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Whither Fidelity?
Pass on the Boston behemoth's large-cap funds.

As the debate over indexing and active management rages on, with a new wrinkle recently added by Joel Greenblatt and his value-weighted index funds, we decided to examine Fidelity Investments' 16 large-cap-dedicated funds with 15-year records. We tallied the 15-year performance of these funds through November 18, 2011, and compared it to the S&P 500 Index including dividends. We used data from Morningstar.com. The results weren't lovely.

Exhibit 1
Fidelity's Large-Cap Funds

Fund	Ticker	15-Year Annualized Return	+/- S&P 500 TR
Fidelity Blue Chip Growth	FBGRX	4.67	-0.57
Fidelity Capital Appreciation	FDCAX	6.59	1.34
Fidelity Contrafund	FCNTX	8.11	2.87
Fidelity Disciplined Equity	FDEQX	4.65	-0.6
Fidelity Dividend Growth	FDGFX	6.14	0.9
Fidelity Equity Income	FEQIX	4.74	-0.5
Fidelity Equity Income II	FEQTX	4.66	-0.59
Fidelity Export and Multinational	FEXPX	8.27	3.03
Fidelity Fifty	FFTYX	6.37	1.12
Fidelity Focused Stock	FTQGX	4.75	-0.5
Fidelity Fund	FFIDX	5.21	-0.04
Fidelity Growth & Income	FGRIX	2.07	-3.18
Fidelity Growth Company	FDGRX	7.49	2.25
Fidelity Independence	FDFFX	6.61	1.37
Fidelity Large Cap Stock	FLCSX	4.53	-0.71
Fidelity Magellan	FMAGX	3.33	-1.92
Average		**5.51**	**0.27**

As Exhibit 1 shows, more than half (nine out of 16) of the funds underperformed the S&P 500 Index for the 15-year period. In aggregate, the funds eked a 27-basis-point victory over the index, which produced a 5.24% annualized return for the 15-year period. But keep in mind that these are pre-tax returns, and holding any of these funds in a taxable account would likely have led to a worse outcome on an after-tax basis. In any case, it seems fair to say the funds matched the index for all intents and purposes.

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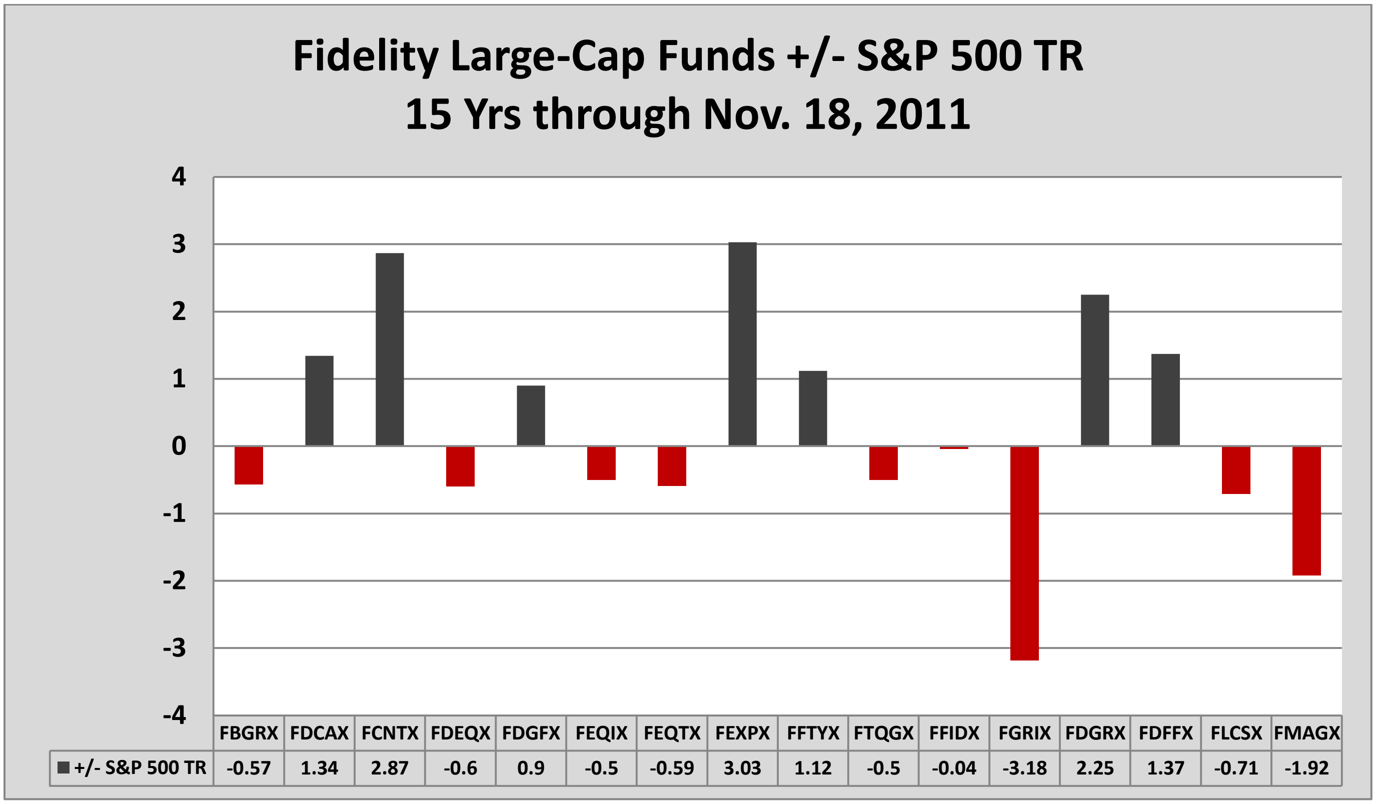
Exhibit 2 presents the funds' relative performances versus the index graphically. No fund exceeded the index by significantly more than three percentage points annually for the 15-year period. One fund (Fidelity Growth and Income) underperformed by a painful three percentage points annually for the 15-year period. Yet another fund (the previously famed Fidelity Magellan) underperformed the index by nearly two percentage points annually for the 15-year period.

