

## So Many Mutual Funds, So Little Time How to Choose and Evaluate Mutual Funds

By: Robert A. Mecca, CFP, MBA, RIA

The following was printed in the February, 2006 edition of *Stocks, Future, & Options* magazine.

Mutual funds...whether you love 'em or hate 'em, it can't be denied that they are here to stay. They provide leverage, liquidity, marketability and diversification. Plus, they come in a variety of styles including money market, fixed income, equity, balanced, real estate, sector, foreign, index and hedge. In fact, don't be surprised if the number of funds grows as new hybrid products, such as mutual funds that invest in both stocks and bonds, evolve. Of course with so many choices, investors must do their research, which goes beyond simply asking, if the fund is "good" or not. What investors need to know is not whether it is good, but whether it is *appropriate* to his/her investment personality.

### **Reason and Risk**

For an investor to determine whether a fund suits his investment personality, he must know why he is investing and know his risk tolerance. Understanding why one invests sounds simple, but actually requires more consideration than one would think. When teaching investment classes, I ask why people invest, and they generally respond, "to make money." But, actually, that's not the reason we invest. Making money a byproduct of why we invest. We invest to attain financial goals. For example, we invest in a 401(k) plan to save for retirement when we plan to consume the money enjoying life traveling, hobbies, and the like. Furthermore, we invest in specific mutual funds within a 401(k) for the purpose of long-term capital appreciation allowing assets to compound tax deferred above the average inflation rate.

Second, a proper perspective on risk helps shape one's investment personality. Knowing your risk tolerance, in turn, helps calculate targeted returns on investment. How much risk an investor is willing to risk helps him choose which mutual fund properly fits into an investment portfolio. But many investors don't know their risk tolerance. Without this knowledge, it is extremely difficult to choose the right mutual fund. The risk identification form below can help you determine your risk tolerance.

## RISK IDENTIFICATION FORM

Contrary to popular opinion, there is no risk-less investment. All assets carry a form of risk. Identification of risk is important in developing appropriate investment strategies.

### Risk

Accept

Investing in the markets including stock, bond, real estate, other \_\_\_\_\_

Investing in a fixed rate asset that has interest rate and reinvestment variances due to rising and falling rates \_\_\_\_\_

Inflation and taxes eroding principal usually associated with liquid assets \_\_\_\_\_

Not able to convert assets to cash quickly without the chance of losing principal \_\_\_\_\_

Currency fluctuation usually associated with stocks and stock funds \_\_\_\_\_

Financial and credit stability of a company that may provide higher yields than other higher quality investments \_\_\_\_\_

To further verify your tolerance for risk, please complete the following:

Yes   No

On a risk scale of 1 to 5 (1= least; 5 = most), I rate myself as a \_\_\_\_\_ risk taker with the understanding that the lower number may mean lower returns. The higher number is an attempt to generate higher returns while accepting losses.

I acknowledge that most assets can fluctuate in value and am prepared to hold my assets during market downturns.      \_\_\_\_\_

How long are you willing to hold investments during market downturns?  
Not at all \_\_\_ 1 to 3 years \_\_\_ 3 to 5 years \_\_\_ over five years \_\_\_

I would rather be out of the stock market because volatility bothers me. I accept the probability that relatively attractive gains can be missed in the long term.      \_\_\_\_\_

I'd rather leave nearly all my money in relatively safe Investments earning nominal yields and taking risk of low returns after inflation and taxes.      \_\_\_\_\_

I am a long term investor and willing to ride out troubled markets for 5+ years.      \_\_\_\_\_

Trying to time any market is difficult and prefer to hold assets in up and down times \_\_\_\_\_

Considering my risk orientation, my realistic target average annual return for the overall portfolio is \_\_\_\_\_% (refer to averages on the next line)  
(hint: bank accounts average 3%, bonds average 6%, stocks average 10%)

By the way, **never** marry a fund family. Some have told me that they are Vanguard investors or Fidelity investors only. Why limit your choices? Don't miss the great values offered by the vast alternatives which could fit nicely into an asset allocation model. It isn't prudent or wise to invest solely with one family if your investment portfolio is a decent size. There are numerous ways to evaluate a mutual fund. Here are some basic strategies to consider. Evaluate mutual funds on a fundamental and technical basis.

### **Fundamental Components to Evaluate**

Once you know the reason for investing and risk tolerance, it's time to evaluate and choose an appropriate mutual fund to determine how it fits into your investment portfolio and how it matches your investment personality. Fundamental components are investment objective, investing styles, manager experience, management fees, load vs. no load, turnover, and income tax implications.

Start by reviewing the fund's *investment objective*. Keep it simple. Either the mutual fund fits your investment profile or it doesn't. If it doesn't, the other fundamental characteristics don't matter. If, for example, the mutual fund under review is a bond fund investing primarily in below-grade securities and you wish to invest strictly high-quality securities, the fund's objectives don't match yours. If you own it, sell and invest elsewhere.

Next, diversify the portfolio with *investing styles*. Mix large-cap, mid-cap, small-cap and international stock funds. Incorporate both growth and value investment styles. Blend high quality short- and intermediate-bond funds.

Check out the portfolio *manager's experience*. How long has he/she managed any mutual fund? How long has he/she managed the particular fund evaluated?

I, for one, like to see a manager with investment experience during both bull and bear markets. Many times, a well-seasoned manager earns his stripes through difficult markets.

