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BY CHARLES STEIN

STAYING ACTIVE

FUND MANAGER ALBERT NICHOLAS HAS CONSISTENTLY BEATEN THE S&P 500 FOR 40 YEARS, DEFYING THOSE WHO SAY STOCK PICKERS CAN'T OUTRUN INDEXES—OR MACHINES.

Nicholas, right, gave up a chance to play professional basketball to instead play the stock market.

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PHOTOGRAPH BY JENN ACKERMAN AND TIM GRUBER

SPECIAL REPORT | MUTUAL FUNDS AND ETFs

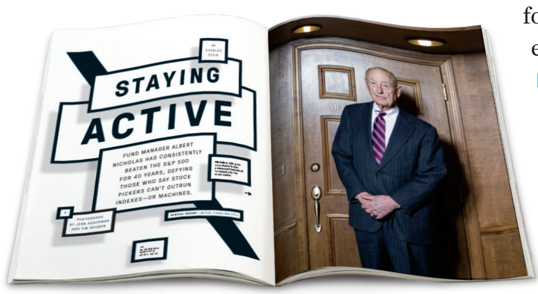
Editor's View

Fund Fights

RECENT HISTORY HASN'T been kind to active fund managers. Last year, just 21 percent of the funds that actively select U.S. stocks beat their benchmarks. No wonder money is streaming out of active management and into passive index funds and ETFs.

One man who has bucked this trend is Albert Nicholas, whose Nicholas Fund tops the diversified U.S. equities category in our annual ranking of the best-performing mutual funds. Nicholas, 84, has outrun the Standard & Poor's 500 Index by an average of 2 percentage points for the past 40 years. "Some guys who are smarter than I am say we can't outperform like this, but we have done it, so I will leave it at that," Nicholas tells Charles Stein (**"STAYING ACTIVE"**).

'Guys who are smarter than I am say we can't outperform like this,' says No. 1 fund manager Nicholas.



One of the smart guys who might give Nicholas an argument is Jack Bogle, founder of index fund giant Vanguard Group. Bogle, 85, has few good things to say about active management or, for that matter, about the innovators who claim they're following in his footsteps, report Michael P. Regan and Robert S. Dieterich (**"IS THERE A NEXT JACK BOGLE? NOT IF YOU ASK JACK BOGLE"**). "Nobody plunges into this battle to build a better industry with any more enthusiasm than I do," Bogle says.

Bogle harbors particular scorn for so-called smart-beta ETFs: "Don't mention smart beta in this office! I don't even know what it means. Baloney. Marketing!" These funds, which track customized indexes and are run by computers, now account for 20 percent of the U.S. ETF market, write Anthony Effinger and Eric Balchunas (**"ATTACK OF THE ALGORITHMS!"**). If a smart-beta ETF is based on an algorithm designed by humans, does that make it active or passive? It depends on whom you ask. In the black-and-white battle between active and passive, there are, it seems, more than a few shades of gray.

Ron Henkoff

EXECUTIVE EDITOR


NICH

Albert Nicholas is well aware that some prominent academics say stock pickers can't beat their benchmarks over the long haul. He doesn't have a Ph.D., yet he has good reason to disagree. The Nicholas Fund, which he has run since 1969, has topped the Standard & Poor's 500 Index by an average of 2 percentage points a year for the past 40 years and has beaten it every year since 2008. ▪ If you think that doesn't make a big difference, consider this: A $10,000 investment in the Nicholas Fund in September 1974 was worth about $2 million in September 2014, roughly twice the value of the same investment in the index. "Some guys who are smarter than I am say we can't outperform like this," says Nicholas, who turned 84 in January. "But we have done it, so I will leave it at that."

Nicholas has been especially hot since the end of 2009, riding longtime holdings such as auto parts retailer O'Reilly Automotive, up fivefold in the five years ended on Dec. 31, and money manager Affiliated Managers Group, which tripled in the same period. Nicholas has owned stakes in both companies for more than a decade.

The numbers made the Nicholas Fund No. 1 in the diversified U.S. equities category in *Bloomberg Markets*' annual ranking of mutual funds.

