

Nine Timeless Rules for Investing in Mutual Funds [and ETFs]

By John Markese

It is surprising how seductive any article can be that proposes some arbitrary number of rules for doing something you are even remotely interested in. So please excuse my use of this artifice because if you invest in mutual funds or exchange-traded funds, or are contemplating investing in them—I desperately want you to pore over these rules.



Rule #1: Understand what the fund invests in and the fund's investment approach before you invest.

Sounds like common sense and simple, but not enough investors take the time to review a prospectus and an annual report.

First, read carefully the investment objective of the fund:

- Will the fund pursue growth in capital, emphasize income, or use a combined approach?

- Will the investment emphasis be on domestic or international stocks, or some combination?
- Will the fund be broadly diversified—in the case of a stock fund, covering diverse industries and stock size categories (large-cap, mid-cap, small-cap)—or will it be concentrated in a few industries?
- Will the manager be effectively fully invested at all times, or will some form of market timing be employed?

When it comes to bond funds, the same questions generally apply, but the spotlight should be placed on maturity, credit risk, yield and taxation. Also, keep in mind that the fixed-income world is much more complex than the stock world. Although stocks may vary in risk, the instruments are structured similarly—a stock is a stock. However, there are many different types of fixed-income instruments, some of which can be complex and confusing—think collateralized debt obligations or auction rate preferreds.

Why look carefully at the investment strategy and the actual investments in the fund? After all, it's up to the

ETFs vs. Mutual Funds

Exchange-traded funds (ETFs) are portfolios of securities that are usually passively managed and that track an index, offering an alternative to traditional index mutual funds. Although they are similar to traditional mutual funds in that they consist of a portfolio of securities, ETFs are listed on an exchange and trade just like an individual stock. This provides trading flexibility that does not exist with traditional index funds.

Most of the mutual fund rules discussed here are equally appropriate when building a portfolio of ETFs.

Figure 1. Fund Category Averages

Fund Category	Total Risk Index	Expense Ratio (%)
Large-Cap Stock	1.08	0.94
Mid-Cap Stock	1.18	1.09
Small-Cap Stock	1.28	1.34
Energy/Resources Sector	1.83	1.13
Financial/Banking Sector	1.45	1.15
Gold Sector	2.34	1.23
Health Sector	0.97	0.99
Real Estate Sector	1.92	1.05
Technology Sector	1.32	1.40
Telecommunications Sector	1.29	1.21
Utilities Sector	0.93	1.08
Miscellaneous Sector	1.36	1.13
Global Stock	1.17	1.18
Foreign Stock	1.33	1.16
Regional/Country Stock	1.63	1.32
Emerging Stock	1.89	1.52
Balanced: Domestic	0.68	0.78
Balance: Global	0.87	0.64
Target Date: 2000–2014	0.55	na
Target Date: 2015–2029	0.81	na
Target Date: 2030+	1.04	na
Corporate High-Yield	0.67	0.91
Convertible	0.84	1.07
Mortgage-Backed	0.17	0.67
Government: Short-Term	0.09	0.55
Government: Intermediate-Term	0.22	0.60
Government: Long-Term	0.83	0.76
Inflation-Protected Bond	0.44	0.50
General Bond: Short-Term	0.20	0.61
General Bond: Intermediate-Term	0.27	0.63
General Bond: Long-Term	0.43	0.80
Muni National: Short-Term	0.09	0.54
Muni National: Intermediate-Term	0.25	0.60
Muni National: Long-Term	0.32	0.58
Muni National: High-Yield	0.53	0.72
International Bond: General	0.41	0.91
International Bond: Emerging	0.73	1.05
International Bond: Currency	0.78	1.55
Index Comparisons		
S&P 500	1.00	
S&P MidCap 400	1.19	
S&P SmallCap 600	1.25	
DJ U.S. Total Stock Market	1.03	
S&P International 700	1.27	
S&P Asia 50	1.50	
S&P Europe 350	1.02	
S&P Latin America 40	1.78	
Corporate Bond Index	0.45	
High Yield Bond Index	0.86	
GNMA (Mortgage) Index	0.15	
1–3 Year Government Bond Index	0.08	
Intermediate Government Bond Index	0.18	
Long Government Bond Index	0.61	
T-Bills	0.02	

