Many of our readers asked for an analysis of Fidelity’s Magellan fund, which reopened to investors last week. Magellan is Fidelity’s flagship fund and has been closed to new investors since 1997. It has a long and storied history, incorporating some of the greatest successes among active managers, along with one notable failure.

Our first thought was to look at the data for re-opened funds. While numerous academic studies have been done on closed funds (see, for example, Are Closed Mutual Funds Better Performers?), surprisingly we could not find any on re-opened funds. (We know there are many academics that read our newsletter and we would be happy to publish such a study.)

We turned to two people that have spent significant portions of their career studying the Magellan Fund. The first is Ross Miller, a professor of finance at the State University of NY at Albany. Miller authored a study of Magellan’s performance under its prior manager, Robert Stansky. Second is Jim Lowell, editor of Fidelity Investor and Chief Investment Officer of Adviser Investments, an RIA specializing in Fidelity and Vanguard funds (see our profile).

A Brief History of Magellan

Magellan’s history spans 45 years and seven individual managers. The most famous was Peter Lynch, who managed Magellan from 1977 until taking early retirement in 1989. During his tenure, Magellan grew from an obscure $20 million fund to become the flagship Fidelity fund with $20 billion under management. As Miller describes, Magellan became “the brightest star in the mutual fund galaxy” under Lynch’s control, consistently beating the major indexes.

Lowell provided us with the following chart, which shows the performance of the fund under each of the seven managers:
Lowell points out that Lynch was not Magellan’s most successful manager. That distinction goes to Fidelity’s founder and Magellan’s original manager, Ned Johnson, whose annual return of 30.3% tops Lynch’s return of 29.2% (these numbers, however, are not risk-adjusted).

Lynch’s investment style was the antithesis of today’s quantitative investment strategies. He often chose securities based on his wife’s shopping preferences, selecting companies that he believed offered competitive and attractive products in the consumer marketplace. He became known for finding “tenbaggers” – securities that would increase ten-fold over a relatively short amount of time.

During Morris Smith’s brief tenure and most of Jeffrey Vinik’s reign from 1992-1996, Magellan did not deviate from the course set by Lynch, and it continued delivering exceptional performance. That streak ended in early 1996, when Vinik undertook a major restructuring of Magellan, by placing over a quarter of the fund’s assets into fixed income. As Miller notes, this was a defensive measure taken at a time when many were saying the stock market had risen too far, too fast. But that timing proved to be incorrect and, as the market continued to rise that year, Vinik ended up trailing the fund’s benchmark (the S&P 500) by 10%.
Vinik voluntarily left Fidelity. But he had taken the first step in fundamentally deviating from Magellan’s charter, which was to be a growth fund.

Vinik’s successor was Robert Stansky, a one-time research assistant to Lynch. Prior to Stansky, Magellan was a large but predictable and understandable fund. Stansky dramatically transformed Magellan.

**Magellan under Stansky**

Stansky liquidated Vinik’s bond positions and quickly restored Magellan’s growth orientation. He did well – although not as well as compared to Lynch – during the tech bubble of the late 1990s. But in 2000 things began to change, and Magellan’s stellar reputation would be forever altered.

Starting in 2000, Magellan exhibited returns that mimicked the S&P 500. However, Stansky had an aversion to technology stocks and, in the wake of the dot com crash, this gave Magellan’s performance a boost, allowing it to track the performance of the S&P.

Beginning in 2002, Magellan’s performance began to falter, as can be seen in Miller’s chart below:

![Graph showing Magellan versus the S&P 500 between 2002 and 2004.](image)

**Figure 1. Magellan versus the S&P 500 between 2002 and 2004.**
Miller’s analysis of Magellan under Stansky shows that Magellan had become a closet index fund, closely tracking the behavior of the S&P 500, but delivering markedly inferior returns. During the period from 2002-2004 Stansky underperformed the S&P by about 9% annually, resulting in billions of dollars of value destruction for Magellan’s shareholders.

A mutual fund can be separated into two components – one which represents the passive or index component (in the case of Magellan, tracking the S&P 500) and one which represents the active component. From 2002-2004, approximately 9% of the returns from Magellan were attributable to its active component. This active component generated an alpha of -50.09% during the 2002-2004, and was the source of Magellan’s poor performance.

Magellan Today

Harry Lange took control of Magellan on October 31, 2005 and transformed Magellan from a large cap core fund to a large cap growth fund, similar in orientation to Lynch’s Magellan. The closet index fund behavior disappeared, literally overnight.

Magellan today bears no resemblance to Stansky’s Magellan.

Jim Lowell has built a successful business around the careful analysis Fidelity’s funds, and has what is perhaps the largest database of manager track records, even larger than Morningstar’s. Lowell’s mantra is “we buy the managers, not the funds.” In the case of Magellan, this approach is essential, since the fund has behaved strikingly different under each of the last three managers.

When Lange took over, Lowell upgraded Magellan from a “sell” to a “buy,” based on Lange’s superior track record as a manager. At the time, Lowell made three predictions, all of which have turned out to be correct:

1. Magellan would move from a domestic growth closet index fund, with a 4% foreign exposure, to a global growth fund with at least one-third exposed internationally.