The winners in the rankings all pick individual stocks and bonds. The rankings are based on U.S.-domiciled funds with more than $250 million under management as of Dec. 31. Funds are ranked by total returns for one, three, and five years and by their Sharpe ratios for three and five years. The Sharpe ratio measures the performance of funds adjusted for risk. Each of the five measures is given equal weight.

Active managers have been on the defensive of late. In 2014, just 21 percent of the funds that pick U.S. stocks beat their benchmarks, according to Morningstar. Investors have noticed and voted with their feet, swapping their actively managed funds for low-cost index and exchange-traded funds. Last year, actively managed mutual funds that buy U.S. stocks suffered a net $98 billion in redemptions, while domestic stock index funds and ETFs attracted a net $167 billion. ETFs, nearly all of which mimic indexes, received $95 billion of the total.

The two biggest recipients of mutual fund cash last year were Vanguard Group, the index fund leader, and Dimensional Fund Advisors, an Austin, Texas, firm that sells index funds with a bias toward small-cap and value stocks. "Conventional active managers promised a lot they were not able to deliver," says David Booth, Dimensional's chairman. (They usually do, says former Vanguard CEO Jack Bogle. See "Is There a Next Jack Bogle? Not If You Ask Jack Bogle".)

Booth's mentor, University of Chicago finance professor Eugene Fama, who shared the Nobel prize in economics in 2013 for his work on efficient markets, is equally dismissive of stock pickers. In a 2009 paper he wrote with Kenneth French of Dartmouth College, Fama concluded that actively managed stock funds collectively return about the same as the stock market as a whole, minus the fees they charge.

SANTA FE, NEW MEXICO–BASED THORNBURG INVESTMENT TOPS BOTH THE GLOBAL BONDS AND GLOBAL EQUITIES LISTS. ITS WINNING STOCK FUND HAS BEATEN ITS BENCHMARK BY AN AVERAGE OF 6 PERCENTAGE POINTS A YEAR SINCE 2006.

Notwithstanding the academic research, the great bulk of fund money is still actively managed. Some $13.1 trillion was invested in U.S. mutual funds at the end of 2014. Of the $8.3 trillion in stock funds, 38 percent was passively managed. Yet that's double the percentage at the end of 2004. Although the money in U.S. ETFs has grown rapidly, from less than $100 billion in 2000 to $2 trillion today, it's still a fraction of the total amount in mutual funds.

The increasing popularity of passive investing has forced stock pickers to speak up. The normally publicity-shy Capital Group, which runs the $1.1 trillion American Funds complex, all of whose funds are actively managed, published two research papers in the past two years. One quoted statistics indicating that most American Funds offerings beat their benchmarks over time, while the other asserted that actively managed funds with low expenses and high manager ownership usually outperform. The firm acted after it was hit by $250 billion of client redemptions from 2008 to 2013. "We believe in what we do, even if at times the world doesn't," says Timothy Armour, Capital's head of mutual funds.

No one at the $1.1 billion Thornburg Global Opportunities Fund, a unit of

Santa Fe, New Mexico–based Thornburg Investment Management, thinks the indexes can't be beaten. Since it was created in July 2006, the global stock fund has crushed its benchmark, the MSCI All-Country World Index, by an average of 6 percentage points a year. It tops the *Bloomberg Markets* ranking of global equities funds.

Co-manager W. Vinson Walden attributes the success to good research and a willingness to be patient. In 2010, the fund bought Brazil Foods, a São Paulo poultry producer whose shares were depressed by concerns about rising commodities prices. Walden saw something else: a low-cost producer with the potential to expand in Brazil and other emerging markets. "We saw a nice tail wind that would last for years," he says.

When the stock slumped again in 2013 due to management turnover, Walden bought more. As an active manager, he says, he can pounce when a company's share price dips below its long-term value. Brazil Foods traded at more than 60 reais a share on Dec. 31, up from 20 to 25 reais when the fund first purchased the stock. "It's been a gift that keeps giving," Walden wrote in an e-mail.