na = not applicable; expense ratio doesn't reflect the ratio of the underlying funds in a target portfolio.
Source: AAI's Quarterly Low-Load Mutual Fund Update, October 2009.
Data as of September 30, 2009.

portfolio manager to implement the approach and the actual investments have already changed by the time you have reviewed the annual report. Well, markets fall out of bed every once in awhile, and if you do not have a feel for how the portfolio is likely to behave in different market environments, you are likely to make poor long-term decisions in reaction to short-term market events.

And if you don't completely understand the portfolio strategy or the investments, what should you do? Run.

Rule #2. Before investing in a fund, determine the fund's relative and absolute risk.

Return usually catches an investor's eye and risk is often an afterthought or no thought—until the market turns sharply down.

Funds tend to rise toward the top of performance lists because they either are managed differently from the other funds or simply take on more risk. And the “managed differently” approach usually also entails greater risks through concentrations in a few industries or investing in only a small number of stocks, or using leverage through

futures and derivative products.

Risk by definition is variation in return over time. The greater the variation in return, the greater the risk. For mutual fund investors, time horizon brings the concept of risk into a practical perspective. A short time horizon combined with a high potential for variation in return is a mismatch. The suggestion that investment in stock funds should only be made if an investor's time horizon is greater than five years is a practical realization of return variation and time.

Two common ways of capturing risk are the standard deviation and beta statistical measures.

Standard deviation measures variation in return for a mutual fund no matter what the cause.

Beta measures sensitivity to the return of the overall market based on the assumption that all other risk, save market risk, can be diversified away.

While both of these measures are provided in AAI's “Guide to the Top Mutual Funds,” taking the standard deviation of a fund's return and comparing that risk measure to other funds' risk is a straightforward way to get a handle on the risk of a fund.

The total risk index measure compares the standard deviation for a fund to all other funds—stock funds, bond funds, international funds, etc.—where a value of 1.00 is average risk. This gives fund investors a framework to judge the risk of one fund against all alternatives.

The category risk index measure compares the standard deviation of one fund to similar funds in the category—small-cap domestic stocks, for example—and an index value of 1.00 is also average. A small-cap growth fund, for example, might top a performance list, but have a total risk index of 1.50 (50% more volatile than the average fund) and a category risk index of 2.00 (twice as volatile as the average fund in its category); therefore, it deserves cautionary warnings. When markets tumble, this fund might fall out of the sky.

A fund's return performance should not be judged without consideration of risk. Figure 1 shows the average total risk index for each mutual fund category.

Rule #3. Always diversify your mutual fund portfolio.

The trick is to build a portfolio of funds that are not highly correlated with each other; they don't all move in the same direction at the same time.

However, you should also realize that during severe market corrections large-cap stock funds, small-cap stock funds, international funds, emerging market funds and even some bond funds will suddenly be highly correlated in the short term. So, while diversification is not always effective, it is still worth doing.

Shorter-term high-quality bond funds and money market funds reduce the volatility of a mutual fund portfolio in the short run, but expose that portion of the portfolio to inflation risk and generally post lower returns than stock mutual funds.

Longer-term bond funds, even U.S. Treasury bond funds, will decline in value as interest rates rise. Rising interest rates can also adversely affect stock funds.

A minimally diversified mutual fund portfolio should have:

- A domestic stock fund,
- An international stock fund,
- An intermediate-maturity (three- to 10-year maturities) bond fund, and
- A money market fund for liquidity.