Exhibit 2



Did Fidelity investors experience different fluctuations from those of the index?

Mediocre performance might be justified if investors experienced significantly different price movements than the index whose performance the funds matched. To gauge the funds' price movements, we examined their "R-Squared" statistics. R-Squared indicates what percentage of an investment's price movement correlate with that of an index. We found that, in aggregate, the funds captured 84% of the movements of the S&P 500 Index. Exhibit 3 shows the results.

Not all the funds are benchmarked against this index. Some have "best-fit" indexes of variations of the Russell 1000 Index or Russell 3000 Index, for example. However, since they are all basically large-cap funds, we used the R-Squared statistics for the S&P 500 to maintain consistency, even it wasn't always classified as the "best-fit" index by Morningstar or if the fund benchmarks itself against a different large-cap index in its prospectus.

In our opinion, investors didn't receive a significant amount of price movement deviations from the index in exchange for index-like performance. The risk (56%) that an investor could have chosen one of the funds that underperformed the index is significant in our opinion. The risk outweighs the slight deviation from the index's price movements that the funds exhibited.

It is interesting to note that the funds that outperformed the index had below-average R-Squared metrics for the group, meaning their price movements correlated less precisely to those of the index.

Contrafund clocked in at 78, and Growth Company registered a 64. The best fund, Export & Multinational, had an R-Squared of 82. To beat the index requires deviance from the index. Index-hugging appears to be the kiss of death.

Exhibit 3

Ticker	R-Squared
FBGRX	93.37
FDCAX	80.83
FCNTX	78.53
FDEQX	93.69
FDGFX	90.46
FEQIX	87.88
FEQTX	90.58
FEXPX	82.03
FFTYX	66.6
FTQGX	82.85
FFIDX	92.6
FGRIX	91.75
FDGRX	64.35
FDFFX	65.28
FLCSX	90.85
FMAGX	92.45
Average	**84.01**

What should investors expect from active management?

What type of return/risk result makes active management worth it will always be a judgment call, but we're rather confident in asserting that matching the index with 84% of the volatility isn't worth it.

Moreover, price movement versus the index may very well not be as important a measure of risk as the possibility of permanent capital impairment. It's doubtful that Fidelity's large-cap equity funds met this standard since they never hold significant amounts of cash. Fidelity may argue that they control the risk of permanent impairment as their analysts go over each company individually. However, so many of their funds have hundreds of stocks that it's unlikely that investors are getting anything more than a kind of generic market exposure.

Finally, Fidelity may argue that some of their equity funds have different objectives than beating the index. For example, Fidelity Equity Income may seek to provide greater income than the index with less volatility in exchange for simple outperformance even over the longer haul. However, Fidelity Equity Inome returned 2.12% in yield over the past year, while the S&P 500 Index returned 2%. Twelve basis points isn't a significant difference in yield.

