

WHAT IS ALPHA?

It's an attempt to measure the value of a money manager. In theory, the higher the alpha, the more a fund's return is attributable to its management rather than the industry it invests in or other broad market forces.

Use it in a sentence. The Mairs & Power Growth Fund has an alpha of 7.77, one of the highest among Minnesota-based mutual funds.

What does that mean? The fund returns 7.77 percent more annually than its closest benchmark (the Russell 1000 Value Index), adjusted for risk.

How is that determined? Alpha equals the difference between a fund's actual returns and its expected performance, given its level of risk. The risk measure, called "beta," is based on how much of the fund's ups and downs can be explained by the ups and down of the overall market. A positive alpha indicates that the fund has performed better than its beta would predict. A negative alpha indicates that a fund has underperformed.

What's the significance? Some see alpha as a measurement of the value added or subtracted by a fund's manager. But there are limitations to the measure. In some cases, a negative alpha can result from expenses, which affect fund returns but not the performance of an index.

How can I find out a fund's alpha? For more information on alpha, beta and other risk/return measures, go to <http://www.morningstar.com>.

Source: Morningstar

It's not easy to beat the indexes, but some mutual funds find ways to do it with regularity.

The best money managers in Minnesota



At the Market
INVESTING COLUMN

Mike Blahnik

Countless studies have shown that at least 70 percent of active mutual fund managers fail to outperform comparable stock market indexes over any given five-year period. Over longer periods, the numbers are even worse, leading many to conclude that the best way to invest in stock funds is simply to buy and hold a selection of index funds.

But what about the other 30 percent of fund managers, those who might give you the best chance of beating the market?

Every three months, at the risk of wrongly encouraging readers to flee their current fund to invest in last quarter's hot fund or sector, we rank the performance of about 100 stock funds and 40 bond funds managed in Minnesota.

Often the funds that are on top one quarter are near the bottom the next. This quarter's worst performer, American Express' AXP Precious Met-

als Fund, was down 22.5 percent in the past three months but remains atop the three-year rankings with a 25 percent average annual return.

A select group of funds, however, seems to appear near the top of the rankings time and time again, consistently outperforming their peers and their benchmark indexes. Those are the funds on which we will focus, after a quarter that saw meager gains for most stock funds and, with interest rates rising, losses for every bond fund.

Beating the market indexes is critical for fund managers. If they don't, why should investors pay the higher expenses of actively managed funds when there are so many inexpensive index-based mutual funds and exchange-traded funds (ETFs) that mirror a wide variety of indexes?

Clark Winslow
FMI Winslow Growth
3-year avg. return: -2.5%
Alpha: 1.4

Steve Leuthold
Co-managers: Jim Floyd, Andy Engel
Leuthold Core Fund
3-year avg. return: 7.6%
Alpha: 1.8

Joe Betlej
Iby Real Estate Securities Fund
3-year avg. return: 17.5%
Alpha: 2.8

George Mairs
Co-manager: Bill Frels
Mairs & Power Growth Fund
3-year avg. return: 10.4%
Alpha: 7.8



Top dogs

Minnesota-managed funds with positive "alpha" over the past three years. **Criteria:** Publicly traded mutual funds with index correlation of at least 85 percent and a performance record and manager tenure of at least three years.

Stock funds	Alpha
Mairs & Power Growth Fund	7.77
Mairs & Power Balanced Fund	2.94
Ivy Real Estate Securities Fund	2.75
AXP Small Company Index Fund*	1.99
Leuthold Core Investment Fund	1.78
First American Real Estate Securities Fund	1.50
FMI Winslow Growth Fund	1.40
AXP Small Cap Advantage Fund	1.18
First American Small Cap Index Fund	0.27
Tamarack Small Cap Equity Fund	0.05
Bond funds	
Sit Minnesota Tax-Free Income Fund	1.42
AXP Global Bond Fund	1.03
Sit Tax Free Income Fund	0.80
Sit Bond Fund	0.56
Bremer Bond Fund	0.28
Ivy Mortgage Securities Fund	0.26

* Positive alpha against the Russell 2000, measured as "best fit." Fund actually uses S&P 600 as its benchmark. Source: Morningstar

A statistic called alpha can help in comparing funds

Mutual fund managers can employ various tactics to try to beat the indexes. One is to take on riskier sectors or stocks, but those might fall out of favor quickly.

