Investing With the Greats

A new type of fund lets shareholders tap the wisdom of the world's best investors.

BY TIM BEGANY

For those looking to play the market like Warren Buffett, hedge fund ace David Einhorn or other investing greats, a new fund category is emerging. In just a few years, it has grown to half a dozen funds designed to reflect the wisdom of the world's best stock pickers.

Most of these "guru" investments are exchange-traded funds that rely on 13Fs, quarterly SEC filings listing the holdings of large institutional investors. Each quarter, the funds scour the 13Fs of investing gurus and use stock screens to construct portfolios based on those filings.

The category's two most established offerings, the **AlphaClone Alternative Alpha ETF** and the **Global X Guru ETF**, have mostly outperformed Standard & Poor's 500-stock index. From their mid-2012 launch dates to late May of this year, these funds beat the index 30% and 16%, respectively. Both have since given up ground but trail the market only slightly.

We're also intrigued by one of the category's newcomers, **Validea Market Legends ETF**, which launched last December. VALX is more proactive, choosing stocks with computer models that incorporate the styles—not the specific stock picks—of famous investors. The aim is to spot great stocks sooner than if the fund analyzed 13Fs, which can be stale by the time they're released because institutional investors have 45 days from the end of each quarter to complete the filings. In each case, the goal is to replicate the success of Wall Street's elite.

Comparing the "13F" Funds

AlphaClone's guru ETF currently holds 73 stocks, and Global X's has 42. AlphaClone bases its picks on proprietary rankings of guru investors, who are scored according to the performance of the portfolios. To build its guru ETF, Global X takes the largest holding from the 13F of every hedge fund with assets of at least $500 million after excluding the funds that don't bet heavily on their top holding.

The resulting indexes for both funds start off equally weighted, but the Al-phaClone ETF then doubles up on stocks the gurus favor most. This often boosts the fund's top holdings to as much as 6% of the portfolio and the smallest to less than 1%, while the Global X ETF typically maintains roughly equal weightings around 2.5%.

Like many of the gurus, the Alpha-Clone ETF also hedges against down markets through short selling, an investment strategy designed to profit when security prices drop. To provide a broad hedge, the fund short sells the S&P 500 when that index ends a month at a price below its average closing value for the past 200 days.

The AlphaClone and Global X funds share some attributes. Both are about 90% domestic equity and nearly 60% large-cap stock, often with substantial overlap. As of December 3, for example, the biotechnology firms Valeant Pharmaceuticals, Allergan and Horizon Pharma were among their top holdings.

Sector bets often widely diverge, though. Recently, for example, the Al-phaClone ETF was 29% healthcare, compared with 13% of the Global X fund.

As both funds are just three years old, it's tough to say which is better. The Global X ETF returned an annualized 14.5% the past three years versus 12.2% for AlphaClone's offering. But the latter's hedging feature could boost long-term returns by mitigating losses during severe market downturns. For that reason, we prefer AlphaClone's guru ETF, even though its 0.95% expense ratio is 0.2% higher than Global X's.

Channeling the Legends

Besides having an expense ratio of 0.79% and mostly owning U.S. companies, VALX hardly resembles the Alpha-Clone and Global X guru ETFs. It usually holds 100 stocks, basing choices on 17 computer models, each representing a famous investor with well-documented methods. This lets the fund draw from present-day gurus such as Buffett and leading contrarian investor David Dreman, as well as from past legends, such as Buffett's mentor Benjamin Graham and former Fidelity superstar Peter Lynch.

To aid stock selection, each computer model incorporates more than 300 measures of company fundamentals such as profitability, valuation and cash flow.

A Closer Look				
		Total Return*		Expense Ratio
	Yield	1-Yr	3-Yr	
AlphaClone Alternative Alpha ETF (ALFA)	0.01%	-8.53%	12.15%	0.95%
Global X Guru ETF (GURU)	1.15	-6.90	14.05	0.75
Validea Market Legends ETF (VALX)	0.05	N/A	N/A	0.79

*Average annualized return. Sources: Morningstar, ETFdb.com.

The models cover the spectrum of investing styles from value to growth.

Though VALX can invest in companies of all sizes, lead manager and Validea CEO John Reese expects the fund will favor the smaller stocks that many guru investors prefer. Over time, smaller stocks usually outperform larger ones.

VALX is currently 60% in small caps and 23% in mid caps, and therefore doesn't overlap much with its large-cap-tilted rivals. It had no top 10 holdings in common with either of its rivals as of December 3, when its largest positions included companies like insurance software developer Ebix, online lender LendingTree and energy producer Valero. VALX's 22% technology sector allocation at that time was nearly double those of AlphaClone and Global X.

We're not concerned that VALX trails the market slightly, as a one-year track record is far too short to render any judgments. Long-term, we think this unusual fund could be a top guru investment. We also like that holdings are equally weighted because that maximizes the effect of faster-growing small and mid caps on portfolio performance.

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