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Fund Times

## Dodge & Cox Balanced Fund Isn't for Everyone

By [Laura Lallos](#) | 08-07-16 | 06:00 AM | [Email Article](#)

*The following is our latest Fund Analyst Report for Dodge & Cox Balanced (DODBX). Morningstar Premium Members have access to full analyst reports such as this for more than 1,000 of the largest and best mutual funds. Not a Premium Member? Gain full access to our analyst reports and advanced tools immediately when you [try Morningstar Premium free for 14 days](#).*

Dodge & Cox Balanced earns a Morningstar Analyst Rating of Gold for its strong long-term record, sound process, rock-bottom expenses, and experienced management team backed by an exemplary firm. It also isn't for everyone.

Those seeking broad stock-market exposure with a predictable bond ballast may be disappointed. Asset-allocation here will fluctuate given market valuations. The fund can hold up to 75% in equities and was near that upper limit for several years because management found stocks more attractive than low-yielding bonds. During 2013's strong stock rally, the managers trimmed the stake below 70%, but it has remained relatively high, even within the allocation--50% to 70% equity Morningstar Category. That helped drive top-ranking returns from 2012 to 2014 but has weighed on performance since.

It's not just asset allocation that sets the fund apart. A patient value approach to stocks that sometimes includes a contrarian bent can pay off nicely, but it creates bumps along the way. The bottom-up process can also result in pronounced sector biases; the stock portfolio has near 20% or more in healthcare, tech, and financials, but it is light on consumer names and has no utilities. The fixed-income portfolio is distinctive, with an emphasis on primarily investment-grade corporate bonds that leverages the firm's industry research resources. The fund has had minimal exposure to Treasuries in recent years but an often-sizable stake in government-backed agency mortgages. With interest rates at rock bottom, the managers have kept duration low.

Steep losses from late 2007 through early 2009, and an above-average loss in 2011, spurred outflows that persist. The fund's Morningstar Risk ratings, which emphasize downside variations in returns, have been High within the category over the past decade. However, its three- and five-year returns through June 2016 were in the top quintile of its category, and its 10-year returns beat the average. Patient value-minded investors will appreciate the advantages of the fund's idiosyncratic approach.

**Process Pillar:** Positive | [Laura Lallos 07/27/2016](#)

This fund ranges farther than the 60/40 balance that its name implies. By prospectus, the equity stake can range from 25% to 75% of assets, and it has been toward the high end in recent years, though the managers brought the stock stake below 70% in 2013, where it remains today. The allocation depends on relative valuations, and the portfolio is built with a three- to five-year time horizon in mind.

The fund holds mostly large-cap stocks that look cheap on a range of valuation measures. The managers rely on bottom-up, fundamental research and favor businesses with good management, competitive advantages, and strong growth

potential. They may take advantage of bad news or a bad macro environment to buy fundamentally strong businesses. The original Hewlett-Packard, in the fund for more than a decade, became emblematic of their contrarian willingness to stick with a pick they believe will turn around, and the fund owns spin-offs [HP Inc \(HPQ\)](#) and [Hewlett Packard Enterprise Co \(HPE\)](#) today.

On the bond side, the managers aim for a yield greater than that of the Barclays U.S. Aggregate Bond Index while minimizing risk of permanent capital loss. An emphasis on corporate bonds leverages the firm's industry research resources; they invest primarily in investment-grade bonds. They eschew esoteric derivatives but will use Treasury futures to manage duration.

The managers pulled the equity allocation down below 70% as equities rallied in 2013, but the stake still has been higher than 65% since, on the high end for the allocation--50% to 70% equity category. That reflects the team's assessment of fixed-income opportunities. They consider overall equity valuations high, too, but are still finding values, notably among financials. They contrast the valuation and growth prospects of high-quality banks such as [Wells Fargo \(WFC\)](#) with those of run-up utilities, a sector they continue to sit out. They also added to [American Express \(AXP\)](#), which lost the [Costco Wholesale \(COST\)](#) business but remains a strong franchise.

Technology continues to dominate the stock side, as does healthcare, notably major pharmaceuticals. ([Alnylam Pharmaceuticals \(ALNY\)](#) is a recent add, a small stake in a more speculative pick.) The fund steadily built an oil-services stake over past several years; it paid off this year, and the team is not adding at current prices.

