WHAT EVERY INVESTOR SHOULD KNOW ABOUT MUTUAL FUNDS

By John Markese

There is some evidence that stock funds at the top of the performance lists are more likely to continue out-performing in the next period, particularly over shorter time periods. But what is more telling is that bad funds tend to continue to be bad.

In mutual fund investing there are no immutable laws to guide us, as we have in physics. But then again, it's not professional wrestling either.

Some of what follows distills the collective experience of mutual fund investing; some of it has empirical evidence pointing its way. But most is simply common sense that investors often set aside or forget in the heat of making an investment decision.

- *Top Performance Lists Are Dangerous.* Probably the single most potentially dangerous action a mutual fund investor can take is to glance at these ubiquitous lists. Funds make the top of the lists not because they are like all the rest of the funds, but because they are decidedly different in some important way. Risk is usually the first important difference. For stock funds, holding stocks that are more volatile than the average stock, holding fewer stocks, or concentrating on only a few industries, raises risk and puts a fund in position to have a greater chance at making the top of the list.

  As an example, take sector funds. You can't beat the market by holding it, which is why you can always find a sector fund of one kind or another at the top of most performance lists. Call it stock picking, or industry weighting, or both, but the net effect is increased risk, and less diversification than the overall stock market.

  Picking the funds at the top of the performance lists assumes that either these same stocks or sectors will continue to do well, or that the managers can continue to deftly take high risk and move money around better than all the rest.

  For domestic bond funds, making the top of the list is a result of the maturity structure of the fund's portfolio. The longest maturity bond funds will be at the top of the performance lists when interest rates are falling, and at the bottom of the lists when interest rates rise. So, investing in bond funds that are at the top of the list is a forecast of interest rates—that they will stay constant or continue in the same direction, a prediction that even professional interest rate prognosticators have been woefully unsuccessful in getting right.

  However, these top/bottom lists may hold a small glimmer of value. There is some empirical evidence that stock funds at the top of the heap one period have a greater likelihood to have this superior performance in the next period, on average—"hot hands" may stay hot. Why might a fund's superior performance persist? Probably because the stocks/sectors emphasized in the portfolio continue to have positive momentum into the next period. The shorter the time periods observed, the more likely this is to be true: quarter-to-quarter performance persistance is more likely than year-to-year. But be careful, this is based on performances of top funds, on average, and investors don't invest in fund averages, but instead invest in individual funds.

  What is more telling, however, is that bad funds tend to continue to be bad. But again, be careful. If an entire category of funds—small stock value funds or emerging market funds, for example—do poorly, then making the bottom list is probably meaningless if your fund has a lot of peer compan-

John Markese is president of AAII.

ions. But if large stock growth funds populate the top list or simply are not to be found in numbers on the bottom list, and your large stock growth fund makes an appearance at the bottom of the pile, it isn't a good sign.

And, of course, being a knee-jerk contrarian and buying funds that make the bottom list on the theory that what falls must rise, is probably a seriously flawed approach to fund selection.

- *Size Matters.* The amount of money invested in a fund does matter, but whether larger is better than smaller depends on the investment objective of the fund. With a large stock index fund, a U.S. government bond fund or a money market fund, the more dollars under management the better. This is because they all operate in very liquid segments of the market where large block transactions are less likely to impact prices—pushing prices up when purchasing and down when selling—and large-scale transactions might prove to be cheaper to accomplish. In addition, large amounts to manage in these funds will not interfere with their investment objective. And, since some fund expenses are fixed, spreading these expenses over more investment dollars should reduce expenses as a percentage of fund assets.

  On the other hand, funds with investment objectives that cover less liquid market segments—small stocks or emerging markets—can be too large. That means that individual trades will tend to be larger, which may in turn lead to higher transaction costs tied to security pricing, a wide bid-asked spread on the stocks, and make portfolio changes harder to accomplish. The classic response of funds that focus on small stocks is to migrate investments to mid-sized and large stocks when they start to achieve a large asset base.

  Actively managed stock funds, when managers are picking stocks and industries and moving money around, can be flooded with new money and find themselves unable to deploy new money expeditiously or effectively. And a flood of new money usually comes after a performance that garners widespread attention and is often difficult to replicate, particularly with the surge of new investment in the fund. An index fund, passively managed and operating in a liquid segment of the market, would not be stumped by a large, sudden inflow of cash.

