A new study identifies mutual funds that tend to outperform the market during certain stages of the economic cycle. A model portfolio, investing in stock mutual funds that have historically performed best under similar market conditions, outperformed the overall market from 1980 to 2002.

How $10,000 invested would have fared in:

- Model portfolio: $1,000,000
- $100,000
- $10,000

Scale is logarithmic to show the data on a comparable percentage-change basis.

90-day Treasury bills (the term spread). As they expected, the professors found that the typical manager’s likelihood of beating the market was strongly related to these four variables. Professor Wermers estimates that as many as a third of the fund managers in the study showed market-beating ability during at least some phase of the market cycle. That compared with just 10 percent of managers who, he said, were able to beat the market’s overall return over the last two decades.

How can this help investors beat the market? To find out, the professors built a hypothetical portfolio that invested each month in the no-load funds that historically performed the best when the four macroeconomic variables were similar to that month’s readings. They back-tested the portfolio from 1980 through 2002, being careful to use only the information that was publicly available going into each month.

The professors say they were startled by this model portfolio’s large and consistent returns over the 23 years. Not only did the model outperform the overall market by eight percentage points a year, on average, but it also handily beat a benchmark portfolio of funds that was similar to it in three ways: in its risk level, in the market capitalization of its holdings and in its place on the growth-to-value spectrum. The professors also compared their portfolio’s gain with that of several strategies that previous research had found to have market-beating potential. None of those others came close.