Another approach is to pick a selection of stocks that don't match any particular index and hope that the differences in performance are favorable. Those funds can have great quarters, but they're difficult to apply for investors who follow specific asset-allocation plans.

Fortunately, there's a way to factor in the risks and compare such a variety of funds to sort out which managers truly are adding value. It's a statistic called alpha.

Alpha is a fund's return in excess of what would have been expected, given the risks the fund took and the performance of its benchmark index. An alpha greater than zero means the manager added value over the index.

It is a good criterion to help investors decide which funds are worthy of their investments.

"It's useful as long as there's a good fit with the index," said Russ Kinzel, director of fund analysis at Morningstar, which provides three-year alpha statistics on its Web site under the "risk ratings" category for each fund.

"The longer the time period,

the better; with three years it's good, but you can still get a little noise," Kinzel said. "What appears to be a manager adding value may be that they just had a sector bias, so it's not infallible."

We used Morningstar's alpha calculations to identify some of the best fund managers in the Twin Cities and find out what makes them stand out. We found that 10 stock funds and six bond funds made the "positive alpha" cut during the past three years, a period of market ups and downs. And we found that the top managers employed a surprisingly wide variety of methods to achieve good results.

Risk plays an important role in determining alpha. For instance, three of the six bond funds were managed by Sit Investments. While the returns on its funds weren't necessarily much greater than their peers, they accomplished the returns by taking less risk, which is always a good thing, all else being equal.

Some funds, notably the two managed by Perkins Capital Management and six managed by Jundt Associates, didn't qualify for the rankings because they didn't match up neatly with any particular index in Morningstar's database.

Minnesota-managed funds

Total three-month, six-month and annualized three-year returns of Minnesota-managed mutual funds (Class A shares only; ranked by three-month return).

Equity funds	3-mo.	6-mo.	3-yr.
Tamarack Small Cap Equity	5.7%	7.8%	7.0%
Mairs & Power Growth	5.2	10.3	10.4
Perkins Discovery	4.2	10.6	11.5
AXP Small Company Index	3.3	9.5	8.4
Sit Science & Technology Growth	3.0	5.8	-12.8
First American Mid Cap Value	2.8	8.8	10.3
General Securities Inc.	2.7	4.6	-2.1
AXP Strategy Aggressive	2.1	2.2	-9.1
Baker 500 Growth Inst.	2.0	5.9	NA
FMI Winslow Growth	2.0	5.4	-2.5
Sit Mid Cap Growth	1.9	8.1	-5.3
Mairs & Power Balanced	1.9	5.4	6.5
First American Small Cap Select	1.8	7.0	9.1
AXP Diverse Equity Income	1.7	4.4	5.6
First American Mid Cap Growth Opp.	1.7	7.9	2.8
First American Large Cap Select	1.7	2.3	NA
AXP Equity Select	1.6	3.6	3.0
Bremer Growth Stock	1.6	3.4	-4.1
First American Equity Index	1.6	3.1	-1.3
Wells Fargo Equity Index	1.6	3.1	-1.3
Tamarack Mid Cap Equity	1.5	4.5	4.1
First American Large Cap Growth Opp.	1.5	4.7	4.1
Sit Large Cap Growth	1.4	5.8	-6.1
Wells Fargo Small Company Value	1.4	6.7	NA
Lutheran Brotherhood Growth	1.4	2.9	-5.4
AXP Mid Cap Value	1.4	7.9	NA
Tamarack Large Cap Equity	1.3	4.1	-4.0
First American Equity Income	1.3	2.6	1.1
Lutheran Brotherhood Value	1.2	4.1	-1.1
AXP Large Cap Equity	1.2	1.4	NA
First American Small Cap Value	1.1	6.6	8.0
First American Large Cap Value	0.9	2.8	-1.1
First American Mid Cap Index	0.8	5.7	5.6
First American Strateg. Asset Select	0.8	NA	NA
Lutheran Brotherhood	0.7	4.2	-4.6
AXP Equity Value	0.7	2.9	-2.0
AXP Growth	0.6	1.5	-7.8
AXP Global Technology	0.5	3.3	-5.6
AXP Dividend Opportunity	0.3	-0.1	-7.7
First American Small Cap Index	0.2	6.2	6.4
AXP Managed Allocation	0.1	3.2	1.9
AXP American Balanced	0.1	1.9	1.2
AXP Discovery	0.1	7.1	4.1
Leuthold Select Industries	0.1	0.2	-0.5
Lutheran Brotherhood Mid Cap Growth	0.1	2.8	-1.8
Sit Balanced	0.1	3.5	-1.1
First American Strategic Agg. Alloc.	0.0	3.0	0.4
First American Strategic Growth Alloc.	0.0	3.0	1.0
Wells Fargo Wealthbuilder Grw. & Inc.	-0.1	3.0	-2.2
AXP New Dimensions	-0.1	0.0	-2.6
Wells Fargo Large Company Growth	-0.1	-0.5	-4.7
AXP Small Cap Advantage	-0.1	6.3	8.2
AXP European Equity	-0.3	0.0	0.0
Lutheran Brotherhood Opp./Growth	-0.3	3.7	3.0
AXP Stock	-0.3	0.6	-2.6
First American Strategic Growth & Inc.	-0.4	2.2	1.7
AXP Mutual	-0.4	1.7	-0.9
AXP Global Equity	-0.6	2.3	-3.3
Markman Total Return Portfolio	-0.8	4.0	NA
AXP Income Opportunities	-0.9	1.8	NA
Leuthold Core Investment	-1.0	0.4	7.5
AXP U.S. Government Mortgage	-1.1	0.6	NA
First American Strategic Inc. Alloc.	-1.3	1.0	4.0