  How large is large? When it comes to net assets, $100 billion may be just fine for an S&P 500 index fund, but $1 billion may choke an actively managed small stock fund. And beware of funds that had extraordinary performance when they had $100 million or less, a relatively small amount in net assets. In order to invest larger amounts they may have to invest money in more stocks and industries, increasing diversification and decreasing risk, dulling performance.

- *Fund Expenses Can Be Costly*. Fund expenses count. And they count more for some investment categories than others. The general rule is that if you invest in a fund that has a significantly higher expense ratio than the average for its category, the long-term performance drag will be costly. Few active fund managers cover the cost of the increased expenses of active management compared to the rock-bottom cost of passively managing an index fund. And if a fund manager is saddled with a relatively high expense ratio due to a small net asset base or high management/research costs, or both, the task of providing above-average category performance is all the more difficult. Some managers, when faced with this dilemma, may boost the risk level of the fund to remain competitive.

  Stock funds are more expensive to manage than bond funds, international funds are more expensive than domestic funds, and funds with large asset bases are cheaper than small funds. But if the expense ratio of a bond fund is approaching 1.00%, or a stock fund 1.50%, think twice before investing. And don't forget stock index funds often change 0.25% or less.

- *Loads Are Loads.* Whether the sales charge, or load, is up front when you buy into the fund, at the end when you sell the fund, or is an as-you-go 12b-1 charge included in the expense ratio, it will cost you. Loads go to sales organizations and sales personnel; they are not used to secure better portfolio managers, better research or better anything. A load reduces your return dollar for dollar. So if you are not getting financial advice worth the load, buying a loaded fund will cost you, perhaps dearly. Load funds do not outperform on average similar objective funds with no loads, and in fact they tend to underperform by the amount of the load. How could they, given what loads are used for? Want to invest with a hot manager in a fund that is loaded? Given the iffiness of historical performance as a predictor of future performance, find a no-load fund with a similar style, performance and risk, and save the load charge.

  Don't forget that almost all fund performance data is reported without adjusting for front-end or back-end loads. However, performance data does adjust for the 12b-1 charge because it is included in the expense ratio, and fund performance net of the expense ratio is accounted for in performance statistics.

- *Market Timing Doesn't Work.* Wouldn't it be wonderful if either you or your fund manager could time the market? You'd make a

mint, but it's only a dream. Nobody, but nobody, has consistently guessed the direction of the bond or stock market over any meaningful length of time, although many will make the claim. And remember that to be successful, timing requires two calls: When to get out, and when to get back in.

One reason beyond low expense ratios that index funds are tough to beat is that they are always 100% invested in the market—they have no cash holdings—when the market takes off. Index funds always call bull markets correctly and they never miss a rally. Yet, they always fail to call a bear market or correction. However, being right on every bull market, as well as avoiding transaction costs and minimizing taxable distributions, is tough to beat.

Since returns on stock and bond funds have been distinctly positive on average annually since we have started keeping records, being ready for bull markets is more important than avoiding bear markets.

When investing in actively managed stock funds, you should hope for superior stock and industry selection, not market timing. If your actively managed portfolio is building up a large cash balance, in excess of 10% of the portfolio, your manager is either engaging in some subtle market timing or there has been a recent rush of cash into the fund. Either case may ultimately lead to poorer performance. For bond funds, when maturities are significantly shortened or lengthened, the impetus is usually market timing driven by an interest rate forecast.

- *Give New Managers and Funds Time to Prove Themselves Before Investing With Them.* With the thousands of funds and fund managers in the investing universe that have track records of at least three years, why invest in an untried fund or manager? While finding funds that will be top performers in their category before the fact is daunting, avoiding disastrous fund investments is within reach. But it requires something upon which to base a judgment. At least a three-year performance history that can be compared to the performance of funds with similar investment objectives and assumed risk is indispensable to evaluate a fund manager or a fund. Consistently favorable performance relative to a peer group of funds over different market environments provides no guarantees of future performance, but it is infinitely better than nothing. You would be surprised how many new funds are quietly buried and new fund managers transferred after the first few disappointing years.

CONCLUSION

Put these few simple bullet points on your refrigerator, enter them into your Palm Pilot, engrave them on your cufflinks, and if you have been contemplating a tattoo, consider inking them onto an easy-to-read spot.

While they are just common sense, paying attention to these mutual fund pearls may make all the difference. ✦