Tie-Breakers: Key Points to Consider When It's a Close Call Between Funds

By John Markese

You've done your research and narrowed down your choices for a particular type of fund, but can't decide between the final two funds.

Flipping a coin is one approach. But a better strategy would be to zero in on a few key points that serve as tie-breakers. While no two funds are precisely alike, top-performing funds can share almost identical investment style and return profiles. Here are some fund tie-breakers to consider and when they might be most important.

Aftertax returns: Making tax avoidance your investment focus is a formula for investment disaster. But keeping your eye on aftertax returns is simply wise investing. For example, Fidelity Asset Manager and Berwyn Income (see box on right) are both balanced funds: Each one invests in both stocks and bonds, and they have similar compound average annual five-year before-tax returns of 14.4% and 14.2%, respectively. And while Fidelity gets the performance nod by a nose for five years, Berwyn leads over three years, so no clear performance winner emerges. The longer five-year period is probably long enough to get a picture of how the fund has performed in different market environments, but still recent enough to be relevant.

Fidelity, however, wins on a tax-adjusted return basis for both periods, producing a higher aftertax return than Berwyn even over the three-year period when Berwyn has a higher before-tax return. Why? Berwyn has a higher percentage of bonds in its portfolio and a higher yield, defined as income divided by net asset value. With capital gains rates significantly lower than income tax rates, the tax penalty is serious. Note, however, that the tax-adjusted return assumes maximum tax rates, where the disparities between capital gains tax rates and income tax rates are the greatest. For investors in lower tax brackets, Berwyn may look better than these tax-adjusted rates portray.

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Tie Breaker: Aftertax Returns

	Berwyn Income	**Fidelity Asset Manager Growth**
Category	balanced	balanced
Compound Annual Returns (%):		
Three-Year	10.9	9.3
Five-Year	14.2	14.4
Tax-Adjusted Annual Returns (%):		
Three-Year	7.6	7.7
Five-Year	10.5	12.9
Yearly Returns (%):		
1996	13.9	17.5
1995	21.0	19.9
1994	–1.1	–7.4
1993	16.9	26.3
1992	21.7	19.0
Yearly Tax-Adjusted Returns (%):		
1996	10.1	14.4
1995	17.6	19.1
1994	–3.7	–8.3
1993	12.8	24.7
1992	17.4	18.1

Risk: Risk is easy to ignore when funds are on the way up, but when markets fall, risk is suddenly right in your face. Founders Growth and Fidelity Capital Appreciation (see box on p. 4) are both growth funds that concentrate on small- and mid-cap growth stocks. Founders Growth, with an annual average return of 16.5% over the last five years, is just short of Fidelity Capital Appreciation's 16.8% average annual return over the same period. But the risk profiles of these two funds are not even close.

There are two useful quantitative measures of risk, both calculated based upon monthly fund returns for the last three years. Beta is a measure of a fund's return sensitivity to the returns of the overall stock market, and works well as a risk measure for diversified funds. The higher the beta, the higher the volatility, and therefore risk. Beta can range from very

large negative numbers to very large positive numbers, theoretically, but most stock mutual fund betas cluster in the range of 0.5 to 1.5. A zero beta would imply no sensitivity to the stock market, and would more likely belong to a money market fund than a stock fund. A negative beta indicates that, on average, the fund and the market move in opposite directions—also an unlikely figure for any stock fund. The stock market's beta is by definition always 1.0; a fund with a beta of 1.5 is expected to be 50% more volatile than the market, and a fund with a beta of 0.5 would be only half as volatile. For instance, if the market rose 20%, a fund with a beta of 1.5 would be expected to be up 30% [20% + 0.50 (20%)] and if the market fell by 20%, the fund might drop 30%. Founders Growth, with a beta of 1.18, is more volatile than the overall market and substantially more sensitive to market moves than Fidelity Capital Appreciation, with a beta of 0.74, which implies less volatility than the overall market.

Tie-Breaker: Risk

	Fidelity Capital Appreciation	Founders Growth
Category	growth	growth
Compound Annual Returns (%)		
Three-Year	11.9	17.9
Five-Year	16.8	16.5
Tax-Adjusted Annual Returns (%):		
Three-Year	8.7	15.2
Five-Year	13.9	13.8
Standard Deviation (%)	9.7	13.9
Beta	0.74	1.18
Investment Style	small-cap growth	small & mid-cap growth

A second measure of risk is standard deviation, a barometer of volatility from any source, rather than just the stock market. Numerically, standard deviation is less intuitive than beta, but the higher the standard deviation, the greater the risk. Beta assumes a diversified portfolio so that other factors such as the risk unique to individual stocks and industries is virtually eliminated, leaving only the risk of market moves. Standard deviation works for all portfolios, diversified or not, and captures the risk from all elements. For example, a gold fund, while diversified among gold stocks, is concentrated in the gold industry, so industry risk has not been eliminated. Gold funds often have very low betas, usually well below 1.0 and sometimes even slightly negative, indicating that they are not as sensitive to stock market moves, but they are far from low risk. The industry element makes them very volatile and they have high total risk—high standard deviations.

Looking at standard deviation as a risk tie-breaker, Founders Growth has a standard deviation of 13.9% and Fidelity Capital Appreciation has a much lower standard deviation of 9.7%. Because both of these funds are well-diversified, beta and standard deviation are in agreement. Both funds produced about the same return, but Fidelity Capital did it with significantly lower risk, getting the nod on a risk-adjusted basis.

