Mutual Funds 5/20/2008 12:01 AM ET

The best funds for your 401(k)

Part 2: Fidelity is the retirement-plan giant, but its style puts a premium on individual fund managers. Keep a close eye on who's running yours.

By Tim Middleton

This is part two of an occasional series on the best offerings from the fund families that hold most retirement plans. To read Part 1, on Vanguard, click here.

Fidelity Investments is the largest operator of corporate 401(k) retirement plans. And it's a good one, offering an excellent array of funds.

But it can be the most daunting fund company with which to invest. Its funds are only as good as their managers, meaning you've got to do much more research than with other fund families to identify the funds you want to own.

"Fidelity is a place, more than anywhere else, where you buy the manager," warns John Bonnanzio, the group editor of the Fidelity Insight investment letter. "You have to like Harry Lange" to buy **Fidelity Magellan** (FMAGX) despite that fund's famous name.

Although it's big, Fidelity remains a gunslinger among investment managers. Its corporate culture is as unlike Vanguard, which I wrote about recently in Part 1, as it is possible to be.

Where Vanguard is buttoned down and thrifty, Fidelity is a cowboy who aims to shoot out the lights. And this cowboy demands to be paid a premium for his marksmanship, whether he shoots straight or not. That puts a premium on managers' skills.

I've developed a list of Fidelity funds whose managers are first rate and whose funds would be excellent candidates for your 401(k). Just bear in mind that if a manager changes tomorrow, the opinion expires. And because the average Fidelity manager has a tenure of only 2.8 years, it could expire quickly.

It's the manager, not the fund, at Fidelity.

Magellan's old magic

Magellan was once Fidelity's flagship and the largest actively managed mutual fund. Today, after shriveling in half to $41 billion in assets, it is back on track to greatness.

Since taking control in October 2005, Lange has channeled about a quarter of the fund's assets into foreign stocks and domestic winners such as **Google** (GOOG, news, msgs) and **Monsanto** (MON, news, msgs). Last year he delivered returns to his shareholders of 18.8%, more than triple the market's gain.

Before Magellan, Lange managed **Fidelity Capital Appreciation** (FDCAX), another big-cap growth fund, for more than a decade. He racked up an outstanding record and just in time for Fidelity, because Magellan badly needed his attention. Magellan had become not only bad in the 1990s and early years of this decade -- it had virtually become an index fund.

Lange has overhauled the fund, and today the portfolio's R-squared, or similarity to the **S&P 500 Index** ($INX), is 79. A 100 would make it mirror the index, and that's where it was before Lange took over.

(Magellan's gain has been Capital Appreciation's loss. Morningstar notes that last year that fund tumbled into the bottom 25% of funds of its type -- badly lagging, among other Fidelity funds, Magellan.)

And a nod to Contrafund

Jack Bowers, the editor of the Fidelity Monitor newsletter, says, "Magellan and Contrafund have strong managers and are in lots of plans, and I rate both of them a buy."

Fidelity Contrafund (FCNTX), which is closed to investors except when bought through employer retirement plans, has been managed for nearly 18 years by Will Danoff, one of the best managers Fidelity has ever had. He has guided Contrafund into the top 5% of large-growth mutual funds, or better, for 15 years.

Danoff, a Morningstar manager of the year in 2007, has often supercharged Contrafund's performance with small and midsize companies, albeit with difficulty. The fund has assets of $75 billion, and it's difficult to put an appreciable portion of that large a portfolio to work in small companies.

Lately, though, he's zeroed in on megacaps, which have been lagging the market.

Over the three years ending May 13, Contrafund delivered annualized returns of 15.3%, 6.5 percentage points more than the market.

Continued: An emerging-markets maestro

Hot emerging-markets manager

The hottest equity category in recent years has been emerging markets, but until four years ago **Fidelity Emerging Markets** (FEMKX) was a dud. Then Robert von Rekowsky took the helm and turned around the portfolio, from ranking among the worst of its type to one of the best. Morningstar says it has beaten all but 3% of its rivals for the past three years.

Don Martin, the owner of Mayflower Capital in Los Altos, Calif., says this is one of the best emerging-markets funds open to retail (as opposed to institutional) investors, and he recommends it highly. "It has reasonable fees for an emerging markets fund, and it has a best-fit alpha of 1.7."

"Alpha" is market jargon for manager excellence. An index would have an alpha of 1.0. Managers can boost returns by taking additional risk, but alpha takes risk into consideration. Von Rekowsky's score indicates he delivers returns 70% greater than would be expected based on the risks he takes. Over the past three years, those returns have averaged 38.2% annually.

Boost your bonds

For investors looking for income, **Fidelity New Markets Income** (FNMIX) is a time-tested way to supplement the meager returns of domestic bonds with those of emerging nations such as Russia, Venezuela and Mexico. Manager John Carlson has been at the helm for 12 years, meaning he's one of the few of his peers who endured the Russian default of 1998. The average fund of this type lost 40% that year; this fund lost only 26.6%.

"We like overseas debt," says Kipley J. Lytel of Montecito Capital Management of Santa Barbara, Calif., noting the fund's yield is 6.1%. That's above the category average and 135 basis points higher than the current yield of a domestic intermediate-term bond fund, the most widely owned type.

Over the past five years, the fund's annualized return has been 10.4%. Carlson invests in dollar-denominated bonds, so there's no significant currency risk -- the danger of the bonds' return swinging simply based on exchange rates.

Newsletter editor Bonnanzio notes that there is one exception to the monitor-the-manager rule at Fidelity Funds, in his words, a fund "whose investment universe will never go out of style." He recommends **Fidelity Select Consumer Staples** (FDFAX), which owns companies such as **Procter & Gamble** (PG, news, msgs), **Coca-Cola** (KO, news, msgs) and **Altria** (MO, news, msgs). It ranks among the top 5% of large-cap core mutual funds for the past five and 10 years, and is down 3% this year, less than the market.

Fidelity has many fine funds with outstanding managers, and it should be possible in almost any Fidelity-managed 401(k) to put together an outstanding retirement portfolio. If your company plan doesn't include all these specific funds, ask your company's investment committee to add them.

Just remember to keep an eye on the manager. When a good one walks out the door, you should always consider following.

At the time of publication, Tim Middleton did not own or control shares of any company or fund mentioned in this column.