How to Rate a Mutual Fund: Personalizing the Star System

By John Markese

Toss the stars, chuck the checkmarks, cast aside the letter grades, and ignore any other mutual fund ratings that come down to an all-in-one rank.

Why?

For one, you can't really understand a fund, your investment, by staring at a checkmark or by gazing at the stars.

Another reason to jettison rating symbols is that they are all based on weighting systems that are unlikely to reflect your specific financial/investment profile: factors that are personal and unique, such as risk tolerance, investment horizon, financial goals, and tax situation.

Finally, the monolithic ranking icons may be overly seductive as investors embrace them as crystal balls when they are really more akin to rearview mirrors.

Personalized Ratings

Here's how you can effectively and efficiently rate a mutual fund and avoid the pitfalls of the flashy all-in-one published rankings.

First, concentrate only on funds that are worth your time. There are thousands of funds floating around for investors to consider, but a much smaller set that warrants consideration. AAII's *Individual Investor's Guide to the Top Mutual Funds* does just that. Sent to all AAII members each March, the Guide gives detailed information on funds. Expense, availability and performance hurdles are imposed on a universe of no-load and low-load mutual funds for inclusion in the Guide:

- ***High expense ratios:*** Funds with high expense ratios, fund expenses divided by net asset value per share of the fund, are excluded from the Guide. High is defined relative to the investment category of a fund. An expense ratio of 1.00% may be high for a government bond fund, but below average for an international stock fund. Funds that had significantly higher expense ratios than their category average do not make it into the Guide. High expenses are difficult for fund managers to overcome and, looking forward, while continued high performance is unpredictable, high expenses are far more persistent and certain. Expenses cut performance dollar for dollar, and are incorporated in returns.
- ***Inaccessible funds:*** If a fund is not easily available for investment by an individual investor, then it should be dropped from consideration. Funds closed to new investors are obviously unavailable. But for many investors, funds with unusually high initial investments, $100,000 or more, are also not easily available. Also, some funds can only be purchased through brokers; they are not directly available to investors from the fund family, adding an unnecessary hindrance.
- ***Underperforming funds:*** Funds that have dramatically underperformed the average of all funds in their category over the long run and funds that haven't been in existence for three years, providing no real basis for analysis and comparison, don't deserve or allow consideration.

- ***Funds with higher-than-average risk:*** Some funds that do perform reasonably well may have achieved that performance by simply "buying" it in the form of extraordinarily high risk relative to their category, which should be a disqualifier for further consideration.

The funds that made it into the Top Funds Guide are of investor interest, they are readily available for investment, have low expenses and no or low loads, above-average returns over three years relative to their investment category and have not "bought" this return performance with mountainous risk. In short, the Guide is the starting point for your personalized fund ratings.

Comparing Similar Funds

The lynchpin of any mutual fund rating effort is the grouping of funds into meaningful and homogeneous categories. Comparisons are doomed from the outset if funds being compared in a particular category actually have different investment objectives, hold different types of securities or have different mixes of securities.

Table 1 lists the fund categories in the Top Funds Guide. They were created to reflect how investors intuitively think of funds when making mutual fund investment decisions, and to group funds together based upon their portfolio composition and financial behavior in different market environments.

As an example of why appropriate category designations and fund categorization are imperative, look at the domestic stock category. For investors wishing to select a small stock fund to add diversification to a portfolio, comparing small stock funds to small stock funds rather than to large stock funds is essential because small stocks do not move in unison with large stocks.

Within the stock fund categories, the different investment styles—growth, value, and growth/value blend—are also designated to facilitate true comparisons.

Funds that invest internationally are categorized so that global stock funds, which may also invest domestically, are compared only to other global funds rather than to foreign stock funds that do not invest domestically.

Under taxable bond funds, the portfolio maturity distinctions are more evident. Short-term government bond funds (average maturity less than three years) produce lower returns and fewer capital gains or losses than long-term bond funds (average maturity over 10 years) over the long run. The risks and returns of these two government bond categories mandate their separation.

Table 1. Fund Categories

Domestic Stock Funds
Large-Cap Stock
Mid-Cap Stock
Small-Cap Stock

Sector Stock Funds
Energy/Resources Sector Stock
Financial/Banking Sector Stock
Health Sector Stock
Gold Sector Stock
Real Estate Sector Stock
Technology Sector Stock
Telecommunications Sector Stock
Utilities Sector Stock

International Stock Funds
Global Stock
Foreign Stock
Regional/Country Stock
Emerging Stock

Balanced Stock/Bond Funds
Balanced Stock/Bond

Taxable Bond Funds
Corporate Bond
Corporate High-Yield Bond
Mortgage-Backed Bond
Government: Short-Term Bond
Government: Intermediate-Term Bond
Government: Long-Term Bond
General Bond

Municipal Bond Funds
National Muni: Short-Term Bond
National Muni: Intermediate-Term Bond
National Muni: Long-Term Bond
National Muni: High Yield Bond

State-Specific Bond Funds
Arizona Bond
California Bond
Colorado Bond
Connecticut Bond
Florida Bond
Georgia Bond
Hawaii Bond
Kentucky Bond
Maryland Bond
Massachusetts Bond
Michigan Bond
Minnesota Bond
New Jersey Bond
New York Bond
Ohio Bond
Pennsylvania Bond
Tennessee Bond
Virginia Bond
West Virginia
Wisconsin Bond

International Bond Funds
International Bond

The Go/No-Go Decision

With funds that should be out of contention eliminated and the surviving funds carefully matched in discrete, homogeneous categories, the next step is to create your personalized rating of funds in a head-to-head comparison of funds in your desired category. This rating process, however, will not end in the assignment of a letter grade, number, or some icon, but in a fully informed invest go/no-go decision.

