

# The Best Funds for 2009

**Special Report** | Fourth Quarter 2008 | by Andrew Gogerty

If 2007 was a stressful year for investors, then 2008 has been a sucker-punch to the stomach. The credit crisis stemming from the default of subprime mortgages continued its spread this year, and in affect caused a complete upheaval of U.S. investment-banking landscape. Who would have thought that Lehman Brothers and Bear Stearns would no longer exist, and that Merrill Lynch's survival would likely depend on ceding a 20% ownership stake to a Japanese bank? The financial sector's troubles bled through to all areas of the market, as concerns about the future profile of global credit access and stability of money market funds sent both stocks and bonds on a roller coaster ride. In fact, in less than a 30-day span during September and October investors were subject to the biggest one day gain of the Dow Jones Industrial Average and one of its worst losses since the Great Depression.

The gyrations have pummeled investor confidence, and the industry has seen outflows from money market and equity funds as investors headed for the safety of cash. In the short run that may appear prudent, but in the long-run now may be a great buying opportunity. Just like fund managers who salivate at the prospect of buying individual stocks below their fair value estimates, the market's broad declines have put whole portfolios of high-quality holdings on sale. While the losses this year made many investors re-examine their risk tolerances, I urge them to continue to invest in high-quality, lower-cost funds in line with their personal asset-allocation targets. That is truly the way to build long-term wealth.

With that advice in mind, I've divided the following list into three sections. The Portfolio Anchors are no hassle ways to begin a new portfolio or leading candidates for a prominent spot during a re-allocation. Our Opportunity Hounds have the guts to wade into downtrodden areas and pick out gems, while our Role Players are just that: a few additional funds that can round out the edges of your portfolio. These picks may look to zig when the rest of your funds zag, but at the same time still contribute to long-term total returns. Keep in mind, I'm not saying that these funds will be top-performers on a

year-in, year-out basis, but over the longer-term of five years or more I think they will come out on top.

## Portfolio Anchors

### Fairholme FAIRX

This fund has suffered right along with the rest of our picks in 2008. Through October 13th, its 22% decline was likely of little comfort to investors, despite being well ahead of the more than 30% decline of the S&P 500 Index and large-blend category. But one year doesn't shake our confidence in manager Bruce Berkowitz and team, and we appreciate that he believes that the key to a fund's success is finding management teams that are serial winners with whom the fund can partner for the long haul. Fund investors who take the same approach won't be disappointed here, as the fund's longterm returns are among the best around.

The fund is positioned relatively conservatively, with almost a constant double-digit cash stake. Turnover is excruciatingly low, and the portfolio typically contains less than 30 holdings. Berkowitz's focus on cash—both as an investment and in evaluating management—has keyed the fund's outperformance this year. Although the portfolio has had upwards of 30% of assets in the financial sector this year, he sidestepped disasters such as insurer American International Group and investment bank Lehman Brothers because he was concerned with the companies' exposure to derivatives and the estimates they make when valuing large portions of their assets. If his team can't understand how a firm gets its cash, or what is behind its balance sheet, the fund will gladly take a pass. I like this approach, and have made this fund the largest holding in my portfolio.

### T. Rowe Price Blue Chip Growth TRBCX

A broadly diversified large-cap portfolio typically keeps this fund out of too much trouble. In 2007, for example, strong showings from Amazon.com, Apple, and others outweighed disappointing performances from Goldman Sachs, UBS, and other financials. We like the fund's steady approach, and we like manager Larry Puglia's long track record. He's led the effort here for almost 15 years, so he's seen his share of

extreme market environments. Investors looking for a large-growth offering that doesn't go to the extremes will like what they find here.

#### **Fidelity Spartan Total Market Index** FSTMX

The U.S. market has been quite the disaster this year, but over the long-term this fund will likely remain a legitimate rival to higher-priced, actively managed largecap funds. This fund tracks the Wilshire 5000 Index, which includes nearly all of the publicly traded stocks in the United States. That profile gives it unparalleled breadth and makes it an ideal choice as an anchor or stand-alone U.S. equity holding. Vanguard, of course, has a suite of topnotch index funds, including a total stock market index offering like this one. Fidelity upped the ante in the index-fund fee wars, however, by permanently reducing the costs of this and four other domestic-equity index funds to just 0.10%. That makes Fidelity's index offerings the cheapest nonexchange-traded funds around.