We did not include privately managed funds in our survey.

Local gold

The Mairs & Power Growth Fund, which specializes in Minnesota companies, was the top alpha producer, with its managers adding an average of 7.77 percentage points to returns.

"We don't have any secrets. We're pretty basic, just a little pick-and-shovel on some of the gold that's right in our own back yard," said Bill Frels, who co-manages the fund with George Mairs.

The fund focuses on Twin Cities companies and gets to know them well; Mairs has been at the firm for 52 years, and Frels has been practicing

in the Twin Cities for 42 years. After that, it's good old fundamental analysis, a "growthier" version of Warren Buffett's style.

"We try to be very disciplined on our buy-and-sell approach, using some rules of thumb, such as not overpaying for growth," Frels said. "The key is to get a feel for what kind of growth is reasonable on a three- to five-year time horizon."

Few sectors have been as difficult during the past three years as large-cap growth, in which success often has meant losing less than the index while waiting for better times.

The FMI Winslow Growth Fund has beaten the Russell 1000 Growth Index in 17 of the 21 quarters since Clark Winslow assembled his team.

"We start with our research, looking for good businesses where we think the stock valuation is reasonable for the future earnings growth," Winslow said. "If we don't like something, either on fundamentals or on price, we don't own it. It doesn't make a difference how big it is in the index." Winslow Capital's portfolio managers also are responsible for re-searching the stocks.

"If the people making the decisions are the ones following the companies day in and day out, they're going to have a better understanding of the company, and a better conviction of when is the time to buy, and when is the time to sell," he said. "We're not dependent on what Wall Street research

Equity funds (cont.)

	Total returns		
	3-mo.	6-mo.	3-yr.
AXP Global Balanced	-1.4	0.8	1.5
First American Short Tax Free	-1.4	-0.7	NA
Lutheran Brotherhood World Growth	-1.7	1.6	-0.2
AXP International	-2.0	2.6	1.5
Sit Small Cap Growth	-2.0	1.0	-4.3
AXP Partners Small Cap Growth	-2.1	-0.9	-4.7
The Tereberg Fund	-2.1	-0.6	NA
Sit Bond	-2.4	-0.2	5.1
First American Int'l Gov't. Bond	-2.4	-0.1	NA
AXP Core Bond	-2.4	-0.1	NA
Tamarack Quality Fixed Income	-2.5	0.4	4.4
Bremer Bond	-2.7	-0.8	4.6
Tamarack Government Income	-2.7	-0.7	4.7
Jundt Growth	-2.8	0.6	-4.8
AXP Global Bond	-2.8	-1.0	10.2
AXP Insured Tax-Exempt	-2.8	-1.2	4.2
Sit International Growth	-2.9	0.4	-8.1
First American International	-3.1	-1.1	-1.2
First American Small Cap Growth Opp.	-4.1	-0.3	3.6
First American Technology	-4.9	-2.1	-13.0
Perkins Opportunity	-5.1	4.2	-8.2
Grizzly Short	-5.3	-7.8	-6.8
Ivy Real Estate Securities	-5.6	5.9	NA
Jundt Opportunity	-5.8	4.7	-4.8
Jundt Mid Cap Growth	-6.0	-0.7	-2.4
First American Real Estate	-6.4	4.8	16.3
Jundt TwentyFive	-6.8	0.5	-10.8
Kopp Emerging Growth	-7.1	-7.4	-13.0
Jundt U.S. Emerging Growth	-8.3	1.5	-1.6
Sit Developing Mkts Growth	-9.1	-4.2	2.7
AXP Emerging Markets	-10.7	0.9	11.0
Jundt Science & Technology	-10.7	3.2	-10.5
AXP Precious Metals	-22.5	-20.7	25.0