Another luxury active managers enjoy: making a big bet on one stock. Longleaf Partners Small-Cap Fund started last year with 13 percent of its money in cement maker Texas Industries. "We are not afraid to make an outsized bet where we like something," says Ross Glotzbach, one of the managers of the $4.4 billion fund. Texas Industries agreed to be bought by Martin Marietta Materials at a premium in January 2014, which helped the Longleaf fund earn the No. 1 ranking among small-cap U.S. equities funds.

The Longleaf small-cap fund, run by Tennessee-based Southeastern Asset Management, boasts roughly twice the return of its benchmark, the Russell 2000 Index, over the past 20 years. The fund's managers will hold cash when they can't find attractive stocks.

'CONVENTIONAL ACTIVE MANAGERS PROMISED A LOT THEY WERE NOT ABLE TO DELIVER,' SAYS DAVID BOOTH OF DIMENSIONAL FUND ADVISORS, WHO'S A DISCIPLE OF THE UNIVERSITY OF CHICAGO'S EUGENE FAMA.

Longleaf also buys beaten-down companies when it believes the long-term prognosis is bright. The fund added energy shares in the fourth quarter as oil prices collapsed. "We are contrarians, and we like to buy things for less than they're worth," Glotzbach says.

The stampede to index funds and ETFs is not as pronounced among bond managers as among stock pickers. Only about 19 percent of the money in bond mutual funds and ETFs is indexed, according to Morningstar.

Still, active bond managers have to demonstrate they are worth the higher fees they charge compared with indexers. Daniel Ivascyn has done that. The $40 billion Pimco Income Fund he has run since 2007 outperformed 99 percent of peers over the five years ended on Dec. 31, while returning an average of 11.6 percent a year. Its benchmark, the Barclays U.S. Aggregate Index, gained an average of 4.5 percent annually.

The numbers were good enough to earn Pimco Income the top ranking among U.S. corporate bond funds for the second year in a row. They also helped Ivascyn win a new job, group chief investment officer. He got the title after bond legend Bill Gross abruptly left Pimco in September.

Ivascyn and co-manager Alfred Murata divide their fund into two buckets: one with high-yielding assets that will do well in a strong economy, and the other with investments that can thrive if the economy weakens. A longtime Ivascyn favorite filled the first pail last year: bonds made up of mortgages that aren't backed by Fannie Mae, Freddie Mac, or Ginnie Mae. Those bonds have rallied as the U.S. housing market has revived. "We still like them, and they have become safer and more predictable," Ivascyn says.

Ivascyn also bet on Australian government bonds, which rose as the Australian economy weakened because of a slump in commodities prices. Pimco Income's managers say their ability to regularly adjust the mix of assets—rather than blindly mimic an index—is critical to their performance, especially in an environment of ultralow interest rates.

Thornburg Investment was a double winner in the *Bloomberg Markets* ranking. Its $1.3 billion Strategic Income Fund topped the global bonds category, with average returns of 7.1 percent over three years and 7.8 percent over five. Co-manager Jason Brady says his ability to buy income-producing securities anywhere in the world is crucial to the fund's success. The fund topped its category despite a 3.2 percent return in 2014, due in part to the fact that it missed out on much of the rally in government bonds. "The risk/reward didn't look that good to us," Brady says. "Too many of the buyers, like the Federal Reserve, don't care if they make money."

Brady has concentrated on corporate debt, including high yield. Because most of his bonds are denominated in dollars, the fund wasn't hurt in 2014 as the dollar strengthened against most currencies. One of Brady's holdings, Odebrecht Offshore Drilling Finance, a Brazilian supplier of ships that explore for oil, yields about 13 percent, a reflection of investor concern about plummeting oil prices. "There is a lot of risk, but we also have a lot of protection," Brady says.

Albert Nicholas, known to friends as Ab, almost chose another field that offered the kind of competitive challenge he thrives on. A star basketball player at the University of Wisconsin, he was offered $6,000 a year in 1954 to play for the Milwaukee Hawks in the National Basketball Association. He took a financial job instead for $4,200. "I think I made the right decision," he says.

