

GETTING GOING

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Forget the S&P 500: Here's How to Tell
If You Are Really Beating the Market

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Stock investors haven't made a whole lot of money over the past five or six years, but they sure feel good about it.

Indeed, I have lately received a slew of emails from ordinary investors, all boasting about how they've whipped the Standard & Poor's 500-stock index. And I believe them. But I don't believe they're investment geniuses.

Here's why beating the S&P 500 is no great accomplishment -- and how to properly gauge your investment prowess.

- **Feeling blue.** In the late 1990s, investors struggled to beat the S&P 500, as a rip-roaring bull market propelled the blue-chip-stock index to 20%-plus gains in five consecutive calendar years. Back then, money managers often whined that they shouldn't be compared to the S&P 500.

They aren't whining anymore. Over the past six calendar years, the S&P 500 has fallen a cumulative 6.6%, including dividends. Meanwhile, the Dow Jones Wilshire 4500 index of small and midsize stocks is up 18%, Morgan Stanley Capital International's Europe, Australasia and Far East index has gained 7.2%, and the Lehman Brothers Aggregate Bond index has notched 48.5%.

Thanks to that disparity in returns, it's been a cinch to beat the market -- assuming you define the market as the S&P 500. In fact, if you haven't outpaced the S&P 500 over the past five or six years, something is likely seriously wrong with your investment strategy.

After all, as part of a well-diversified portfolio, you ought to spread your money across large stocks, smaller companies, foreign markets and bonds. Any mix of that kind should have handily beaten the S&P 500.

Still convinced that beating the S&P 500 is the litmus test for investment genius? In that case, even I can claim to be a market-beating genius.

I have my individual retirement account and my taxable account at a fund company that offers monthly updates on my personal rate of return. Apparently, over the five years through April, my investments have clocked 8.6% a year, well ahead of the S&P 500's 2.7% annualized gain.

Yet it would be absurd for me to boast about my investment acumen. Almost all of my stock-market money is in index funds, which are designed to replicate the performance of the market averages. The only reason I appear to be beating the market is because my index funds include exposure to small stocks and foreign markets, both of which have easily outpaced the S&P 500.

- **Measuring up.** Of course, there's a chance that you have indeed picked market-beating stocks and funds. To know for sure, however, you need to compare each of your picks to the right index -- and often that isn't nearly so flattering.

Consider the performance of actively managed U.S. stock-mutual funds. According to Chicago investment researcher Morningstar Inc., 68% of these funds have beaten the S&P 500 over the past five years. But you get a totally different picture if you use the correct benchmark indexes.

For proof, check out an ongoing study by Standard & Poor's, a division of **McGraw-Hill**. It divvies up funds into nine "style boxes" and then analyzes their performance against an appropriate index. For instance, small-company value funds are stacked up against the S&P SmallCap 600/Citigroup Value index, while midcap blend funds are compared to the S&P MidCap 400 index.

Result: Over the five years through March 31, a majority of funds in all nine categories have lagged behind their benchmark index. "In my experience, over long periods of time, it's highly unlikely that a manager will beat a properly defined benchmark," says Nelson Lam, an investment adviser in Lake Oswego, Ore.

Want to see just how different your investment mix is from the S&P 500, while also getting a better handle on which indexes to use when assessing your portfolio? Head to www.morningstar.com¹, click on "tools" and then input your portfolio into the site's "Instant X-Ray."

That will tell you, among other things, your portfolio's mix of U.S. stocks, foreign stocks, bonds and cash. It will also compare your stock portfolio's sector weightings and average market capitalization to the S&P 500. My hunch: You will discover your investment mix looks nothing like the S&P 500, and thus there's no way your portfolio's success should be judged using that index.

So which indexes should you use? As a first step, you might compare the results of your stocks and funds to the performance of index funds that focus on the same market sector. To that end, head to www.vanguard.com², the Web site for Vanguard Group. At the site, you can get detailed performance information on Vanguard's slew of index funds.

"The problem is, your funds may invest in a slightly different universe of stocks," Mr. Lam warns. "For instance, you might compare your international fund to an international-index fund. But if your international fund has a lot of emerging-markets exposure, it might not be a fair comparison."

To get around this problem, you could use Morningstar's Instant X-Ray to analyze all your holdings and then create a shadow portfolio of multiple index funds that has a similar overall mix of sectors and regions. What if the shadow portfolio outperforms your investment picks? Maybe you aren't an investment genius after all -- and maybe you should buy the shadow portfolio.

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