MUTUAL FUND CLASSIFICATIONS: HOW DO YOUR FUNDS FIT IN?

By John Markese

With the explosion of new funds, each jockeying to stand out from the crowd, fitting funds into neat classifications has become increasingly challenging, even for those in the mutual fund business.

Odds are that if you have not taken the time to do a careful analysis of the styles and investment objectives of your various mutual funds, you have overlaps as well as gaps in your portfolio. And you may be way off in your opinion on just how well your funds have done relative to their peers.

Blame it on the explosion of new funds: With each jockeying to be different and to stand out from the crowd, fitting funds into neat classifications has become increasingly challenging, even for the firms in the business of reporting on mutual funds.

CLASSIFYING BY OBJECTIVE

In the case of stock funds, not too long ago funds were classified solely by investment objective—capital gains versus income. That evolved into three generally used classifications: aggressive growth, growth, and growth and income. As a group, the aggressive growth category has higher risk, higher returns, and low dividend yields; most of the return in the category is from capital gains. The portfolios of aggressive growth funds tend to be more concentrated—fewer stocks and fewer industries. Sometimes, only two industry sectors may dominate the portfolio. And often the individual stocks held represent newer, developing industries and companies that are purchased on the expectations of rapidly increasing earnings and stock price, not dividends. There are more smaller companies in these portfolios than larger firms in mature industries, but many technology stocks went from small to large in a blink and are still found in aggressive growth portfolios, along with very large firms that still have substantial growth potential.

The aggressive growth category funds are predominately managed by adherents to a growth approach rather than a value approach. Growth managers seek stocks with high sales and earnings growth, high profit margins, and strong positions in their industry. And they look for stocks with prices that have moved stronger than the overall market. These stocks normally have extremely high price-earnings ratios and price-to-book value ratios, and zero or near zero dividend yields. Of course, paying a high price for current earnings and buying low or no dividends is the antithesis of value investing.

Funds in the growth investment objective category generally invest in larger, more mature stocks in more mature industries than the aggressive growth funds, but they too are managed predominately by growth-focused managers. In addition, some managers in this category will use a style that blends some value with growth. Dividends appear simply because these are larger, more mature stocks. These stock portfolios are also less concentrated, more industries are represented, and as a result growth funds are on average less risky than aggressive growth funds.

The growth and income investment objective category is the domain of the value manager and the large-cap, dividend-paying stock. Funds in this category are often called equity-income funds or total return funds, with returns from both capital gains and income. Industries such as banking, insurance, and utilities pop up commonly because of long dividend-paying traditions.

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This category is the least volatile and highest income producer among the stock funds.

OTHER CLASSIFICATIONS

Even within each classification the investment style—growth, value, or both—and stock size—large cap, mid cap, or small cap—may result in very different stocks and industries. Relying solely on investment category classifications clearly is inadequate for diversification purposes. And, of course, performance over the same period and market condition may vary dramatically within these categories.

Classification of funds using prospectus information on the price-earnings ratios and dividend yields of the stocks in the portfolio, or the risk classifications is not precise. Different sources of mutual fund information will categorize funds very differently. For instance, a fund may be on the boundary between growth and growth and income; classifying it as a growth fund usually would result in the fund having worse relative performance within its category, while classifying it as growth and income will probably make the fund look better relative to its peers. Classification has significant ramifications for performance evaluation.

Table 1 breaks down fund performance and characteristics by investment objective category and investment style for all domestic stock funds reported in AAII's *Quarterly Low-Load Mutual Fund Update.* One thing is certain: investment category and style make a difference.

Large cap is the least volatile as measured by standard deviation and beta. Standard deviation is a measure of variation in return; the larger the standard deviation of return the greater the risk. Beta is a measure of risk relative to the market as measured by the S&P 500. A beta of 1.0, for example, is a risk level equal to the market, 0.50 is half as risky, and 1.50 is 50% more volatile.

Growth, no matter what the size of the stocks in the portfolio, is riskier than value. Because aggressive growth as an investment objective is overwhelmingly managed in the growth style and has the most small-cap funds, it is the riskiest of the categories. Conversely, growth and income is large-cap value and has the least risk.

Yield moves opposite to risk due to the types of stocks that pay significant dividends. Large-cap value stocks are where the high yields reside and these are the least risky. Of course, the proportion of total return that is due to yield versus capital gains has important tax implications; in taxable accounts high yield relative to capital gains is less desirable on a tax-adjusted basis.