One step up in diversification would add:

- A large-cap fund,
- A small-cap fund,
- An international fund investing in stocks of developed countries, and
- An emerging markets stock fund.

For simplicity and efficiency, all could be index funds, including the bond fund.

Target date retirement funds accomplish this diversification all in one fund, and manage the weightings over time toward a specific date (see "Taking Aim at Your Retirement: A Look at Target Date Mutual Funds" in the June 2009 *AAIL Journal*, available at AAIL.com).

Beyond the selection of mutual funds in a portfolio, the second element of diversification is the question of determining the portfolio weights

for each.

The portfolio allocation weights should be a function of risk tolerance and investment horizon. The more risk tolerant and the longer the horizon, the greater the allocation to stock funds, with more emphasis on small-cap stock funds, international stock funds and emerging market funds.

Weighting any one fund heavily will detract from diversification and, conversely, a small asset allocation—less than 5% of the portfolio, for example—will not materially add to diversification.

However, markets don't stand still and neither do your portfolio allocations. As segments of your portfolio change in value—stock mutual funds and stock ETFs come to mind—so does your effective diversification. It is worthwhile to evaluate your portfolio at least annually—quarterly is also reasonable—to determine if your portfolio percentage allocation targets are materially different from your actual portfolio. If they are, and your risk tolerances haven't changed, then portfolio rebalancing is in order.

The simplest way to rebalance a portfolio is simply to direct new investment money available to any underweighted portfolio segments.

If new money is not sufficient to accomplish the rebalancing over a six-month to one-year timeframe, then periodic selling of investments in overweighted portfolio segments and additional investments in underweighted areas may be necessary. Start first with investments in tax-sheltered accounts to avoid any tax liabilities.

The difficulty, however, in selling to rebalance any portfolio is that some portion of investments that have done well will have to be sold, and some investments will have to be made in portfolio segments that may have performed relatively poorly.

Keeping an eye on your portfolio allocations and making adjustments if necessary may impact your diversification even more than the individual mutual funds and ETFs you select.

Finally, don't forget to take a total view when considering diversification—

include not only your mutual funds, but other similar investments, such as individual stocks or bonds. And don't overlook all your retirement accounts.

All investment elements have an impact on diversification. Diversification is a key building block for investment success. It allows investors to combine individually risky investments that are not highly correlated into a portfolio that reduces risk without reducing return, a goal for every investor.

Rule #4. Stay away from sector funds unless you have specialized industry knowledge (most investors don't).

Sector funds by their nature are non-diversified. They concentrate holdings in one or a few industries.

All industries have particular cycles—energy and real estate, for example—and these cycles are, at best, extremely difficult to anticipate. A significant portfolio commitment to one or two sector funds may well defeat diversification efforts for the overall portfolio and destabilize the portfolio in the short run. Investing in 20 sector funds may make some sense from a diversification viewpoint, but that would be obviously impractical.

Stick with diversified funds unless you possess some particular understanding of a sector through your education, work experience or interests and then only weight your total portfolio toward that sector by no more than 5% to 10%.

Rule #5. Don't invest in high-cost funds, and avoid loads.

Fund expenses eat return: More expenses, less return.

And while returns are unpredictable in the short run, expenses as a percentage of your mutual fund investment are relatively constant.

A fund with significantly higher expenses than the average for its category is more likely to underperform its peers on average. And for bond funds, expenses reduce yield dollar-for-dollar, and are harder for a bond portfolio manager to overcome.

Compare a mutual fund's expense

Table 1. AAI Resources

"The Individual Investor's Guide to the Top Mutual Funds," published annually, provides data on the top funds in each category, reporting return and risk for each fund over various time periods.

"AAII's Top Mutual Funds Guide—Plus," found in the AAI Guides area of AAI.com offers a full data page on all no-load and low-load funds tracked by AAI, giving return and risk data over various time periods along with portfolio manager, investment style, portfolio composition, services, fees, and minimums.

