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Follow the Smart Money

We polled top financial pros to find five of their favorite funds.

By Adrienne Carter

In theory, mutual funds are a convenient and cost-effective way to invest for retirement. In reality, there are thousands out there, and many are high in costs and low in returns.

We went to some leading financial advisers, people whose job it is to ferret out the best funds for their clients. Using their recommendations, we assembled a small but diverse list of smart funds, any of which you could easily work into an investment program. For sure, hundreds of other funds could work, too. But you won't go wrong with any of these.

iShares Dow Jones Select Dividend Index Fund (DVY)

Dividends are a pretty sweet deal these days. The tax rates on most are now 15%, down from 35% or more two years ago. Plus, in a market like this one that stubbornly refuses to move much in either direction, a fairly predictable stream of dividends is the closest thing investors have to a sure bet. Exchange-traded fund iShares Dow Jones Select Dividend Index is one of the cheapest and easiest ways to boost any portfolio's dividend income.

The \$7.1 billion fund -- it only launched in late 2003 -- focuses on companies that have steadily increased their dividends over the past five years. Not surprisingly, the

100-company portfolio is chock-full of utilities, industrials, and financial companies. But it also has a good dose of health-care holdings such as pharmaceutical giants Merck (MRK) and Bristol-Myers Squibb (BMY).

Now the fund's yield is a shade over 3%, vs. 1.7% for the Standard & Poor's 500-stock index. One caveat: Not all the dividends qualify for the 15% tax rate. In 2004 the fund's \$1.91 a share distribution included 28 cents of nonqualified income, which was taxed at the shareholders' regular income tax rate. As with any ETF, you'll need a brokerage account to buy shares. Still, for a small price up front, this fund has a pretty hefty payout.

T. Rowe Price Capital Appreciation Fund

It isn't easy to define T. Rowe Price Capital Appreciation. Indeed, fund analysts disagree on how to classify this \$6.4 billion portfolio. Morningstar (MORN) calls it a moderate allocation fund, while Lipper (RTRSY) counts it as a multi-cap value fund.

BusinessWeek's Mutual Fund Scoreboard labels it a domestic hybrid -- a combo of stocks, bonds, and cash. But with its unusual invest-anywhere strategy, the fund not only defies categorization, it defies the odds. It hasn't had a single losing year since 1990.

The idea is simple: Manager Stephen

Boesel seeks out undervalued investments, whatever they may be. He may load up on stocks, high-yield bonds, convertible securities, or even cash, depending on which offers the best opportunity. "The fund has a split personality," jokes Boesel, who has run the fund since 2001.

He generally keeps the equity stake at 60% to 70% of assets, though it can go to 100%. Currently around two-thirds of the fund is stocks, mainly "fallen" growth companies. Given the threat of rising interest rates and a flattening of the yield curve, Boesel avoided bonds. Some 20% is in cash, but he's looking to put some of that into convertibles.

The ability to change course gives the fund a stability that an all-stock fund doesn't have. "It's never going to return 40% in a year," says Robert Steffen, a fee-only financial planner in Bloomington, Minn. "But it's never going to lose 20%, either."

Dodge & Cox International Stock Fund (DODFX)

Kenny Rogers would be impressed. When it comes to the stocks in their portfolio, the seven-person team at Dodge & Cox International Stock knows when to hold them, and it knows when to fold them. But they're not gamblers. Group members, who together must reach a consensus on investments, take a hard look at each

BANG FOR THE BUCK

FUND / SYMBOL	CATEGORY	MANAGER	SALES CHARGE	EXPENSE RATIO	TOTAL RETURN*		
					1-YR.	3-YR.	5-YR.
iShare Dow Jones Select Dividend Index DVY	Large-cap Value	Team	None**	0.40%	14.45%	NA	NA
T. Rowe Price Capital Appreciation PRWCX	Domestic Hybrid	Stephen Boesel	None	0.78	10.72	12.62%	13.64%
Dodge & Cox International Stock DODFX	Foreign	Team	None	0.77	22.45	19.59	NA
Pimco Commodity Real Return Strategy PCRAX	Natural Resources	John Brynjolfsson	5.5%***	1.24	15.53	NA	NA
Metropolitan West Total Return Bond MWTRX	Intermediate Bond	Team	None	0.65	7.81	7.85	7.18

* Appreciation plus reinvestment of dividends and capital gains before taxes, for periods ending June 30, 2005. Multi-year returns are average annual.