The portfolio turnover rate—how actively the portfolio is managed as measured by the lesser of purchases

TABLE 1. MUTUAL FUND PERFORMANCE BY CATEGORY, SIZE, AND STYLE

Investment Category	Annual Return (%) 1-Yr	3-Yr	5-Yr	10-Yr	Bull Market Return* (%)	Bear Market Return** (%)	Yield (%)	Portfolio Turnover Rate (%)	Beta	Standard Deviation (%)
Aggressive Growth	1.8	13.5	16.3	16.2	139.2	–10.0	0.1	140	1.10	24.3
Growth	6.2	19.0	18.8	15.4	147.6	–6.5	0.5	72	0.95	18.3
Growth & Income	4.8	18.7	18.4	14.7	137.7	–6.0	1.7	65	0.79	15.5
Investment Style										
Large Cap	**11.2**	**22.2**	**21.1**	**16.9**	**170.0**	**–6.6**	**0.7**	**75**	**0.91**	**16.9**
Large-Cap Grth	19.4	25.1	22.8	18.0	192.8	–7.6	0.5	86	0.96	17.9
Large-Cap Grth/Value	14.5	23.1	21.5	16.6	174.9	–7.0	0.7	72	0.88	16.9
Large-Cap Value	6.8	20.5	20.1	16.1	156.0	–6.1	0.9	66	0.86	16.2
Mid Cap	**6.1**	**17.1**	**17.7**	**15.4**	**139.5**	**–7.5**	**0.6**	**119**	**0.96**	**19.4**
Mid-Cap Grth	13.4	19.0	19.1	16.8	158.5	–8.8	0.4	150	1.05	20.9
Mid-Cap Grth/Value	1.8	15.9	16.6	14.6	126.2	–7.1	0.7	95	0.92	17.8
Mid-Cap Value	–2.9	14.7	15.9	13.8	116.0	–6.0	0.9	78	0.86	17.3
Small Cap	**–7.9**	**10.4**	**13.1**	**13.2**	**99.3**	**–8.4**	**0.6**	**102**	**0.96**	**21.3**
Small-Cap Grth	–3.6	10.7	14.0	14.5	109.2	–10.3	0.2	126	1.08	23.3
Small-Cap Grth/Value	–16.2	8.8	12.1	12.9	86.1	–7.3	0.5	78	0.92	19.4
Small-Cap Value	–15.7	9.5	11.8	11.7	84.1	–6.0	1.0	66	0.81	18.4
Growth	**9.2**	**18.3**	**19.1**	**16.7**	**158.7**	**–8.9**	**0.4**	**114**	**1.04**	**20.9**
Growth/Value	**3.1**	**17.7**	**18.2**	**15.4**	**142.7**	**–7.1**	**0.7**	**77**	**0.90**	**17.8**
Value	**–2.4**	**15.9**	**17.0**	**14.4**	**128.1**	**–6.1**	**0.9**	**67**	**0.85**	**17.2**

**Bull market period from 7/94 to 3/99.*
***Bear market period from 2/94 to 6/94.*

Source: AAII's Quarterly Low-Load Mutual Fund Update/S&P Micropal. Data as of 3/31/99.

TABLE 2. SIZE AND STYLE BOXES: AN EXAMPLE

First Quarter 1999

Aggressive Growth Funds

Fund	Cap. L M S	Style G V
ABN AMRO:Sm Cap Grth/Cmn (RSMCX)	❑❑■	❑■
Adv Innr Cir:White Oak (WOGSX)	■❑❑	■❑
Amer Cnt:Giftrust/Inv (TWGTX)	❑❑■	■❑
Amer Cnt:Growth/Inv (TWCGX)	■■❑	■❑
Amer Cnt:Ultra/Inv (TWCUX)	■■❑	■❑
Amer Cnt:Vista/Inv (TWCVX)	❑❑■	■❑
Ariel Fund (ARGFX)	❑■■	❑■
Babson Enterprise Fund (BABEX)	❑❑■	❑■
Babson Enterprise Fund II (BAETX)	❑■■	❑■
Baron Asset Fund (BARAX)	❑❑■	■■
Berger One Hundred (BEONX)	❑■❑	■❑
Berger Small Company Grth (BESCX)	❑❑■	■❑
Bull&Bear Spl Equities (BBSEX)	❑❑■	■❑
CGM Capital Development (LOMCX)	❑■❑	■❑
CRM Small Cap Value/Inv (CRMSX)	❑❑■	❑■
Cappiello-Rush:Emerg Grth (CREGX)	❑❑■	■❑
Chesapeake Aggressive Gr (CPGRX)	❑■■	■❑
Columbia Special (CLSPX)	❑■■	■❑
Crabbe Huson Special (CHSPX)	❑❑■	❑■
Dreyfus Gr & Val:Agg Grth (DGVAX)	❑❑■	■❑
Dreyfus Gr & Val:Agg Val (DAGVX)	■■❑	❑■
Dreyfus Gr & Val:Emg Ldrs (DRELX)	❑❑■	■❑
Dreyfus Gr & Val:Sm Val (DSCVX)	❑❑■	❑■
Dreyfus New Leaders (DNLDX)	❑❑■	■■
Excelsior Small Cap Fd/A (UMLCX)	❑❑■	■❑