#### **Sound Shore** SSHFX

Managers Harry Burn and Gibbs Kane largely avoided subprime problems by sticking to their knitting of seeking out beaten-down firms with solid fundamentals. They have no interest in finding the turnaround stories with the potential for the greatest gains if there's a real risk the company could fail. Rather, they want the companies with the best balance sheets and a high level of confidence of what a company will earn in the next few years. Their patient and careful strategy has helped the fund deliver solid long-term results, and its year-to-year returns have also been remarkably consistent, with the fund ranking in the large-value category's best half in six of the past seven years. We wouldn't expect the latter to continue, especially during a growth-fueled rally, but over time the fund is in position to remain a winner.

#### **Vanguard GNMA** VFIX

How can we recommend a mortgage fund when the mortgage universe has come under such fire? Easily. For starters, it holds a diversified mix of Ginnie Mae mortgages, which, unlike other mortgage issues, are backed by the full faith and credit of the U.S. government and have been for some time. Second, its ultra low expense ratio provides it a nearly insurmountable advantage over its government-focused peers. The fund's expense advantage has helped it post strong long-term results, while its focus on government mortgages has kept it out of trouble. Its focus is narrow, but we think it has broad appeal.

#### **Dodge & Cox International** DODFX

This offering has quickly emerged as one of the standouts in its class. That's because it draws upon a highly experienced management team. The typical skipper here has nearly two decades of experience at Dodge & Cox, and several members of this fund's management team also serve as managers on the superb Dodge & Cox Stock. As with the other Dodge & Cox funds, the managers apply a patient, bargain-hunting approach here. (The fund's turnover rate is invariably in the single digits, and its portfolio's price multiples are low relative to other value-oriented foreign funds.) We're not surprised with the fund's consistent success and that it has gotten off to a strong start—Morningstar named this fund's management team its International-Stock Managers of the Year for 2004—and we think its future prospects remain equally bright. In addition to having an experienced management team plying a time-tested strategy, the fund also has the benefit of very low costs: Its 0.65% expense ratio is one of the cheapest levies for a no-load, foreign large-cap offering. Like the U.S. market, foreign stock markets have been weighed down by global credit concerns and overall slower growth, but international exposure still remains a core foundation to any well-constructed portfolio.

#### **Opportunity Hounds**

##### **Third Avenue Value** TAVFX

Marty Whitman (like all of our picks in this section) made our list last year, and we continue to think he is one of the better bargain-hunters around. He has been known to bulk up on junk bonds, small-cap stocks, overseas issues, or nearly any other investment type that he sees as cheap. That flexibility can make this fund hard to slot into an asset-allocation plan, but it means the fund has the potential to deliver good results in a variety of market conditions. Indeed, the fund delivered strong results in 2000, when the market struggled, but also put up big numbers from 2003 to 2006, when the market rallied. We also like the fund's quarterly shareholder letters, which keep investors very informed about what Whitman is buying and selling, and why.

##### **Primecap Aggressive Growth** POAGX

The fund's approach can cause some ups and downs, but it's a proven one that has been in place for almost 10 years at Vanguard Capital Opportunity. When management finds cheap, out-of-favor growth stocks it will look to take advantage of them, even if owning them means holding outsized stakes in specific sectors of the market. This fund's smaller asset base allows it to be flexible and opportunistic, in that management can build up meaningful positions quickly and exit

just as fast. That's not to say the team trades rapidly. In fact, the fund has one of the lowest turnover rates in the mid-growth category.

#### **Loomis Sayles Bond** LSBDX

Managers Dan Fuss and Kathleen Gaffney have more latitude than most to take advantage of market volatility. The duo will venture into junk bonds, emerging markets issues, government bonds, and currency in an effort to deliver superior results. Fuss and Gaffney also position the fund based on their interest-rate outlook. Added interest-rate sensitivity and added credit risk make this fund a risky option for bond investors, but market volatility means opportunity for Fuss and Gaffney. The fund has dug itself somewhat of a hole in 2008 with its stakes in corporate and high-yield bonds, but over the long-term we think investors comfortable with its potential for ups and downs will continue to like what they find here.

#### **Metropolitan West Total Return** MWTRX

The management team at MetWest has been tracking subprime mortgages in earnest since 2004. That homework helped them largely avoid the problems associated with the sector in 2007, and they used their research heft to emphasize residential-housing-related fare—prime and subprime—given high yields, significant total-return potential, and good protection from actual loan losses in 2008. To be sure, management was on the other side of the table in 2002, when it was caught off guard by extreme volatility in the corporate-bond sector. However, good bottom-up research helped the fund recover the ground it lost during the market's subsequent rally. We expect that research will again pay off for shareholders here going forward.

#### **Role Players**

##### **T. Rowe Price Real Estate** TRREX

Manager David Lee just celebrated his 10-year anniversary as lead skipper on this offering, and his experience combined with the fund's low fees increases its odds of staying ahead of the pack. Lee doesn't have any army of analysts behind him touted by some rivals, but has managed to beat them nonetheless. More importantly, this fund shares the broader T. Rowe Price philosophy of long-term investing. In fact, the fund has been one of the most consistent offerings in the category, and its expenses have come down as assets have grown. So, while we don't expect real estate funds to be a ray of hope in every down market, their diversification value makes adding exposure to this sector a no-brainer.

