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Multi-Cap Funds: A Rose By This Name Truly Is Different

by

Don Cassidy

Senior Research Analyst

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MULTI-CAP FUNDS: A ROSE BY THIS NAME TRULY *IS* DIFFERENT

Don Cassidy
Senior Research Analyst
Lipper, Denver

Executive Summary

- The multi-cap designation is real, and its proper population exhibits meaningful differences on a variety of scales versus truly size-specialized funds.
- Analysts, boards, managers, financial advisers, and individual investors should take care to know what kinds of funds they actually are evaluating so that fair and therefore meaningful comparisons are used before decisions are made.
- Actual operating parameters of true multi-cap funds tend to be more favorable than weighted averages of other fund types.
- Performance is one area where the positive difference is very notable.
- In turnover and commissions costs, multi-cap funds do not excel, but differences across sizes remain crucial to recognize.

Executive Summary

"Got multi-cap?" Maybe as an investor you should. Or, perhaps more important, maybe you are one of many investors or financial advisers who *are* holding multi-cap funds but do not know it. And, certainly, members of mutual fund organizations should take care to compare funds with accurately selected peer groups. This report explores the characteristics of this fund type, which some rating services do not acknowledge.

Population Definition and Size

Lipper's definitions of U.S. Diversified Equity (USDE) Funds require that a fund in the large-cap, mid-cap, or small-cap classification must have at least 75% of its assets invested within just one of those market-capitalization ranges. Broadly diversified domestic equity funds not thus focused on one cap-size approach to the market are instead called multi-cap funds, since they have no apparent strong dedication to any particular size of stocks. Thus, the Lipper matrix is 4x3 in dimension, rather than the 3x3 approach used by some others. Most fund-classification systems recognize a middle or uncommitted position (core or blend) on the *style* dimension; logically a similar degree of freedom (i.e., multi-cap) should be recognized in terms of market capitalization in order to characterize investment approaches accurately. Table 1 details the breakout of funds as classified by Lipper in the various cells of the USDE matrix. Multi-cap portfolios represent over 28% of all such funds; they are greatest in number in the value column and are second in number by only a small difference among core funds, lagging only large-cap funds. Overall, they are greater in number that either mid-cap or small-cap funds.

Table 1: Numbers and Percents of Funds By Type in Lipper's USDE Funds Matrix

	Value	Core	Growth	Total
Large-Cap	134	335	222	691
Multi-Cap	**175**	**315**	**158**	**648**
Mid-Cap	82	132	184	398
Small-Cap	92	245	198	535
Total	483	1027	762	2272

Percents

	Value	Core	Growth	Total
Large-Cap	5.9	14.7	9.8	30.4
Multi-Cap	**7.7**	**13.9**	**7.0**	**28.5**
Mid-Cap	3.6	5.8	8.1	17.5
Small-Cap	4.0	10.8	8.7	23.5
Total	21.3	45.2	33.5	100.0

For a variety of reasons, precision in classification of fund numbers is very important. From a relative-performance standpoint, funds classified outside their true peer groups are subject to systematic movement over time, from the bottom of the rankings to the top, as market leadership rotates. For example, envision a fund that is truly multi-cap in nature being classified as "large-cap" but actually holding less than a preponderance of its assets in the upper size tier of the market: when large-cap stocks are trailing other types in terms of performance, such a fund will levitate toward the top in performance rankings because it does not hold as much in the lagging asset class as its putative competitors do.

Table 2: Examples of Very Large Multi-Cap Funds Classified Otherwise Elsewhere
(Percentage of Total Net Assets by Capitalization)

Fund Name	% Large	% Mid	% Small
Fidelity Contrafund	56.4	28.2	15.3
Fidelity Growth Co	50.8	27.0	22.2
Vanguard Tot Stock IX	65.4	18.6	16.0

From another important perspective, accurate descriptions of funds help assure an investor and his/her advisor that *de facto* asset allocation is as was intended. Again, envision a truly multi-cap fund that is, in this case, classified as a mid-cap fund. An investor and his/her advisor may decide that allocations of 40%/30%/30% in large-/mid-/small-cap are appropriate, and may purchase and hold three funds accordingly. But if the selected "mid-cap" fund in fact has only 50% of its assets so invested, the actual portfolio allocation to mid-cap stocks will be only 15% (versus the intended 30%), and the weightings of large and small will be higher than desired. Misallocation would be driven by imperfect labeling. This is not a problem that can be addressed by SEC regulation about fund naming, since various rubrics differ as to the dollar boundaries between the size classes, and the SEC is not going to define the sizes as it has not defined "growth" as precisely as it defines a geographic region or an industry/sector. Therefore, close attention to actual holdings is of paramount importance in any labeling scheme.