Growth and Income Funds

Fund		Cap. L M S	Style G V
AARP Growth:Growth & Inc (AGIFX)		■❑❑	❑■
ABN AMRO:Value/Cmn (RVALX)		■❑❑	❑■
Amer Cnt:Equity Inc/Inv (TWEIX)		■■❑	❑■
Amer Cnt:Income & Gr/Inv (BIGRX)		■❑❑	❑■
Amer Cnt:Real Estate/Inv (REACX)		❑❑■	❑■
Amer Cnt:Utilities/Inv (BULIX)		■❑❑	■■
Amer Cnt:Value/Inv (TWVLX)		■■❑	❑■
American Gas Index (GASFX)	i, s	❑■■	❑■
Americas Utility (AMUTX)	s	■■❑	❑■
Aquinas Equity Income (AQEIX)		■■❑	❑■
BNY Hamilton:Eqty Inc/Inv (BNEIX)		■❑❑	❑■
Babson Value Fund (BVALX)		■■❑	❑■
Baron Growth & Income (BGINX)		❑❑■	■■
Berger Growth & Income (BEOOX)		❑■❑	■❑
Boston 1784 Grth & Income (SEGWX)		■■❑	■■
CGM Realty Fund (CGMRX)	s	❑❑■	❑■
Century Shares Trust (CENSX)	s	■❑❑	❑■
Cohen & Steers Realty Shs (CSRSX)	s	❑❑■	❑■
Columbia Common Stock (CMSTX)		■■❑	■■
Columbia Real Estate Eqty (CREEX)	s	❑❑■	❑■
Copley Fund (COPLX)		■■❑	❑■
Dodge & Cox Stock (DODGX)		■❑❑	❑■
Domini Social Equity Fund (DSEFX)		■❑❑	■❑
Dreyfus Fund (DREVX)		■■❑	■■
Dreyfus Growth & Income (DGRIX)		■■❑	❑■

A solid box ■ indicates the investment style the fund has most closely followed as determined by its performance. Multiple solid boxes indicate multiple styles.

***L**: Large-cap stock focus*
***M:** Mid-cap stock focus*
***S:** Small-cap stock focus*
***G:** Growth investing focus*
***V:** Value investing focus*

Source: AAII's Quarterly Low-Load Mutual Fund Update, April 1999.

or sales of securities as a percentage of portfolio value over a year—is also likely to indicate the potential for taxable distributions. The turnover for aggressive growth funds, on average, is twice that of growth and income funds; growth funds are nearly twice as active in trading stocks as value funds. Small-cap funds are also more active than large-cap funds. Higher portfolio turnover also means higher transaction costs, a corrosive element for returns.

But even with all these style pigeonholes, many funds don't fit into just one. In AAII's *Quarterly Low-Load Mutual Fund Update* and annual *Individual Investor's Guide to Low-Load Mutual Funds*, funds are classified by category, but the size of stocks and investment style is also noted, and many funds use a combination.

No matter what the fund calls itself and no matter what investment objective it falls into, how it behaves is all that is important. Table 2 shows how funds can be classed by how they track various indexes; large-cap, mid-cap, small-cap, growth, and value. Some fund's returns are highly correlated with more than one index in terms of both size and style. American Century Ultra is both large cap and mid cap, with a growth style. Baron Asset fund is small cap, but has a growth and value blend.

ENSURING DIVERSIFICATION

If you want to be well-diversified, take note of the blackened boxes from Table 2. It is obvious that different stock sizes and styles perform differently, particularly over shorter time periods. And remember different industries are often found grouped in size categories, particularly new and emerging ones.

When eyeballing your funds' performance, look carefully at size and style, follow the blackened boxes, and make up a peer group for comparison purposes if the general categories aren't a reasonable fit. Ultimately, absolute performance is important for your investment portfolio. But when judging how well a particular fund has done, and that fund type is part of your overall portfolio diversification plan, then a relative comparison to like funds is called for.

Size does count and style just may be substance.✦