Your first focus should be to review the category performance list of funds, which precedes the individual data fund pages in the Guide. The category performance table is in order of descending fund performance for the current year-end, with supporting performance statistics for three years, five years, and 10 years, along with category risk and total risk. This performance listing is worthwhile simply to familiarize yourself with how these funds and the category have behaved. All of these statistics are repeated on the individual fund data pages along with additional information. Funds that seem appealing on a preliminary performance and risk basis can be evaluated by using the individual fund page.

Rating a Fund

You can start tailoring your rating once you get to the individual fund data pages in the Top Funds Guide.

Performance: Funds with a high positive difference from category returns for the three-year and five-year time periods should be your focus. However, be sure to look at the year-by-year returns, and the year-by-year difference from category returns to see how consistent the fund's manager was in producing the longer-term returns. If the fund has high returns above the category simply because of one big year, move on.

Tax-adjusted returns: These figures are important for investors in high tax brackets. Big differences between yearly returns and yearly tax-adjusted returns should be a red flag waving high tax bracket investors away. However, if you intend to hold the fund in a tax-sheltered account—an IRA or 401(k), for example—then the tax bite is not an important consideration.

Bull and bear market returns: These period-specific returns provide an insight into how a fund behaved on the upside and downside. This is a psychological risk-sensitivity test: If you look at the numbers on the downside and don't flinch, both you and the fund are a match.

Risk: This is a four-letter word, but don't avert your attention from the risk measures. In fact, make sure you stare at them—it is too easy to be transfixed simply by the returns of a fund.

Category risk index: If this measure is high, that probably accounts for a fund's top performance. For stock funds, if you intend to invest for long periods—in excess of five years—this remains important but it is less important than making sure your entire portfolio is well diversified. If you don't expect to be invested for at least five years, then you probably should not be in stock funds no matter what the risk numbers are.

Standard deviation: This is a measure of the volatility of a fund, and it can be used to compare the risks of all mutual funds, bond and stock funds alike, domestic and foreign. It gives you a relative risk measure to compare when assembling a portfolio—by examining the standard deviations of all of the funds in your portfolio, you can better judge the overall risk you are taking on based on your asset allocation decision.

Once again, however, you should tailor your risk rating based on how it fits in your overall portfolio and the length of your investment horizon. For long-term investments, day-to-day, week-to-week, even quarter-to-quarter variations in return are not critical for investment success, although they are critical to investor psychology. These risk measures are less important if:

- You are a long-term investor,
- You can take the short-term heat without breaking your long-term plan, and
- The fund is part of a well-diversified portfolio.

What the risk measures tell you, however, is how a fund is likely to perform in various market situations.

Per share data: This section of the individual fund data pages provides insight into the income versus capital gains nature of the fund. Investors desiring income from the fund investment should focus on the net income distributions per share and yield (net income per share as a percentage of average net asset value per share). Conversely, those investors considering holding a fund in a taxable account and who have no need for income generation from the fund should rate funds with low or no yield more highly.

Shareholder information: At this point in your rating process, a check of the shareholder information is worthwhile. If the investment minimums seem fine, check the fees section. You should give the highest rating to no-load funds and the lowest for loads. The maximum load that a fund can have and still make the Guide is a front-end load of 3.00%, but then it cannot also have a 12b-1 load charge. This latter load is a continuing load, or sales charge, that is levied annually and included in the expense ratio—the only load reflected in the performance numbers. Long-horizon investors should probably favor a small front-end load and no continuing load; shorter-term investors, say less than six to eight years, might be better off with the 12b-1 annual charge of 0.25%.

The Final Step

By this point, you already have a relative rating in mind, and have zeroed in on a fund or two in the category you have examined. But before you make a final decision, get each fund's prospectus and annual report.

The prospectus discusses the fund's investment objectives and the annual report lists the fund's actual investments—hopefully it will list the types of securities you were expecting to see.

Now you have an informed opinion, a rating tailored to your own circumstances, and an understanding of the investments and investment process underlying the fund's name.

And, if you must have a formal rating, give your final fund choice four puppies, or four chocolate sundaes, or four corkscrews—you get the idea. Table 2 summarizes the steps outlined here.

Table 2. How to Rate a Fund Summary

Step 1: Concentrate only on funds that are worth your time.
Concentrate on funds that:

- Are readily available to you
- Have low expense ratios
- Have above-average returns for three years
- Have reasonable risk

Step 2: Group funds into meaningful and homogeneous groups.
For example:

- Small-stock funds with small-stock funds
- Within stock groups according to style-growth, value, or both
- Global funds with global funds
- Government funds by maturity

Step 3: Create your personalized rating of funds

- Review performance lists of fund categories

Familiarize yourself with how a category of funds behaves

- Look at returns over three, five, and 10 years
- Check category risk and total risk
- Pick funds that look appealing on a performance and risk basis

Step 4: Tailor your rating with an in-depth look at an individual fund

- Check returns against category returns for all periods and year-by-year returns
- Check tax-adjusted returns if you are in a high tax bracket and intend to hold the fund in a taxable account
- Check your reaction to bull and bear market returns
- Make sure risk figures match your investment portfolio needs and time horizon
- Make sure income and capital gains data for past years match your needs
- Check fund investment minimums and fees

Step 5: Obtain and read the prospectus and annual report for any fund you've chosen before investing

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