Steady funds for unsteady times

Several low-risk Money 70 funds have held up better than their peers so far this year. Here’s why.

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(MONEY Magazine) – Remember those slow-but-steady stock funds that frustrated you last year - the ones you thought about getting rid of because they were lagging when the market was up?

Well, a market downturn like this, in which the average large-cap growth fund has lost 6.8% since January, serves as a good reminder of why you want Steady Eddies in your long-term portfolio.

During the recent bull market, low-risk equity funds that avoided high-flying, high-priced stocks routinely found themselves in the bottom half of their peer groups. This includes several Money 70 offerings, such as American Funds American Mutual, FPA Perennial, Jensen and Matrix Advisors Value.

Despite disappointing five-year numbers, we kept these portfolios on our list of recommended mutual funds and ETFs because we thought their disciplined approach to investing made them sound choices for difficult times. We also thought it was unfair to judge them strictly on how they performed in an uninterrupted bull market.

Today's downturn is bearing this out. In times like these, investors tend to flock to safe havens, such as the blue-chip stocks favored by these funds. As a result, these funds now rank near the top of their peer groups for the year.

Granted, even a conservative fund can lose money in this type of market. But it's likely to lose less than the market. For instance, the Fairholme fund, another risk-averse Money 70 member, is down just 0.03% so far this year.

If the economy slides into a recession or if conditions on Wall Street worsen, these funds will attract even more attention. That's because "low-risk stock funds have always focused on attributes that are prized in a recession - such as high-quality stocks and cash," says Chris Davis, an analyst at Morningstar.

Here's a look at how some Money 70 funds are staying ahead of the crowd in this market. Note that not all conservative funds follow the exact same playbook.

A willingness to hold cash

The $7.3 billion Fairholme fund uses cash in a couple of different ways. First, it plays defense with it. When Fairholme's managers can't find stocks they like - shares of high-quality, industry-leading firms trading at deep discounts - they simply let their cash stake grow.

In fact, cash is often the fund's single largest holding, making up as much as 30% of assets. "Our main rule is to not lose money," says co-manager Bruce Berkowitz.

But cash also comes in handy when the fund's managers want to go on the offensive. The fund's cash stake has been whittled down to around 20% lately as the managers have scooped up bargains such as St. Joe's (JOE), a Florida real estate developer, and WellCare (WCG), a managed-care company.

A focus on high-quality stocks

The bull market of the past five years rewarded a certain kind of mediocrity. "Lots of middling companies commanded high prices because they were targets of private equity, which could buy them and turn them around," says Eric Ende, co-manager of FPA Perennial.

But because this $337 million midcap growth fund invests only in well-run companies that deliver a high return on capital - in other words, extremely profitable outfits - its holdings didn't enjoy the same private equity premium that others did.

But that boom has fizzled out, so the market is coming back around to FPA Perennial's turf: companies with strong balance sheets and earnings growth like CarMax (KMX, Fortune 500), the used-car retailer, and the trucking firm Knight Transportation (KNX).

The discipline to be diversified

While some investors bet on only a few of their best ideas in a choppy market, the managers of American Funds American Mutual are sticking with their broadly diversified portfolio - some 200 mostly dividend-paying stocks such as General Electric (GE, Fortune 500) and IBM (IBM, Fortune 500). This strategy helped the $20 billion fund avoid disasters in troubled financial stocks (less than 14% of the fund's assets are in that sector vs. 24% for its peers).

Not surprisingly, the fund has performed better than average this year. Better still, it has done the same over the past one and three years - all with a safer-than-average portfolio.

Now a note of caution: If you already own low-risk funds and are thinking of increasing your allocation to them, be careful. If stocks continue to fall and low-risk funds continue to outperform, the market will do the job for you.

In the long run you need to hold both stable funds like these and aggressive funds that have not fared as well in today's market. In fact, **Anthony Ogorek**, a financial adviser in Williamsville, N.Y., says, "Now's the time to start looking at rebalancing into your harder-hit holdings."

While it may make you nervous to add money to a fund that is down sharply (perhaps because of holdings in some disastrous stocks), remember that your low-risk funds will help cushion any short-term losses. And you'll probably be glad you had exposure to aggressive funds when the market revs back up.