From an analytical and competitive standpoint in the funds business, various assessments ranging from peer-group relative performance, to relative expenses, to turnover and commissions costs, to competitive net flows and product-line fullness can be strongly biased if funds are classified less than precisely. Merit awards and percentile rankings by various rating firms are of course driven by inclusion or exclusion of specific funds and assumed competitors in any given classification. The primary objective of classification is to create true peer groups so that ratings and rankings are fair and so that they do not wander based on transient market-leadership movements, but instead truly reflect manager expertise as adjusted by expenses.

In the research underlying this report, we have found that multi-cap funds have recently outperformed the weighted average of other USDE funds: their expense ratios are lower, their turnovers are lower, they have been gaining market share of assets, and their net flows have been more steady than those for other USDE fund groups as a whole. Thus, when multi-cap funds are identified and analyzed, they indeed prove to be "different." Those *de facto* differences add yet another argument for separate classification of these funds.

Performance

Performance is arguably the single aspect of mutual funds that draws the greatest media and public scrutiny on an ongoing basis. It is therefore notable that we found a consistently positive performance differential in favor of multi-cap funds compared to the rest of the USDE universe, dollar weighted. This finding was robust across time frames from one to 15 years (periods ended May 31, 2005), with but a single exception: two years in value funds, where the deficit was a mere 44 basis points per year. The accompanying table highlights the key data.

Table 3: Multi-period Performance Differential of Multi-Cap and other USDE Funds.

	Value	Core	Growth	Total	Period (years)
Large-Cap	9.99	6.12	4.54	6.87	One
Multi-Cap	**11.87**	**9.01**	**7.60**	**9.23**	
All Except Multi	11.28	7.87	6.14	8.33	
Large-Cap	14.23	10.70	10.13	11.60	Two
Multi-Cap	16.14	**14.96**	**14.57**	**15.12**	
All Except Multi	**16.58**	13.54	12.72	14.15	
Large-Cap	5.87	3.92	3.06	4.38	Three
Multi-Cap	**7.78**	**7.08**	**7.22**	**7.31**	
All Except Multi	7.45	5.80	4.72	5.95	
Large-Cap	3.81	-1.91	-7.47	-1.65	Five
Multi-Cap	**8.12**	**1.65**	**-2.83**	**1.70**	
All Except Multi	7.08	1.31	-4.32	1.28	
Large-Cap	11.14	9.48	8.46	9.75	Ten
Multi-Cap	**12.62**	**11.56**	**11.55**	**11.84**	
All Except Multi	12.00	10.28	9.33	10.52	
Large-Cap	11.30	10.69	10.06	10.78	Fifteen
Multi-Cap	**12.79**	**12.35**	**12.42**	**12.51**	
All Except Multi	12.14	11.05	10.46	11.29	

It is well established in the academic literature and in actual long-term performance data that small beats mid-cap, which in turn outruns large. Therefore, in the interest of simplicity of presentation we show multi-cap performance against only the overall average and the large-cap funds with which they are most often confused. What the results show is that investors who bought all multi-cap funds would have fared better financially than others who bought all available funds focused on specific capitalization allocations. One might reasonably argue that perhaps the results shown are end-point dependent, or that if investors had allocated their money differently the results might not have favored multi-cap portfolios. Even if those points are granted, a key finding remains: returns in multi-cp funds *are systematically different* from those among either large-cap or mid-cap funds, and therefore one must be sure to compare a specific fund of interest against its properly defined peer group in order to draw fair conclusions. This warning applies to boards of directors, chief investment officers, performance comparison analysts, individual investors, and financial advisers evaluating funds for clients. The differences are real!