Fund size: What about total assets under management by the fund? Is bigger better or is smaller better? The answer, of course, is: It depends. A U.S. government bond fund or an index fund probably can't be 'too big,' since in general average costs decline and size doesn't get in the way of managing the assets. On the other hand, an aggressively managed fund, particularly one concentrating in mid-cap and small-cap stocks, can lose flexibility and be less nimble when assets grow too large. A fund that is growing too fast can also pose difficulties for the manager, who may have trouble simply getting the new money invested effectively and in a timely manner. Size and rapid growth often force funds to change their investment strategies.

As an example (see box below), the Kaufmann fund shot up in assets along with its performance from year-end 1992 to year-end 1996, jumping from $313 million to $5,274 million. Given its investment style of focusing on small growth stocks, managing over $5 billion may be difficult without some changes in strategy or simply a dilution of investment style and control. SteinRoe Capital Opportunities had a similar run-up in assets, but the dollar scale is much smaller, with $1,544 million by the end of 1996. While SteinRoe at $1.5 billion is getting large for its investment style, which focuses on mid-cap and small-cap growth, it is far smaller then Kaufmann, tipping the balance in its favor.

Tie-Breaker: Fund Size

	Kaufmann Fund	SteinRoe Capital Opportunities
Category	aggressive growth	aggressive growth
Compound Annual Returns (%):		
Three-Year	21.7	21.9
Five-Year	18.8	18.8
Annual Tax-Adjusted Returns (%):		
Three-Year	20.9	21.4
Five-Year	18.3	18.4
Total Assets (mil $)		
1996	5,274	1,544
1995	3,159	332
1994	1,583	172
1993	965	166
1992	313	129
Investment Style	small-cap growth	small & mid-cap growth

Expense ratios: Expense ratios (fund expenses per share divided by net asset value per share) are often overlooked because expenses are netted out against income, and reported returns already include the impact of expenses. So, if the return is competitive, who cares about expenses? Well,

two points are important. First, expense ratios are relatively unchangeable—they are easy to forecast, whereas returns are not. Second, the higher the expense of a fund, the greater the drag that a portfolio manager must overcome in the long run in order to be consistently better than other funds in the category. Also, high expense ratios are relatively easier to overcome in fund categories that produce higher returns on average, such as aggressive growth stock funds, than in fixed-income fund categories where expenses have a greater effect on returns. The Vanguard High Yield Municipal Bond Fund and the T. Rowe Price Tax-Free High Yield Fund (see box below) share investment objectives and almost identical performance figures. But Vanguard is hard to beat on expenses no matter what fund you choose, with an expense ratio of 0.2% versus 0.75% for the T. Rowe Price fund and 0.65% for the average municipal bond fund. No contest.

Tie-Breaker: Expense Ratio

	T. Rowe Price Tax-Free High Yield	**Vanguard High Yield Municipal Bond**
Category	tax-exempt bond	tax-exempt bond
Compound Annual Returns (%):		
Three-Year	5.3	5.4
Five-Year	7.6	7.7
Tax-Adjusted Returns (%):		
Three-Year	5.2	5.1
Five-Year	7.4	7.2
Expense Ratio (%):		
1996	0.75	0.20
1995	0.79	0.20
1994	0.79	0.20
1993	0.81	0.20
1992	0.82	0.23

Portfolio manager tenure: What better way to judge a fund manager than by the performance of the fund? But the current fund portfolio manager may not have been running the fund when the performance numbers were inked. Fidelity Equity Income II and T. Rowe Price Equity Income (see box at upper right) have nearly the same five-year average annual returns, both are growth and income funds and their investment style is virtually the same—a large-company value-based approach. However, Brian Rogers has been managing the T. Rowe Price fund since January 1989, and Bettina Doulton took over the Fidelity fund in December 1996. The five-year performance for T. Rowe Price Equity Income is Brian Rogers' work, whereas none of the Fidelity Equity Income II performance is Bettina Doulton's. In an uncertain world, a manager's tenure and performance record provide useful information, at least valuable enough to break a tie.

Tie-Breaker: Manager Tenure

	Fidelity Equity Income II	**T. Rowe Price Equity Income**
Category	growth & income	growth & income
Compound Annual Return (%):		
Three-Year	15.6	18.8
Five-Year	16.9	17.0
Tax-Adjusted Returns (%):		
Three-Year	13.4	16.1
Five-Year	14.7	14.3
Portfolio Manager	Bettina Doulton	Brian C. Rogers
Year Manager's Tenure Began	1996	1989
Investment Style	large-cap value	large-cap value

Loads: Sales commissions, also known as loads, are probably the clearest tie-breakers. Take the case comparison of Fidelity Europe and T. Rowe Price International European Stock (see box below). Both have comparable performance records and even similar risk, expense ratios, size, and manager profiles. They have identical investment objectives, focusing on European stocks, and they are offered by large fund families with a long menu of services. Fidelity charges a 3.0% front-end load and a 1.0% redemption fee for all money removed in less than 90 days. Neither front- and back-end loads nor redemption fees are reflected in performance figures. And while returns going forward are always uncertain, the load is charged with perfect certainty and reduces your performance dollar-for-dollar without any beneficial effect on fund performance. Of course, if you are in a special retirement program and the load is waived, these two funds are in a dead heat.

Tie-Breaker: Loads & Fees

	Fidelity Europe	**T. Rowe Price Int'l European Stock**
Category	international stock	international stock
Compound Annual Returns (%):		
Three-Year	16.6	16.8
Five-Year	14.4	13.9
Annual Tax-Adjusted Returns (%):		
Three-Year	15.1	15.7
Five-Year	13.3	13.0
Load (%)	3.00	0.00
Load Type	front	—
Other Fees	1% redemption fee (90 days)	none

Instead of flipping a coin, flip through this list of fund tie-breakers before choosing a fund. And if nothing else, these tie-breakers will remind you that funds should not be selected solely on the basis of past performance.