If Fidelity isn't providing much in the way of downside risk or deviation of price movements from the index, is there a return threshold active management can meet to justify its existence? It turns out that Warren Buffett commented on this once. In his defense of active management and value investing, The "Superinvestors of Graham and Doddsville," he mentioned that a 4-point per annum advantage over the S&P 500 would be a solid performance. Buffett made this remark in the context of closing his original partnership, and telling his former partners that, for continued stock exposure, they should invest with his friend and former classmate Bill Ruane at the Sequoia Fund in 1969.

It's unclear why Buffett chose this standard against which to hold Ruane, but it seems reasonable that active managers should beat the index by more than, say, 1 percentage point per annum over an extended period of time (though certainly not every calendar year) in order to declare themselves successful and in order to justify a process as repeatable. It's true that 1 percent per annum over a multi-decade period isn't insignificant in terms of the dollar value at the end of the investment, but it's not clear that such a performance will typically betray a repeatable process.

Although Ruane is no longer alive, the current managers at Sequoia worked with him and maintain a value discipline, though they have gravitated to Buffett's new style of owning better businesses at decent prices than owning decent or mediocre businesses at dirt-cheap prices. In any case, we thought we'd take a look at Sequoia's recent performance to see if it has lived up to Buffett's criterion in recent times.

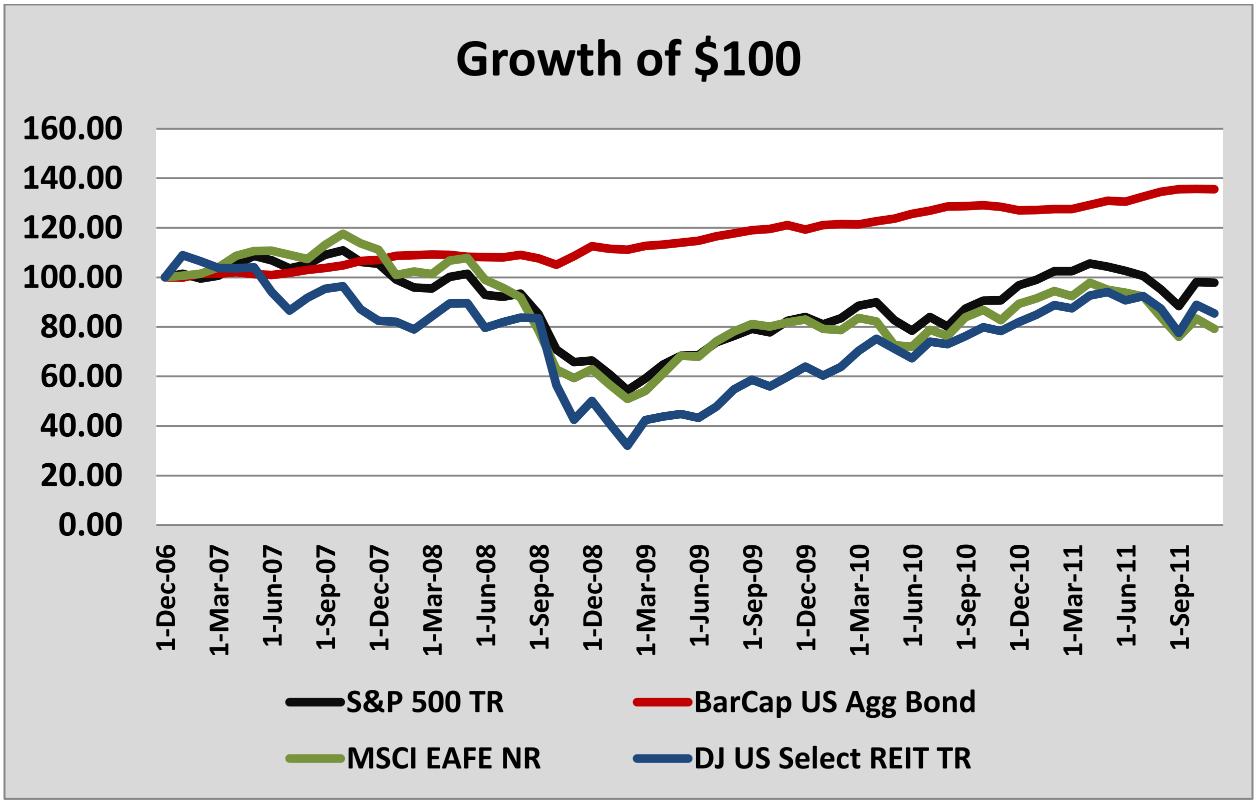
For the 15-year period through November 18, 2011, Sequoia Fund has returned 8.79% annualized, which represents a 3.55 percentage point annualized victory over the index over that period. That's not quite the 4 percentage point victory Buffett wanted, but it's close. Moreover, it's better than any of the Fidelity funds, including the best—Export and Multinational with its 3 percentage point per annum victory over the index—could muster. Perhaps not coincidentally, Sequoia's R-Squared versus the S&P 500 Index over the past 15 years is 53, a much lower number than the Fidelity average of 84 and indicating price movements significantly different from that of the index.