Nicholas opened his own Milwaukee-based investment firm in 1967 and two years later started the Nicholas Fund. His 45 years running one fund make him the third-longest-serving mutual fund manager in the U.S., after Ernest Monrad, 84, of Northeast Investors Trust, and Rupert Johnson Jr., 74, of the Franklin DynaTech Fund.

Nicholas's firm runs six mutual funds and a total of $5 billion in assets. His son David, 53, is co-manager of the Nicholas Fund and lead manager of the $715 million Nicholas II fund, which buys midcap stocks, and the $323 million Nicholas Limited Edition fund, which invests in small caps.

After a strong start in the 1960s, the Nicholas Fund lost 53 percent in the recession of 1973 and 33 percent in 1974. Nicholas changed his strategy. He abandoned the chase for hot stocks and looked for companies he could hang on to—steady growers with strong balance sheets and limited exposure to the ups and downs of the economy. The idea was to make money by avoiding steep plunges. "We have two principles," he says, adapting an old joke. "The first is: Don't lose money. The second is: Don't forget principle No. 1."

ALBERT NICHOLAS CHANGED HIS STYLE AFTER BIG LOSSES IN 1973 AND 1974. SINCE THEN, HE HAS INVESTED IN STEADY GROWERS WITH STRONG BALANCE SHEETS AND LIMITED EXPOSURE TO THE UPS AND DOWNS OF THE ECONOMY.

Nicholas's focus on avoiding losses helped him in 2008, when he beat 93 percent of peers, and in 2011, when he beat 96 percent as the S&P 500 gained 2.1 percent. He largely avoids banks, cyclical businesses, and commodities producers, including energy companies. "I don't know anyone last year who said oil was going to fall 50 percent," he says. "So much for predicting."

O'Reilly Automotive is a longtime Nicholas favorite. The Springfield, Missouri–based retailer grows steadily in good economic times and bad. "When the economy struggles, people keep their cars longer," he says. Nicholas first put the stock in his fund in the third quarter of 2002, when it sold for an average of just over $14 a share. On Feb. 17, the price was $206. He is hanging on to the stock, though it looks expensive on paper. "We are patient with great companies, even if they are a little overvalued," he says.

AMG has also been in the portfolio since 2002 and had appreciated roughly fivefold since then as of Dec. 31. The Beverly, Massachusetts, firm buys up small money managers and gives their executives an incentive to continue to perform well. AMG owns a stake in Yacktman Asset Management, whose AMG Yacktman Fund boasts an average return of 13.9 percent over the five years ended on Feb. 17.

Nicholas has known bad times. His experience with losing money in the 1970s, and again in 2001 and 2002, when he bought plunging tech stocks too soon, has shown him it doesn't take much to fall behind. Yet he is not about to sit down with a textbook by Eugene Fama. "We think if we stick to our philosophy and protect people on the downside, we can produce a pretty good record," he says. "The past 40 years has proved that."

Charles Stein covers funds at Bloomberg News in Boston. cstein4@bloomberg.net With assistance from **Laurie Meisler** in New York.

HOW WE CRUNCHED THE NUMBERS

We used two Bloomberg functions to create the mutual fund rankings. The first was Fund Screening (FSRC), which we used to generate separate lists for global, diversified U.S., and small-cap U.S. equities funds and for U.S. corporate and global bond funds. The second was Fund Scoring (FSCO), which we used to create a model with five criteria: total returns, net of fees, for one, three, and five years and Sharpe ratios for three and five years, all as of Dec. 31.

All searches included only active, open-end, U.S.-domiciled, Class A funds with more than $250 million in total assets as of Dec. 31. We excluded institutional-class, index, sector, and market-neutral funds. For global equities and global bond funds, we limited the universe to funds described as global in the Bloomberg database.

In scoring the funds, we blended returns with the Sharpe ratio because that measure shows how well the return of a fund compensates investors for the risk taken. A fund that takes substantial risk to produce a high return may have a lower Sharpe ratio than a fund that takes less risk and gets a lower return. Our screen model gave equal weight to the five criteria, with each fund in the same group awarded a score from zero to 100 based on its performance in the group. The winning funds were those that received the highest scores.