Review *management fees*. Every mutual fund has a management fee, the investor's cost for the privilege of using professional management. Certainly don't overpay for these valuable services, but don't automatically reject a fund strictly on this basis. Typical annualized fees for bond funds are about one percent and stock funds are about one and a half to two percent. It would be a major mistake solely to invest in a fund because management fees are relatively low. What really counts is what you put in your pocket. Consider the following two funds:

	<u>FUND A</u>	<u>FUND B</u>
Investment objective	large cap value stock	large cap value stock
Management fee	.80%	1.75%
Average return	8%	11%

Everything else equal, investing in Fund B would generate higher net returns net of management fees, thus should be seriously considered all else equal.

Most mutual funds have a *load* (commission) tagged to them. An investor can pay commissions when entering or exiting a fund. Another investor mistake involves considering only no-load funds. As an independent, fee-only consulting firm, we don't sell funds but make specific recommendations. In addition to no-load funds, we may recommend loaded funds when appropriate if a fund fits all the criteria of one's investment personality plus demonstrates higher returns net of fees and commissions.

*Turnover* is very important for many reasons. First, it spotlights how aggressive a portfolio manager may be. A stock portfolio with 100 percent turnover demonstrates that the manager turns a portfolio about once every twelve months. A fund with 200 percent turnover shows stock flips in six months. Typically, higher turnover results in higher management fees.

More importantly, higher portfolio turnover usually reflects a *tax-inefficient* mutual fund. Recognizing whether a fund is tax efficient is essential for an investor to determine where it could fit into his investment portfolio. Depending on your income tax bracket, tax consequences can make or break returns. The higher the tax bracket, the more severe the consequence. Every year, a mutual fund investor participating in a tax-inefficient fund could pay significant tax on both ordinary income *and* capital gains.

Review the mutual fund prospectus for its tax efficiency status or call the fund. If the particular fund has all the merits you seek even though not tax efficient, there is still a valid strategy to use to your advantage. Place the mutual fund in a qualified account. Examples of qualified accounts include traditional IRA, Roth IRA, traditional 401(k), Roth 401(k) and annuity. This way, the dividends, interest, and capital gains compound tax deferred or tax free for a Roth until age 70 ½. Over time, you'll save significant money.

But there are other tax issues to understand. People don't realize that when they buy funds with embedded capital gains, there is a potential tax liability. Government regulations require mutual funds to pay out capital gains at least yearly. Embedded capital gains are time bombs. Know when the bomb goes off before investing and you'll survive.

As an example, let's say that a fund distributes \$2 capital gains per share July 1 and you invest June 29 at a net asset value of \$20 per share just prior to the distribution. In that case, you realize the capital gains for income tax purposes while the market net asset value drops to \$18 per share. Your cost is \$20 per share even though you own more shares through a dividend reinvestment plan. But, in essence, the investor pre-pays the tax. Investing in a non-qualified account (non IRA) you may soon discover this unpleasant experience when a 1099 tax form arrives in the mail and taxes are due even though you did not sell the fund.

Because nearly all stock funds pay capital gains towards the end of the year, I rarely recommend investing in non-qualified stock funds during December to help avoid paying unnecessary taxes. Instead, our strategies concentrate on investment purchases in qualified accounts where distributions are not taxed.

### Technical Components to Evaluate

If one were to stop their analysis with fundamental analysis, the evaluation wouldn't be complete. A technical evaluation of a mutual fund includes a look at the following technical components: returns (absolute and relative), standard deviation, Sharpe ratio, alpha, beta and  $R^2$ .

First, view *returns* in two ways: *absolute* and *relative*. Let's say you are a moderate risk taker desiring an average annual total return to of eight percent. Look at the history of the fund for comparison. Examine at least five years—preferably ten years. For long-term investors, see how the fund performed under both favorable and unfavorable market conditions. In difficult markets, you would be wrong stating a fund is “bad” just because the returns did not meet your target. On a *relative* basis, the fund may be doing just fine. For example, if a comparable index is up four percent for the year and your fund is up six percent, it may lag a desired targeted return but still outperform versus the index.

Looking at a mutual fund's returns and ignoring risk can be dangerous. *Standard deviation* measures the variability, or dispersion, of returns around its mean. Generally, you want lower standard deviation.

The *Sharpe ratio* measures return and risk. It is one tool to help demonstrate whether the fund has a favorable risk-to-reward relationship. In general, look for a positive ratio

$$\text{Sharpe ratio} = \frac{\text{Average annual return minus risk-free return}}{\text{Standard deviation}}$$

*Alpha* compares the fund's performance versus a relative index. The higher the alpha, the better the fund has performed vis-à-vis its comparable index.

*Beta* measures volatility. When I think of beta, roller coasters come to mind. The higher the roller coaster, the more exciting and sometimes terrifying it is. A high beta of, say, 1.25 indicates that the fund can be volatile, much like a massive roller coaster with intimidating drops and striking turns. It can be a rewarding thrill, but also very scary. A beta under 1.0, on the other hand, indicates a relatively tame ride.

$R^2$ , based on a scale of zero to 100, says whether a fund's movement is attributable to the market index. So, an  $R^2$  of 89 means the stock fund's movement highly correlates to the S&P market movement. For proper diversification, construct an investment portfolio with various  $R^2$  funds.

**Take the Time**

Certainly, proper evaluation takes time. With these guidelines, you can construct a high-quality investment portfolio closely reflecting your investment personality, maximizing returns, minimizing risk and reducing income taxes. Your money can work harder and smarter moving forward towards your financial goals. That's what financial planning is all about and how investors succeed.

*Robert A. Mecca, CFP, MBA, RIA is president of Robert A. Mecca & Associates, LLC, a full-service, fee-only life planning consulting firm located in Mt. Prospect, Illinois. He also teaches investment classes. Bob is listed in The Guide To Americas Best Financial Planners. He can be reached at 847-359-2900 or [www.MeccaOnMoney.com](http://www.MeccaOnMoney.com).*