Volatility

Perhaps not surprisingly, multi-cap funds display a modestly lower average standard deviation of returns than do their size-designated cousins. To examine this issue we measured fluctuation of returns across three time frames: individual monthly returns across 36 and 60 months (ended March 31, 2005) and 52 weekly returns ended at the same date. The smallest difference (15 basis points) occurred in the three-year comparison, and the largest (29 basis points) occurred in the five-year comparison (which included all of the recent bear market's violence). Table 4 provides the details.

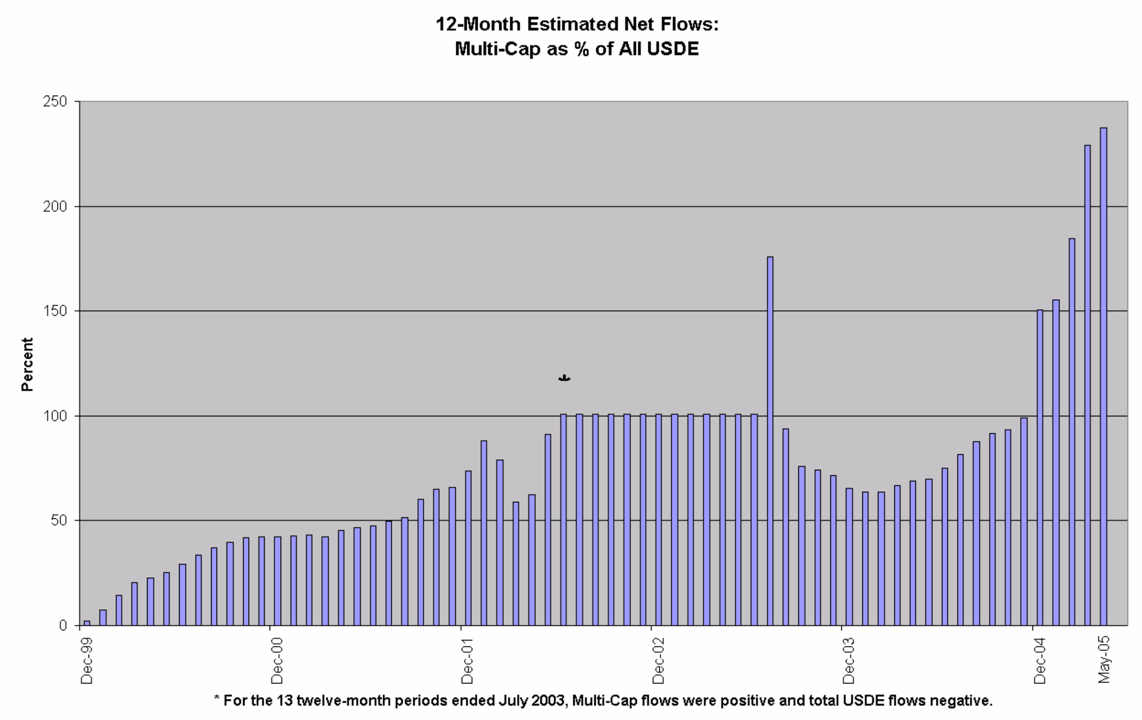
Table 4: Comparison of Percent Standard Deviations of Returns for USDE Funds.

	36 Months	60 Months	52 Weeks
Multi-Cap	4.52	5.23	1.51
Average: L, Mid, Sm	4.67	5.52	1.71

This finding is reasonably intuitive in that the size-diversified portfolio is likely to enjoy a blending of stocks whose sizes may individually go into/out of style over time. In addition, the portfolio manager here has more freedom to shift size focus over time, thus potentially muting the greater volatility associated with any single size-defined asset class and arguably taking his or her permitted greater advantage of shifts in leadership that develop.

