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Mutual Funds

The 4 best mutual funds for 2006

My bets rely on dropping interest rates, "hot hands," high energy prices and new strength in the Japanese economy.

By Timothy Middleton

With stock and bond markets going nowhere, don't you wish you had bought **Fidelity Emerging Markets Fund** (FEMKX) at this time last year, before its remarkable surge of 40.3%? Even the 18.4% return in the last 12 months of **Janus Core Equity Fund** (JAEIX) sounds pretty good, doesn't it?

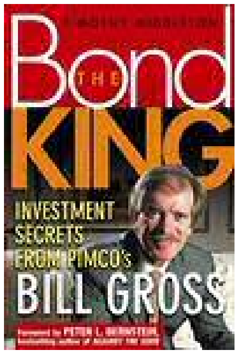
I didn't identify those funds a year ago. I didn't even try. But this year I am going to float some predictions. Economists forecast gross domestic product. Why shouldn't I forecast how a few mutual funds will behave?

Besides, those economic forecasts are never right, so I can judge my success against a pretty low hurdle.

In truth, I want to predict the best funds to own for the next 12 months purely to focus my thoughts on how I think next year's markets will unfold. It is my conclusions regarding that outlook that lead me to the four specific mutual funds I discuss below. I'll give my arguments: You decide.

Slow growth and hot hands

Broadly, what I foresee happening is a slowing of domestic economic growth. That will ease pressure on monetary authorities to kick interest rates significantly higher. It will also send more of us scrambling overseas in search of better returns.



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One brake on growth will be stubbornly high energy prices. But I don't expect the entire oil patch to prosper in unison. Confronted with higher prices, consumers look for alternatives. I think that will boost one particular energy fund more than others.

I could be completely wrong, of course, and that leads me to yet another fund. A phenomenon exists in investing known as "hot hands." That's another way of saying performance tends to persist for significant periods, because trends don't expire overnight. So I'll offer one suggestion that doesn't rely on my analysis, but only on this long-established pattern.

I hope you'll be stimulated to test yourself with this exercise. MSN Money is home to a number of online forums, and I moderate one of them, called the Start Investing community. Wander over and post your own ideas. A spirited conversation is always more fun than a monologue.

As rates fall, this fund flies

My first pick is **American Century Target Maturity 2025** (BTTRX). It owns what are called zero-coupon Treasury bonds maturing in 2025. Zeroes have no coupon or annual yield: All of their payout is built into the face value of the bonds. You buy at a discount to that value; and when the bonds mature, you get their full value, the difference being the annualized rate of interest at which you bought the bond.

Today, these zeroes are trading at 50.26 cents on the dollar, meaning their yield to maturity 20 years from now is 4.58%. With this fund, as with a CD of the same maturity and interest rate, if you invest 50.26 cents today you'll get back $1 in 20 years.

But a CD doesn't trade every day in the marketplace. Zeroes do. Their price is the inverse of their yield. If long-term interest rates go down 0.5 percentage points, the value of this fund will go up 10%. You are not going to get a 10% return on Treasury bonds any other way.

I think rates are more likely to go down than up for two reasons. The first is purely transitory: They have been pushed up in recent months by the spurt in energy prices, which raised the prospect of inflation. That fear is already receding, and rates have stopped rising in response.

The second is that the current economic expansion is getting old. The average time it has taken a business cycle to go from trough to peak since 1945 has been 52 months, according to the National Bureau of Economic Research. The current expansion began in November 2001 and will celebrate its 52nd month in February. When the economy turns down, the Fed will cut rates to fight recession. Some time next year, the current cycle of rate hikes will stop, which the market will interpret as a precursor to cuts, and bonds will rally.

Warning: This fund is hyper-volatile. It sank 5.3% in September, when hurricanes prompted inflation fears, and a further 3.3% in October. If you buy it, be prepared for a bumpy ride.

An alternative within the energy sector

I think the economy is going to begin sputtering in part because energy prices are up 50% or more in the last year. As I've written before, I think energy is a good long-term bet for the next decade, but one particular energy fund seems to me likely to do exceptionally well.

It is **PS WilderHill Energy** (PBW), an exchange-traded fund that follows an index of environmentally friendly energy companies. The fund's largest holding is **Energy Conversion Devices** (ENER, news, msgs), which develops solar panels.

High energy prices encourage oil companies to dig more wells, but they also encourage consumers to cut back. In places where sunlight is abundant, like Southern California, solar panels are becoming popular, sometimes allowing consumers to generate so much electricity they sell some back to the power company.

Japan: found in transition

If high energy prices depress the economy they'll stomp on equities as investors become more defensive. But investors won't just stop investing. They'll merely look elsewhere. Right now their eyes are on Japan, and my third pick is **T. Rowe Price Japan** (PRJPX).

Prime Minister Koizumi, who was re-elected in a landslide in September, is the first Japanese politician in at least 15 years to address the country's economic problems. After trading sideways for a year, Japanese equities rallied after his reelection, and both Japanese nationals and foreign investors have been flocking to Japanese stocks ever since.

The Price fund racked up gains of 13.7% in the three months ended Nov. 16. But it was already doing better than other Japan funds, and in the year to date has advanced 21.3%. Credit goes to lead manager M. Campbell Gunn, who took over the portfolio two years ago and transformed the fund from above average to top tier.

Unlike most of his peers, who focus either on giants like **Toyota Motor** (TM, news, msgs) or small companies like **Nidec** (NJ, news, msgs), a chip maker, Gunn buys companies of all sizes, and his picks have been consistently superior. Morningstar analyst Arijit Dutta says Dunn "runs a nicely balanced fund that provides exposure to a broad swath of the Japanese market."

A slow, and hot, hand

My hot-hand pick is **Permanent Portfolio Aggressive Growth** (PAGRX), managed for nearly 15 years by the incredibly patient Michael J. Cuggino. This portfolio's turnover is 2%, which is buy-and-hold carried to an extreme.

Cuggino's patience can test your own. Markets blow one way and then another, so he blows in and out of fashion. But right now he's got the wind at his back. The fund is heavy with energy names like **Frontier Oil** (FTO, news, msgs), which represents 13% of assets. Frontier is a refiner of so-called sour crude, more sulphurous than the best but also more abundant.

Cuggino also has a big stake in **Ryland Group** (RYL, news, msgs), a broadly diversified home builder. This group has taken a beating in recent months as the national housing bubble appears to be deflating. Cuggino, however, thinks Ryland will continue to prosper because it builds homes in all price categories, not just the expensive kind most in danger of collapsing. "Housing has more underlying strength than people give it credit for," he says.

I've included Permanent Portfolio among my picks because markets seldom move like the Mississippi, in broad and lazy unison. They're more like the Colorado, tumbling one way and then the other, swirling with eddies. This fund doesn't fit any particular theme, but it doesn't have to, to be successful in the urban canyon of Wall Street.

If you think I'm all wet, sound off in our Start Investing community. Maybe we can get a contest going.

At the time of publication, Timothy Middleton didn't own any securities mentioned in this article.