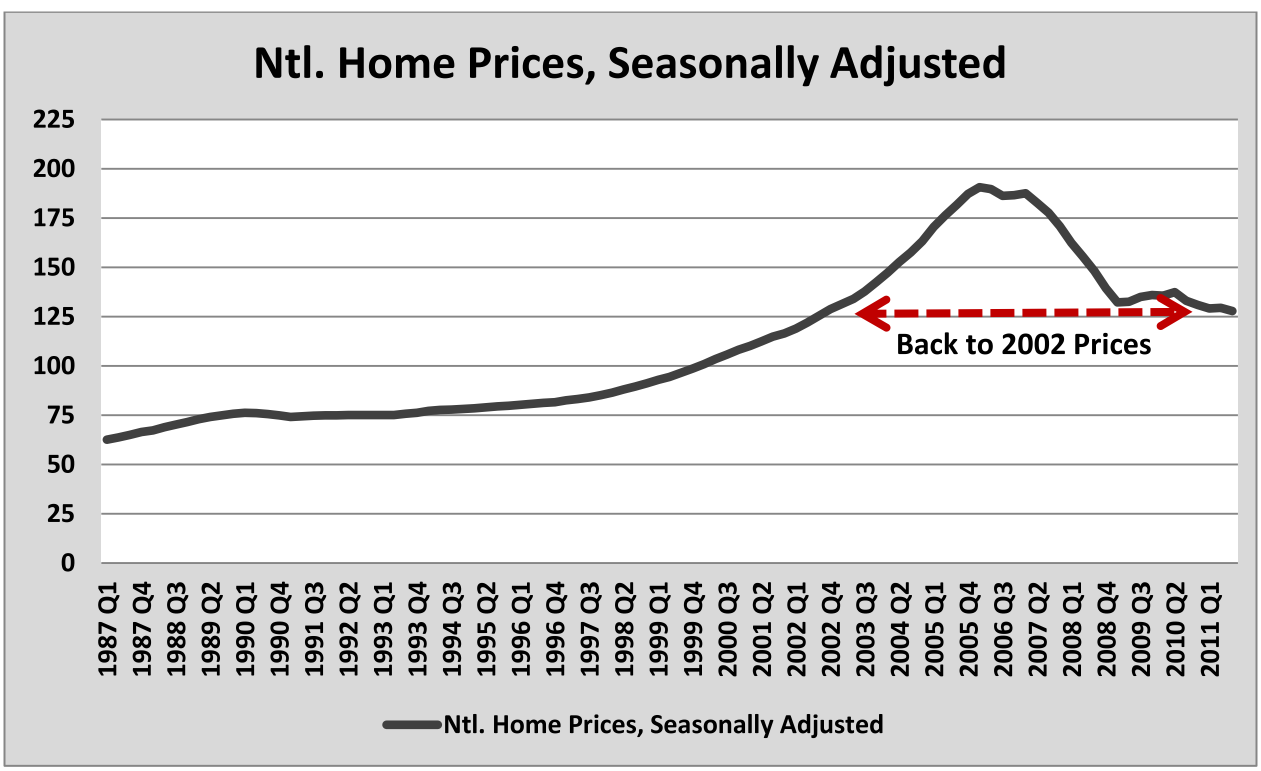
Conclusion

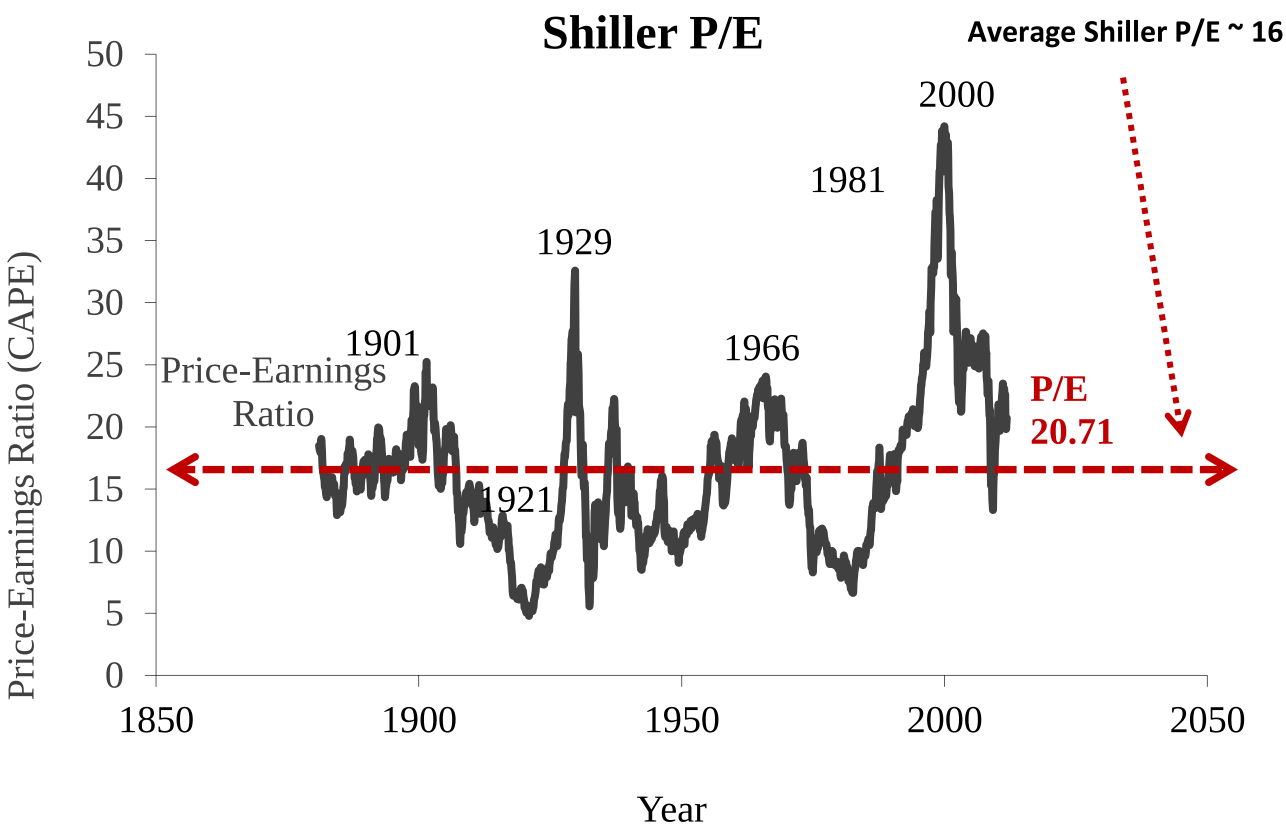
Consultants tend to fetishize comparisons to the index, and they've encouraged managers to engage in what Seth Klarman calls the "relative performance derby," trying to beat the index or a benchmark by a minuscule or insignificant amount every year and even every quarter. Additionally, professional investors are also paid on short-term time periods (less than three years, for example), which incentivizes them to hug the benchmark, since they're not given ample time for unusual bets to work out. There is an institutional imperative toward hugging the index consistently in order to maintain job security, despite the fact that it's known that superior managers often go through 3-year periods of underperformance.

Over a fifteen year period, however, a comparison to a benchmark is valid. The abuse of short-term benchmarking shouldn't render active management immune from ultimate comparisons to an index over the longer haul. If active management can't show any positive performance separation between itself and a standard benchmark such as the S&P 500 Index over such a decade and one half, and doesn't provide a meaningfully different price movement experience, it's not worth the effort for the investors. No doubt, though, the effort has been profitable for Fidelity.

Touchstones






Shiller P/E
Average Shiller P/E ~ 16
50
45
40
35
30
25
20
15
10
5
0
Price-Earnings Ratio (CAPE)
2000
1981
1929
1901
Price-Earnings Ratio
1966
P/E 20.71
1921
1850
1900
1950
2000
2050
Year

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