Flows

Recently, multi-cap funds have enjoyed very strong net inflows of money. Some of this might be attributed to the presence in this classification of a few funds that have become very popular in the post-scandal period. However, we believe another somewhat subtler force is at work: since losing a great deal of money in stocks and funds in the bubble-unwinding bear market, individual investors have become very cautious and many now have low self-confidence about their choosing abilities. A multi-cap choice reduces the chances of timing market tastes badly or late and offers instead a comfortable middle-ground path: let the professionals decide, since I do not know how to do this very well. For 27 consecutive months, beginning six months before the first scandal revelations, net inflows have been larger in multi-cap funds than in any of the specific-size types; in a number of recent cases (five of the six months since December 2004), the former have had net inflows, while the others combined have suffered outflows. With such striking differences in overall flows patterns, competitive analysis of one's product line can be significantly misled by classifying a true multi-cap fund as either a large-cap or mid-cap product.



Expense Ratios

Multi-cap funds differentiate themselves slightly, but positively, when one examines relative expense ratios. Using the latest reported fiscal year's data for all funds, we find that multi-cap funds have a dollar-weighted 0.91% expense ratio, slightly below that of large-cap funds (0.94%). For whatever combination of reasons, the multi-cap types came in about 8 or 9 basis points lower in the growth and core styles but were some 4 basis points higher among value-type funds. One factor that may have been helping the unconstrained funds lately is that they have been gaining assets, while large-cap portfolios taken as a whole have seen net drains. This contrasting dynamic exerts some influence on relative economies of scale.

Table 5: Relative Expense Ratios of Multi-Cap and other USDE Funds

	Value	Core	Growth	All
Large-Cap	0.787	0.954	1.107	0.942
Multi-Cap	**0.827**	**0.861**	**1.025**	**0.910**
Mid-Cap	1.138	1.029	1.246	1.114
Small-Cap	1.158	1.111	1.253	1.167
All Except Multi-Cap	0.910	0.989	1.165	1.011

Expense ratios for mid-cap and small-cap funds cluster quite closely but are clearly some distance above those for the multi-cap type. Such funds are of course more research-intensive and many have come into being in more recent years when new funds seemed to be adopting slightly higher advisory fees than had been taken in the deep past. For whatever the reasons, mid-cap and small-cap portfolios' total expense ratios are in the 1.11% and 1.17% area on a dollar-weighted basis (we prefer to use dollar weighting since it reflects what is happening to investors' assets collectively and eliminates any biases in weighting multi-class versus single-class funds). Those numbers are 20 to 25 basis points above what investors in multi-cap funds are bearing. On an overall-average basis the multi-cap funds have a 10% and 10-basis-point cost advantage versus the aggregate of all USDE funds pursuing individual size mandates: 0.91% against 1.01%. As noted above, only the large-cap funds beat them and that was by just 3 basis points. In this case, comparing a fund that is truly multi-cap in nature against a fund focused truly at the upper capitalization ranges might not be too much of a biased exercise. However, if a true multi-cap portfolio is called mid-cap in other description/classification schemes, considerable apples/oranges issues are raised on average.

Turnover Ratios

Interestingly, multi-cap funds' portfolio managers seem to engage in moderately lower annual turnover than do the managers of other USDE portfolios on average. (Again, we examined dollar-weighted averages to neutralize the effects of size discrepancies and to prevent multiple counting of multi-class funds.) The average portfolio turnover as a percentage of ANA for the single latest reported fiscal year was 46% for multi-cap funds versus 52% for the combination of all small-, mid-, and large-cap portfolios. Looking at the individual size groupings, the lower-turnover pattern holds for all except large-cap funds. This finding is perhaps somewhat counterintuitive in that arguably the multi-cap manager has a wider universe of stocks in which to buy and sell and also must deal with occasional size-defined shifts in market leadership. Nevertheless, the numbers stand as quoted. Table 7 provides the details for each cell of the USDE matrix.

With the exception of a single cell pair in the 4x3 USDE matrix, namely among growth-style portfolios, large-cap funds had moderately lower turnover than did the multi-cap types. There, however, the comparison was striking, with a difference of 52% versus 72% in favor of the unconstrained managers. We find any degree of lower turnover for multi-cap funds to be really quite remarkable, in that managers here have the entire securities universe in which to shop and are arguably pressured to match the performance of competitors—other managers whom they presume to be actively allocating on a size basis as market tastes shift. One can perhaps readily understand how large-cap *core* and *value* managers achieved moderately lower turnover than did their size-unconstrained colleagues: many of the former are closet indexers to some extent. If you are a large-cap manager, when do you ever actually sell out your large positions in IBM, ExxonMobil, GE, Pfizer, or Bank of America?