2. Magellan would immediately reverse its overweight in financials and underweighting in technology, and would underweight in the former and overweight in the latter. This happened in the first quarter of 2006.

3. As a result of 1 and 2, Magellan would chart a course for out-performance.
Both (1) and (2) actually hurt Lange in the short term. Although Lange beat the S&P 500 by 1.5% in 2005, he trailed the index by 8.6% in 2006. But in 2007 Magellan’s return was nearly four times the S&P 500 (18.8% v 5.5%) with a beta of 1.06. The Russell 1000 Growth Index, now perhaps a more relevant yardstick, was up 11.8% in 2007. Lange achieved this through his international exposure and by significantly overweighting technology (2007 was the first time in five years that the NASDAQ outperformed the S&P 500). He also benefited by dramatically underweighting financials.

Over Lange’s tenure, Magellan has returned 25.6% versus 19.5% for the S&P 500.

Lowell stresses the importance Magellan to Fidelity as a whole. Investors assume that, as goes Magellan, so goes the whole fleet. Over the last five years there has been a dramatic pullback in funds from Fidelity. But today two-thirds of Fidelity’s managers are outperforming their specific benchmarks, over short, intermediate, and long term time frames, beating industry averages.

Lowell expects to see Magellan marketed very heavily. Over the last decade, Fidelity has transformed from a mutual fund behemoth to a full service financial conglomerate, marketing platforms and services geared to servicing the retirement assets of investors. Lowell notes that “marketing of individual funds and managers is virtually non-existent.” But he says that Fidelity “wrote the book” on growth fund investing and has some of the best growth fund vehicles. “They weren’t telling people about it and their core message suffered,” notes Lowell.

Over its existence Magellan has delivered just above 18% annual returns, well in excess of the S&P 500. Lowell believes it is now in the hands of “a truly talented growth manager” and notes that Lange “has turned what was looking like a cursed ship into cruise toward higher highs.” In his investment newsletter, Lange makes this prediction: “My contrarian bet for 2008: Bet on Harry. His track record at his funds prior to Magellan is nothing short of spectacular; and his lessons learned from running Magellan will serve him well in his new charge where he only has to deliver returns as opposed to responding to PR flak.”
A Closer Look

Looking at Magellan under **Fund Grades**, with data as of 11/30/07, we can see the how it behaves relative to a number of indexes:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Diversification Grade</th>
<th>Correlation To</th>
<th>Fund Asset Class Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Domestic Growth</td>
<td>D+</td>
<td>0.921</td>
<td>Domestic Equity</td>
</tr>
<tr>
<td>Mid Cap Growth</td>
<td>D</td>
<td>0.900</td>
<td>Domestic Equity</td>
</tr>
<tr>
<td>Large Cap Growth</td>
<td>D</td>
<td>0.893</td>
<td>Domestic Equity</td>
</tr>
<tr>
<td>Total Domestic Equity</td>
<td>D-</td>
<td>0.888</td>
<td>Domestic Equity</td>
</tr>
<tr>
<td>World Equity</td>
<td>D-</td>
<td>0.883</td>
<td>International Equity</td>
</tr>
</tbody>
</table>

Magellan has a very strong growth orientation, and a strong correlation with mid-cap in addition to large-cap. Morningstar shows that Magellan holds 21% of its portfolio in mid-cap stocks. We also see that Magellan has a large exposure (20% currently, according to Morningstar) in foreign stocks. The low grades for diversification confirm the absence of closet indexing, and are indicative of an active management strategy.

Fund Grades provides this “report card” for Magellan, relative to its best fit index, Total Domestic Growth:

<table>
<thead>
<tr>
<th>Overall</th>
<th>Diversification</th>
<th>Expense</th>
<th>Relative Risk</th>
<th>Return</th>
<th>Risk of Material Underperformance</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>D+</td>
<td>B</td>
<td>C-</td>
<td>C+</td>
<td>C+</td>
</tr>
</tbody>
</table>

Our analysis of FundGrades looked at a number of the most popular funds in the Advisor Perspectives universe. In that analysis, the closest peer to Magellan is the Growth Fund of America (GFAFX) which, at the time, also earned an overall grade of C. That grade has since improved to C+, mostly because of superior scores in the Relative Risk criterion (implying lower volatility relative to its benchmark).

Magellan currently ranks 436th among the most popular funds in the Advisor Perspectives universe. It ranks 43rd among US large cap growth funds.

A bet on Magellan is first and foremost a bet on continued outperformance from growth stocks. Growth outperformed value in 2007, ending a seven year run for value. The average P/E for Magellan is 19.4, squarely in the growth category. As we note above, a bet on Magellan is also a bet on continued outperformance from mid-cap and foreign stocks. The largest three holdings in Magellan – Nokia
(NOK), Corning (GLW), and Google (GOOG) – represent approximately 15% of assets. In 2007, these three securities rose 90%, 28%, and 48%, respectively, so a bet on Magellan may be a bet on identifying a small group of securities that deliver truly superior performance (reminiscent of the days of tenbaggers). Overall, a bet on Magellan is a bet on Harry Lange and his ability to replicate his results from 2007 in what may be a challenging market in 2008.

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