#### **Vanguard Inflation-Protected Securities** VIPSX

This fund's appeal is more-narrow, but it has a number of valuable traits, including a rock-bottom fees. Its primary goal, however, is its ability to defend against inflation by holding U.S. Treasury Inflation-Protected Securities, commonly called TIPS. These securities have a fixed coupon rate, but their principal value adjusts based on changes in the consumer price index. As this principal is revised upward, the bonds pay more interest to bondholders. To be sure, the fund isn't immune to interest-rate risk, but overall we think it can play an important role within a broadly diversified portfolio.

#### **Brandywine** BRWIX

Manager Bill D'Alonzo's go-anywhere portfolio can play a suitable supporting role within a portfolio dominated by large-cap stocks. His team focuses on identifying companies that they believe will beat the next round of earnings estimates. But rather than just evaluating the business prospects and financial statements, D'Alonzo's analysts work the phones and contact suppliers, customers, and competitors to get the full picture of a company's potential. The results have been good thus far and its returns haven't been closely correlated with those of the S&P 500 Index. We remain fans of this unique approach, and continue to expect good things from this fund in the years ahead.

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*Andrew Gogerty is the editor of Morningstar Mutual Funds.*

# Metropolitan West Total Return Bond Fund (M-Class) ★★★★★

5-Star Overall Morningstar Rating based on risk-adjusted returns as of 9/30/08 among 984 Intermediate-Term Bond Funds.

## NET PERFORMANCE TOTAL RETURNS - As of September 30, 2008

	Q3 '08	YTD	1-year	Annualized			
				3-year	5-year	10-year	Since Inception
<b>MWTRX (Inception: 03/31/1997)<sup>1</sup></b>	-1.77%	-2.65%	-0.71%	3.51%	4.40%	5.50%	6.38%
<b>Lehman Brothers Aggregate Index<sup>2</sup></b>	-0.49%	0.63%	3.65%	4.15%	3.78%	5.19%	6.13%
<b>Under/Outperformance</b>	-128 bps	-328 bps	-436 bps	-64 bps	62 bps	31 bps	25 bps
% Rank in Category			44	18	2	4	

The performance data quoted represents past performance and does not guarantee future results. Current performance may be lower or higher. Performance data current to the most recent month-end may be obtained at [www.mwamllc.com](http://www.mwamllc.com). The investment return and principal value of an investment will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Without fee waivers, returns would have been lower. The Fund offers another class, the performance for which will vary due to fees and expenses.

For MWTRX the total expense ratio is 0.66% and the net expense ratio is 0.65%. Expenses reflect a contractual agreement by the Adviser to reduce its fees and/or absorb expenses to limit the Fund's total annual operating expenses for the current fiscal year. The Adviser voluntarily extended the agreement for the current fiscal year, and expects to renew the contractual expense limitation each year in May. For more information about fees and expenses, please read the prospectus.

<sup>1</sup> Total return figures assume reinvestment of all distributions. Total returns reflect fee waivers in effect. Without fee waivers returns would have been lower. For Class M, 12b-1 fees were not charged until April 1, 2000.

<sup>2</sup> The Lehman Brothers Aggregate Index is an unmanaged index not available for direct investment. Unlike a mutual fund, the performance of an index assumes no taxes, transaction costs, management fees, or other expenses.

Bond Funds have the same interest rate, yield and credit risks associated with the underlying bonds in the portfolio, all of which could reduce the Fund's value. As interest rates rise, the value of the Fund can decline and an investor can lose principal.

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year Morningstar Rating metrics. The Metropolitan West Total Return Bond Fund M-Class was rated 4 stars for the 3-year period, 5 stars for the 5-year period and 5 stars for the 10-year period against 984, 848 and 456 U.S.-Domiciled Intermediate-Term Bond Funds respectively.

The Metropolitan West Total Return Bond Fund (MWTRX) was ranked by Morningstar as of 9/30/08 based on total return within the Intermediate-Term Bond category. The fund received a percentile ranking of 44%, 18%, 2% and 4% among 1126, 984, 848 and 456 funds for the one-, three-, five- and ten-year periods, respectively. Morningstar ranks funds from 1 (being the highest percentile rank) to 100 (the lowest percentile rank). A top-performing fund will receive a rank of 1 in its category. Morningstar ratings and rankings are for the M share class only; other classes may have different performance characteristics. Past performance is no guarantee of future results.

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