Equity funds

	Total returns		
	3-mo.	6-mo.	3-yr.
AXP High Yield Bond	-0.1	1.7	6.4
Lutheran Brotherhood High Yield	-0.4	1.5	6.1
Sit U.S. Gov't Securities	-0.9	0.6	3.8
Sit Tax Free Income	-0.9	0.5	3.7
First American High Income Bond	-1.2	0.2	9.8
First American Gov't. Mortgage	-1.2	0.2	4.8
First American S/T Bond	-1.2	0.2	4.7
AXP Short Duration U.S. Gov't.	-1.3	-0.3	3.4
Sit Minnesota Tax Free Income	-1.4	-0.2	4.4
Ivy Mortgage Securities	-1.4	0.8	NA
First American Minn. Income Tax Free	-1.8	-0.6	4.5
AXP Limited Duration Bond	-1.9	0.0	NA
Lutheran Brotherhood Limited	-2.0	-0.3	4.1
First American Interm. Tax Free	-2.1	-0.8	4.7
AXP Minnesota Tax-Exempt	-2.1	-0.9	4.7
AXP Intermediate Tax-Exempt	-2.2	-0.9	4.3
First American Tax Free	-2.2	-0.6	5.5
Lutheran Brotherhood Municipal	-2.4	-0.8	4.8
Hardford Tax-Free Minnesota	-2.5	-0.7	NA
First American Intermediate Bond	-2.5	-0.3	4.9
AXP Selective	-2.5	0.0	3.3
AXP California Tax-Exempt	-2.5	0.7	4.3
AXP Diversified Bond	-2.5	-0.1	4.7
Wells Fargo Mn Tax-Free	-2.5	-1.1	5.0
First American Core Bond	-2.5	-0.2	5.2
Lutheran Brotherhood Income	-2.6	-0.2	5.4
AXP High Yield Tax-Exempt	-2.7	-1.2	4.4
AXP Tax-Exempt Bond	-2.7	-1.0	4.1
Ivy Bond	-2.7	-0.1	NA
First American Corp. Bond	-3.6	-0.4	5.6

Source: Bloomberg News

tells us, and I think that leads to better decision making."

The fund, a smaller version of the \$800 million Winslow manages for institutions, weathered the 2001-02 bear period by being underweight in technology and pharmaceuticals, then switching into economically sensitive stocks in time to catch last year's run-up.

Core competency

In contrast to Winslow's "bottom-up" style of finding good companies, the Leuthold Core Investment Fund works "top-down," using technical factors to gauge which asset classes and market sectors will outperform, then working down toward stock picking.

"We try to be in the right asset classes, trying to navigate between stocks and bonds correctly in terms of risk vs. reward," said Jim Floyd, who co-manages the Leuthold Core Investment Fund with Steve Leuthold and Andy Engel.

"Next are the market sectors: small-cap vs. large cap and growth vs. value. Then it's finding the leadership in terms of groups, like technology or financial. Stock selection is last; when we do add value with stock selection, it's great, but we don't spend a great deal of time doing that because we pick a package of stocks in particular industries."

That might be a drawback in the current market, which acts more like a market of stocks than a stock market. "It's been so-so this year because the leadership is tough to find," Floyd acknowledged. "People are taking less risk, worrying about whether the market is going to go the other direction."

Thinking small

Small-cap stocks have resoundingly outperformed large caps during the past five years, and the AXP Small Cap Advantage Fund has stood out among its Russell 2000 index peers.

Good stock selection and good risk management vs. the index have helped the fund outperform, say portfolio managers Kent Kelley and Jake Hurwitz of Kenwood Capital Management, which manages the fund for American Express. They like to favor companies that have superior cash-flow generation, earnings and valuations.

Although a rising interest rate environment generally favors large-cap stocks, the duo is optimistic and says that in this expanding economy small caps still have superior earnings prospects and carry reasonable relative valuations.

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