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Nicholas Fund (NICSX)

March 31, 2016

Please read the information below along with the included article from Bloomberg Markets.

Portfolio Manager: Albert (Ab) O. Nicholas, CFA
Associate Portfolio Manager: David O. Nicholas, CFA

Investment Philosophy:

The advisor invests in high quality, long-term growth companies that meet our investment criteria, which includes
- A strategic position within their industry
- An enduring franchise, product or brand
- Consistent, or improving, earnings growth and free cash flow
- Low debt levels
- Reputable management with meaningful stock ownership
- Out-of-favor or undiscovered companies
- Stock price below long-term potential value

Investment Approach:

Nicholas Fund pursues long-term capital growth through a diversified stock portfolio of small- to large-sized companies with capitalizations generally between $1 to $100 billion.

Portfolio Information:

Date of Inception:	07/14/1969
Net Assets:	$3,274.3 million
Number of Holdings:	43
Weighted Avg. Trailing P/E Capped:	15.48x
Weighted Avg. Forward P/E Capped:	16.77x
Weighted Avg. Market Capitalization:	$60,513.5 million
Weighted Median Market Capitalization:	$25,506.7 million
Weighted Harmonic Avg. Price/Book:	3.49x
Turnover Rate:	11.76% (09/30/15)[1]

[1] Annualized.

Performance History: as of March 31, 2016

	1 Year	3 Year	5 Year	10 Year	40 Year
Nicholas Fund	-8.68%	10.84%	12.19%	8.29%	12.57%
Standard & Poor's 500 Index	1.78%	11.82%	11.58%	7.01%	11.00%
Ending value of $10,000 invested in Nicholas Fund	$9,132	$13,618	$17,773	$22,172	$1,139,052

Expense Ratio: 0.72%

Performance data quoted represents past performance and is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-800-544-6547 or visiting www.nicholasfunds.com/returns.html.

The ending values above illustrate the performance of a hypothetical $10,000 investment made in the Fund over the timeframes listed. Assumes reinvestment of dividends and capital gains. Returns shown do not reflect the deduction of taxes that a shareholder would pay on Fund distributions or the redemption of Fund shares. These figures do not imply any future performance.

Top Ten Holdings:	% of Net Assets
Gilead Sciences, Inc.	4.69%
Walgreens Boots Alliance, Inc.	4.63%
Affiliated Managers Group, Inc.	3.74%
Thermo Fisher Scientific Inc.	3.57%
Aon plc	3.52%
LKQ Corporation	3.47%
Chubb Limited	3.31%
AT&T Inc.	3.29%
International Business Machines Corporation	3.24%
O'Reilly Automotive, Inc.	3.11%
	36.57%

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the Fund, and they may be obtained by visiting www.nicholasfunds.com. Read carefully before investing.

Diversification does not assure a profit or protect against loss in a declining market.

Mutual fund investing involves risk. Principal loss is possible. Investing in small and medium sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, stock price fluctuations and liquidity.

Index Definitions - You cannot invest directly in an index.
The Barclays U.S. Aggregate Index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.
The MSCI All-Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.
The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization.
The Standard & Poor's 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

Fund holdings and/or sector weightings are subject to change at any time and are not recommendations to buy or sell any security.

Glossary of Terms:

Beta	Beta measures the sensitivity of rates of return on a fund to general market movements.
Book Value	Net asset value of a company, calculated by subtracting total liabilities from total assets.
Cash Flow	Measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.
Free Cash Flow	Measures the cash flow available for distribution among all the securities holders of an organization.
Harmonic Price/Book	Price per share divided by book value per share. The harmonic function reduces the impact of outliers in the denominator on the aggregate calculation.
Market Capitalization	The market price of an entire company, calculated by multiplying common shares outstanding by the current market price per common share.
Price/Earning(P/E) Capped	A valuation ratio of a company's current share price compared to its per-share earnings or in the case of REITs (real estate investment trusts), their funds from operations. These weighted average values are limited in a range between 0 and 60.