"The Individual Investor's 2009 Guide to Exchange-Traded Funds," published annually, provides returns, index tracked, asset size and expense ratio for over 750 ETFs. It appears in the October *AAII Journal* and is available at AAI.com in the AAI Guides area.

ratio to the average for its category in Figure 1. If the fund's expenses are appreciably higher, look for a lower-cost fund.

Also, always keep in mind that index funds have much lower expense ratios. For example, a stock index fund is likely to have an expense ratio in the 0.10% to 0.25% range, far lower than the average non-index stock fund.

Loads are essentially charges for marketing and sales force compensation. They do not buy better management, research or performance. Like expense ratios, they reduce your return dollar-for-dollar.

Performance data for mutual funds includes the impact of expenses. However, the reported returns do not adjust for loads, except in the case of the 12b-1 load that is continuously charged. Front-end and back-end loads are not reflected in the return numbers.

If I can't talk you out of a loaded fund, then seek only low-load funds: funds with front-end loads, back-end loads or redemption fees that are less than 3% and fund 12b-1 load options that are 0.25% annually or less.

The no-load, low-cost index fund should always be considered as a default option.

Rule #6. Pay attention to a mutual fund's tax efficiency and where you hold it.

The goal is to minimize taxes on your mutual funds, maximize aftertax returns and, when possible, defer taxes

to future periods—although the possibility of higher future taxes may make this latter strategy less productive.

Mutual funds make distributions of income and capital gains whether you want them to or not. The ideal mutual fund would make no distributions and when you want cash you would simply sell shares—first sold would be any shares that would generate a loss, second sold would be shares with the smallest long-term capital gains.

In lieu of the mythical ideal tax fund, seek funds that make few distributions for your taxable holding; mutual funds that you find attractive in spite of a history of high distributions should be relegated to your tax-deferred accounts, particularly if the distributions are taxable income or short-term capital gains. Keep in mind, however, that all redemptions from tax-deferred accounts (non-Roth IRA) are taxed at ordinary income tax rates.

Tax-exempt municipal bond funds, of course, should only be held in taxable accounts. Real estate investment trust (REIT) fund income distributions are fully taxable and do not qualify for lower dividend taxation rates.

Taxes are here to stay. Play accordingly.

Rule #7. Don't buy or sell a mutual fund based upon absolute performance—the top (or bottom) performance list trap.

The basis for performance evaluation is how a particular fund has per-

formed against its peer group.

For example, if you are concerned about or interested in a large-cap value fund, compare the fund to the average performance of the fund category over one-, three- and five-year periods, along with making a relative category risk comparison. Also, look at individual annual performance numbers to determine if one spectacular year has distorted the longer-term average performance. This will also provide insight into the consistency of the fund's return in different market environments.

Comparison to an index benchmark is also of value.

And don't toss a fund from your portfolio because of poor absolute returns if the fund continues to perform well against peers. You hired the fund to invest in a particular market segment with a particular style. No approach works in all markets.

Beware of the bright lights of those top performance lists. The performance glare can be distracting. Funds can only reach the top of the list if they are different from all the other funds, take on more risk or were just a portfolio that was in the right place at the right time. Funds that top all other funds over a quarter or even a year often quickly burn out.

Table 1 lists AAI resources that report the performance of mutual funds and ETFs and give a complete picture of fund risk and return over time.

Rule #8. Put together a portfolio of mutual funds that you can readily monitor and grasp.

You don't have to follow your mutual fund portfolio or the individual funds daily, weekly or even monthly. A quarterly review is not overkill, and at least an annual evaluation is warranted.

At one extreme, that single all-in-one mutual fund—a target date retirement fund, for example—is the model of simplicity, easy to monitor and understand for most investors. But because of multiple accounts, 401(k) plans, IRAs, etc., this is impractical.