The duration of the bond portfolio was four years at the end of June, low relative to the benchmark Barclays U.S. Aggregate Bond Index. The emphasis remains on mostly investment-grade corporates and agency mortgages. With fixed-income opportunities slim, the managers bought a few preferred stocks with attractive yields a year ago but say such opportunities are scarce today.

#### **Performance Pillar:** Positive | Laura Lallo 07/27/2016

An emphasis on equities has shaped relative performance in recent years. It was a huge advantage from 2012 to 2014. The fund landed in the top percentile of the moderate-allocation category in 2012 and 2013, with strong showings from holdings in the technology and financials sectors. The equity-heavy allocation helped boost the fund to the top quartile of the category in 2014 as well. It has been a marked disadvantage in 2015 and the first half of 2016, however, particularly given an emphasis on financials stocks and lack of utilities.

This decisive, sometimes contrarian, strategy is bound to lag at times, but shareholders who surged into the fund in the early 2000s came to expect consistent outperformance, until the financial crisis upended expectations. The fund's steep losses from late 2007 through early 2009 spurred outflows that persist to this day. However, despite an above-average loss in 2011, the fund recovered from that bottom. Even after the past lackluster year, its three- and five-year returns through June were in the top quintile of its category, and its 10-year returns beat the average.

This is consistently one of the stronger long-term performers in the category. Over the past 20 years, the fund has captured 113% of the category's upside and only

95% of the downside. However, its current Morningstar Risk score, which covers the past decade, is High.

**People Pillar:** Positive | Laura Lallo 07/27/2016

As with all Dodge & Cox funds, this one benefits from considerable depth of management experience. The stock component is guided by an eight-person investment policy committee. John Gunn and Greg Serrurier stepped off the committee in 2016, but the team still has an average tenure at the firm of 23 years, and includes chairman and chief investment officer Charles Pohl and director of research Bryan Cameron. The fixed-income investment policy committee saw two retirements within the past several years but still comprises eight members averaging 22 years of firm experience, including Dana Emery, CEO and director of fixed income.

This collaborative approach minimizes key-person risk and produces thoughtful, original research. The funds benefit from continuity of management and consistent hiring practices that bring one or two new analysts into the firm each year. As of mid-2016, there were 33 industry analysts and portfolio managers, in addition to 25 fixed-income analysts and managers. (The industry analysts cover both stocks and corporate bonds, while the bond team includes additional corporate analysts, as well as agency, government, and asset-backed specialists.)

If history is a guide, most of these analysts will spend their careers at Dodge & Cox. Indeed, investment professionals rarely leave for any reason other than retirement, and most become partners in the firm.

**Parent Pillar:** Positive | Laura Lallo 05/02/2016

Dodge & Cox is an exemplary firm. CEO and president Dana Emery and chairman Charles Pohl are also lead members of the investment team and run both the firm and its funds with a long time horizon. The average fund manager tenure of more than 20 years is exceeded only by a few boutiques and is much higher than is typical for a large fund company.

There are no stars here; each fund is run collaboratively by an investment policy committee. Ideas can come from any analyst but must survive extensive peer review. Although the funds have seen outflows in recent years, the firm has continued to build the investment team at a slow-and-steady clip. It totals roughly 60 managers and analysts, most of whom become partners.

Dodge & Cox has rolled out only six strategies since it first opened in 1931. The most recent is a global fixed-income offering that launched in May 2014; the firm developed its foreign-bond capabilities as a natural extension of its international-equity expertise. While the firm has eschewed marketing, it is among the largest mutual fund companies today. Asset growth can hinder execution, but management has proved willing in the past to safeguard its strategies by closing funds.

Managers are heavily invested in the funds and the firm and have ample incentive to serve shareholders, as evinced by low costs, clear communications, and a sober long-term approach.

**Price Pillar:** Positive | Laura Lallo 07/27/2016

Even though this fund has seen net outflows since 2007, expenses have not gone up. Its 0.53% expense ratio is a bargain for an actively managed balanced fund; it would be inexpensive even for a diversified bond fund. Management's low-turnover strategy

has also minimized transaction costs.

Low expenses are an advantage for any fund, but they can be particularly significant in the moderate-allocation category. No-load funds with expenses in the highest quintile charge more than 1.15%. That's comparable to the most expensive no-load large-cap stock funds--and a hefty price to pay for a portfolio with a significant chunk in bonds.

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