** Exchange-traded fund, subject to stock brokerage commissions.

*** No-load shares are available through Schwab, Fidelity, T.D. Waterhouse and other mutual fund supermarkets

NA = Not applicable

Data: Morningstar, *BusinessWeek*

company's valuation and growth prospects. Behind the team are 20 analysts who cover the globe.

In-depth research gives them the confidence to load up on -- or unload -- specific sectors or countries. The managers now have just 10% of the fund's assets in European financial stocks. That's about half the weighting in the Morgan Stanley Capital International Europe Asia Far East Index, the fund's benchmark. They have 15% in emerging-markets companies, including the Brazilian energy giant Petrobras (PBR) and South Africa's Standard Bank Group. The MSCI index doesn't have any exposure to that fast-growing group.

Dodge & Cox developed this research-intensive, team-style investing in the 1930s, originally with domestic equities and bonds. So far it's paying off for the company's four-year-old international value fund. The fund's 19.59% annualized returns since mid-2002 put it in the top 2% of its peers. The firm's top-drawer equity and balanced funds are so popular they're now closed to new investors.

Pimco Commodity Real Return Strategy Fund

To be truly diversified, you need more than stocks, bonds, and cash. That's why owning a fund like Pimco Commodity Real Return Strategy makes sense. Hard assets such as oil and gold help hedge against inflation, and they tend to do well when financial assets are doing poorly. "Stocks, bonds, and cash have been the mantra because that combination has done quite well over last couple of decades," says Michael Francis, an independent consultant to 401(k) plan sponsors. "Now we're in an economic cycle that warrants diversifying your retirement portfolio into nonfinancial assets."

Some investors look to the stocks of oil drillers, gold miners, or steel manufacturers to gain exposure to commodities. That may work, but stocks are imperfect proxies. An accounting snafu or a management scandal could crush the stock regardless of what's happening with

commodities. Such companies also tend to be more highly correlated with the S&P 500 than commodity prices, making them a less useful tool for diversification.

This \$9 billion Pimco fund tracks the Dow Jones AIG Commodity Total Return Index using derivatives. So it's a direct play on the prices of energy, precious and industrial metals, and agricultural products. It's a good balance to the equity funds in a portfolio, since commodities tend to go up when stocks go down. In fact, there have been only two years since the 1970s when both stocks and commodities have gone down. To avoid the hefty 5.5% sales charge, you can buy the no-load D-class at Charles Schwab and Fidelity Brokerage Services and other mutual fund supermarkets.

Metropolitan West Total Return Bond Fund (MWTRX)

The trio -- Tad Rivelle, Laird Landmann, and Stephen Kane -- who run Metropolitan West aren't afraid to make sizable bets. They will load up on corporate bonds or mortgage-backed securities, even if most managers are running the other way, and their contrarian thinking has paid off. Over the last five years, the fund has earned a 7.2% average annual return, outpacing its peers by a half a percentage point a year.

It's not always easy going against the crowd. In 2002 the fund got burned by sizable stakes in the bonds of telecommunications and energy companies. The fund lost 1% that year, a period when the Lehman Brothers (LEH) U.S. Aggregate Bond Index was up 10%. But the managers -- who cut their teeth at the bond behemoth Pimco -- remained patient, arguing that despite the industries' woes the bonds had huge potential. They were vindicated during a subsequent corporate-bond rally, and many of their holdings surged. Over the past three years, the fund has produced annualized returns of 7.9%, putting it in the top 5% of intermediate-term bond funds.

Today, Metropolitan West's managers are more cautious. They've lowered the

duration -- the fund's sensitivity to interest rates -- to 3.7 years, compared with four years for their benchmark index. And they've pared back their positions in corporate bonds and mortgage-backed securities. At the same time, they've increased their stake in asset-backed securities, mainly triple-A rated home-equity loans, which they think are a better value and offer more protection from rising interest rates than regular mortgage-backed debt.

What also helps the MetWest stay ahead is an eye on overhead. Its expense ratio is 0.65%, vs. 1.07% for its peers. In a low interest-rate environment, those fractions of a percentage point really count.