However, if you have more than eight funds, including a money market fund, your portfolio may be cluttered,

Related Articles

For more information relating to the Nine Rules, you can access these articles at AAIL.com.

Rule #1. Understand what the fund invests in and the fund's investment approach before you invest.

"Fund Statements: What to Look For" in Investor Classroom area

Rule #2. Before investing in a fund, determine the fund's relative and absolute risk.

"Grappling With Fund Risk" in Investor Classroom area

Rule #3. Always diversify your mutual fund portfolio.

"Taking Aim at Your Retirement: A Look at Target Date Mutual Funds," June 2009 *AAIL Journal*

"The Core Approach to Building an Effective ETF Portfolio," October 2008 *AAIL Journal*

AAIL Portfolio Observer page at AAIL.com with recommended asset allocation and diversification strategies

Rule #4. Stay away from sector funds unless you have specialized industry knowledge (most investors don't).

"Your Mutual Fund Portfolio: Choosing the Level of Complexity" in Funds area

Rule #5. Don't invest in high-cost funds, and avoid loads.

"Fund Expenses: Class Matters When Buying Multi-Class Fund Shares," June 2002 *AAIL Journal*

"Capitalizing on the Index Fund Advantage" November 2005 *AAIL Journal*

Rule #6. Pay attention to a mutual fund's tax efficiency and where you hold it.

"Tax-Efficient Investing: Picking the Right Pocket for Your Assets," November 2005 *AAIL Journal*

Rule #7. Don't buy or sell a mutual fund based upon absolute performance—the top (or bottom) performance list trap.

"The Top Funds Over 5 Years: Surviving the Claws of a Bear Market," April 2009 *AAIL Journal*

Rule #8. Put together a portfolio of mutual funds that you can readily monitor and grasp.

"How Many Mutual Funds Should You Have in Your Investment Portfolio?" in the Funds area
"Fund Investors' Biggest Mistakes and How You Can Avoid Them," in the Funds area

Rule #9. Don't even think about market timing.

"The Sell Decision With Mutual Funds: Knowing When to Walk Away," in the Funds area

"Your Portfolio: Maintaining Perspective," November 2008 *AAIL Journal*

"What Every Investor Should Know About Mutual Funds," in the Funds area

possibly redundant and most certainly a challenge to monitor. The behavior of the portfolio is also probably impossible to intuitively understand when markets gyrate, creating anxiety that often runs to making ill-timed and poorly thought out decisions fueled by emotions.

Adding more and more funds does little for diversification, but is sure to confuse and discourage reasoned investment thought.

Rule #9. Don't even think about market timing.

Market timing always seems so appealing when looking back.

But investors often embark on a market timing trip at the wrong time. They commit more to sectors or the overall market *after* significant moves up, and they often reduce positions or sell out completely *after* markets have

corrected. The result: They buy high and sell low—a losing proposition.

If your portfolio was appropriate for the long term in the first place, market timing attempts will throw it out of kilter, requiring another market timing attempt to bring it back into balance.

If you don't have the courage to sell when everyone else is in a buying frenzy, and to buy when there is nothing but absolute and utter investor despair, then market timing attempts are sure to jeopardize your long-term financial health, not to mention the physical and mental toll.

So when you start thinking that you know what the market will do over the short term and get the urge to time the market, slap yourself hard and come to your senses.

Keep These Thoughts in Mind

Stay diversified.

Construct a portfolio of mutual funds with a risk level that you can live with in the worst market debacle.

Understand how your portfolio will behave.

Pay attention to the individual mutual funds.

Avoid high costs and fad investments.

In other words, take the time to educate yourself on investing, maintain a long-term viewpoint, and make reasoned, informed decisions, and relax—you will do just fine.

Can you think of any more rules for investing in mutual funds and ETFs?

I hope you can and when you do, please E-mail them to journal@aail.com or post them to the on-line version of this article at AAIL.com and we will share them with all our AAIL members. ▲

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