among brokers that if you sold American Funds you never had to say you're sorry,” Greenwald said in a telephone interview.

American Funds attracted an industry-leading $425 billion in net deposits in the six years ended Dec. 31, 2007, Morningstar data show. It lost $53 billion to redemptions in the first eight months of 2011, compared with $50 billion in all of last year, $20 billion in 2009 and $15 billion in 2008, Morningstar data show.

The firm's popularity earlier in the decade “may have created unrealistic expectations,” Kevin McDevitt, an analyst at Morningstar, said in a telephone interview.

Investors' preference for bonds is benefiting firms such as Newport Beach, California-basedPacific Investment Management Co., Greenwald said.

Bond Funds

“American isn't a major player in that portion of the market,” Greenwald said.

Bonds make up about 15 percent of American's mutual fund assets, according to the firm, compared with 27 percent at Vanguard and more than 90 percent at Pimco.

Nor is American a big investor in small and mid-cap stocks. The S&P 500 has returned 27 percent a year since March 9, 2009, trailing the 34 percent annual gain for the S&P Midcap 400 Index and a 32 percent increase for the Russell 2000, a proxy for smaller companies.

Some money managers, including Jeremy Grantham, chief investment strategist for Boston-based Grantham, Mayo, Van Otterloo & Co., have said blue-chip U.S. stocks will be the best-performing equities over the next few years because they're the most attractively priced relative to earnings prospects.

“If I were an investor I would be comfortable with the high-quality, large-cap companies that American owns,” said Morningstar's McDevitt. *--Bloomberg News--*