Table 6: Relative Turnover Ratios of Multi-Cap and other USDE Funds Matrix

	Value	Core	Growth	All
Large-Cap	27	41	72	45
Multi-Cap	**36**	**46**	**52**	**46**
Mid-Cap	44	54	100	69
Small-Cap	53	57	90	67
All Except Multi-Cap	33	45	82	52

Looking elsewhere in the matrix, it is perhaps surprising that the degree of higher turnover ratios was not even more pronounced in the small-cap and mid-cap types, which each averaged just a bit less than 70%. Companies in these parts of the corporate size and maturity spectrum experience much greater operating change over time than do their larger and more mature cousins. And clearly their stocks display greater volatility, arguably prompting money managers to buy and sell more often. Indeed, it was exactly in the growth column, where portfolios are more prone to aggressive management, that the highest turnover ratio averages (90% and 100%) were exhibited for the small-cap and mid-cap managers.

Once again, it bears mention that comparison against true peers is very important. For example, a true multi-cap value fund with perhaps a 30% turnover ratio might appear to be slightly above average on this measure if examined against true large-cap funds but would be comfortably below average against its own real peers. And if one looks at a multi-cap fund in proper context, namely that its manager does face choices from the entire universe in a dynamic market environment, one comes to a different conclusion as to turnover practices than if one sees that fund through a different (and not quite as refined) lens.

Commissions Costs

The scandal involving improper frequent trading has increased the attention paid to commissions costs, since trading to some extent drives portfolio managers' buying and selling, which increase trading costs. Not all trading costs (spread slippage and market impact) can be precisely measured, but to the extent that funds comply with SEC regulation and report commissions paid it can be seen that higher turnover generally leads to higher commissions paid, as would be intuitively assumed. Our research has indicated (See FundIndustry Insight Report titled, "Mutual Fund Trading and Transaction Costs at http://www.research.lipper.wallst.com/searchResults.asp#anchorFundIndustry) and in a smaller set of portfolios that in many dozens of cases commissions costs *per se* exceed 1% of ANA per year, and in a smaller set of portfolios they actually exceed the widely watched reported "total expense ratio," which is calculated excluding them. The above is recited as a prelude to a study of commissions in multi-cap funds versus other diversified types, because such factors may in some ways have affected the observed results in recent years.

The patterns regarding relative commissions costs by type of fund run strongly in parallel to those for portfolio turnover ratios. Commissions costs, which Lipper measures in basis points per dollar of ANA, run inversely by size of the stocks involved: large-cap funds incur the lowest commissions, followed by mid-cap, with small-cap funds spending the most. This is true not only in the summary column of the accompanying table, but also in each column with a single exception (the same one as on the turnover table): multi-cap growth funds spent the lowest amount on commissions per dollar of assets, even besting large-cap growth funds. This is a direct parallel to the anomalous cell in the turnover ratio grid, where large had 72% but multi only 52%.

Table 7: Relative Commissions Costs of Multi-Cap and other USDE Funds

	Value	Core	Growth	All Styles
Large-Cap	5.6	5.9	16.9	8.3
Multi-Cap	**8.3**	**13.3**	***13.5***	**11.8**
Mid-Cap	16.1	14.5	27.8	20.1
Small-Cap	21.1	23.0	32.0	26.2

Commissions are one area in which multi-cap funds do not show up as better than other size-specific types. We believe the reason for this is that typical commissions costs involved in running small-cap and mid-cap portfolios are so substantially higher than for trading large-cap stocks that on a weighted-average basis the commissions involved in running multi-cap funds are above those for large-cap types. Whatever the exact averages per type, however, it is important to recognize the existence of real differences and therefore to compare a fund against its true peer group. Looking only at large versus multi, the differences in commissions per dollar of ANA average 42%, and they range from 20% in the growth style to 125% in the core cell of the matrix.

- END -