Briefly Noted

Five Investment Questions to Ask

The Securities and Exchange Commission (SEC) says there are five basic questions investors should ask before making any investment to avoid being a victim of financial fraud.

1. Is the seller licensed? State and federal licenses are required for selling a wide variety of investment products. Before giving money to a broker, ask about his credentials and what his licenses are. Then conduct a background check. The Financial Industry Regulatory Authority's (FINRA) BrokerCheck website (brokercheck.finra.org) and the SEC's Investment Adviser Public Disclosure website (www.adviserinfo.sec.gov) are good places to start. We also suggest checking with your state regulator (contact information can be found at www.nasaa.org) and doing an Internet search on the adviser's name using Google or a similar search engine to see if any red flags appear.

2. Is the investment registered? Most funds will be registered under the Investment Company Act of 1940 (aka, the '40 Act). Similarly, exchange-listed publicly traded companies are required to file quarterly and annual reports with the SEC, which can be found in the SEC's EDGAR database (www.sec.gov/edgar/searchedgar/webusers.htm). If an investment is not registered, it may be difficult to find financial information, sell quickly or easily get current price information.

3. How do the risks compare to the potential rewards? Investments with potential high returns commonly come with high levels of price volatility. The SEC warns that "many investment frauds are pitched as high return opportunities with little or no risk." Ask to see actual historical returns and volatility, if available. Be wary of strategies being promoted as offering big gains and no losses.

4. Do you understand the investment? If you do not understand what the investment is, how the strategy works or what the risks are, don't buy it. If the prospectus or the adviser does not explain the investment to your satisfaction, don't buy it. The last thing a fraudster wants are direct questions and demands for straightforward answers. You are always better off passing up on an investment you don't fully understand.

5. Where can you turn for help? The SEC operates an investor assistance line at 800-732-0330. Also check the SEC, FINRA and NASAA websites.

Source: "Five Questions to Ask Before You Invest," U.S. Securities and Exchange Commission.

A Checklist for Rolling Over a 401(k)

If you are changing jobs or are close to retirement, you will be considering what to do with your 401(k) plan assets. Even if you ultimately decide to leave your investments in your former employer's plan, you should investigate your options to ensure you are making the best choice. Morningstar's Christine Benz created a checklist of steps to take.

Check your account value: Account balances above $5,000 open the door to many options, including leaving it with your former employer (if the plan allows you to do so) or rolling it into an IRA or your new employer's 401(k). If your account balance is below $5,000, your former employer can legally remove you from its plan. Balances below $1,000 can be cashed out.

Determine whether you want to stay within the 401(k) confines: This decision will be partially determined by your former and/or current plans' guidelines. If you are allowed to do so, you will need to weigh the pros and cons. Employer retirement plans offer some protections and can give you access to fund options not available outside the 401(k) structure. Alternatively, moving your account outside of the 401(k) structure gives you more choices.

When making this decision, compare the costs and fund selection of the 401(k) plan(s) against the options available to you through an individual brokerage or mutual fund account. If you like the 401(k) structure and have the option of either staying with your former employer's plan or moving it to your new employer's plan, you will need to compare and contrast the two. Also, look at your options for rolling over to an IRA account, which can be held at the brokerage firm or mutual fund company of your choosing.

Consider Converting to a Roth IRA: If you are moving your money out of your former employer's plan, you have the option of converting it to a Roth IRA. You will pay ordinary income taxes on the amount converted, so there is a trade-off to consider. If you had a Roth 401(k), it must be rolled over to a Roth IRA account or a Roth 401(k), if your new employer offers such a plan.

Execute and decide what to invest in: Merely thinking about what to do is not enough; you must fill out the paperwork. Most brokerages and mutual funds make the process simple and can walk you through the forms. After the rollover is completed, be sure to invest the money according to your long-term allocation strategy.

Source: "A 401(k) Rollover Checklist," Christine Benz, Morningstar.com, August 24, 2014.

Why Momentum Strategies Can Crash

Momentum strategies targeting stocks with relative outperformance have been shown to boost returns during normal market conditions. During the initial stage of a new bull market, however, these strategies lose their edge. The decline in performance can be dramatic and occurs as a rotation in preferences favors past losers over past winners.

Professors at Columbia University and the Booth School of Business called these occurrences "momentum crashes." They point to the end of the 2007–2009 bear market and the start of the subsequent bull market as an example. During the period of March through May 2009, stocks ranking in the bottom decile for past performance (low relative strength) gained 163%. Conversely, stocks in the top decile (high relative strength) gained just 8%.

Such lousy performance is typical following periods when the lagged two-year market return is negative, according to the authors. Fourteen of the 15 worst momentum crashes occurred during such periods. All momentum crashes happened when "the market rose contemporaneously, often in dramatic fashion." In a portfolio going long the stocks with the strongest relative price strength and short the stocks with the weakest relative price strength rank, "the short side of the portfolio—the losers—are 'crashing up' rather than down."

Beta, a measure of a stock's volatility, is a key characteristic of these momentum crashes. During a bear market, shares of defensive or counter-cyclical companies are favored. When a rebound begins, significant upside volatility occurs. This can push the beta of the winners portfolio (composed of stocks with the best past returns) above 2.0. The beta of the losers portfolio (made up of stocks with the worst returns), however, can jump up to 4.0 or 5.0. Higher betas imply greater volatility in the share price. During periods characterized by a strong upward market move, holding high beta stocks can lead to higher returns.

Put another way, a momentum portfolio that is long winners and short losers has significant negative market exposure near the end of a bear market. While this can make the bear market more tolerable by reducing the downside (aka "drawdown"), it leaves the portfolio with significant negative market exposure when the market rebounds significantly upward. The authors say this exposure is "even more negative for extreme past return sorted portfolios."

Source: "Momentum Crashes," Kent Daniel and Tobias Moskowitz, National Bureau of Economic Research, August 2014.

Fund Manager Tenure Based on Peer Returns

Since active mutual funds are judged on their returns, it would seem logical for the tenure of solo managers to be tied to their performance. This appears to be the case, though tenure has more to do with not underperforming competitors than beating category benchmarks.

Two professors sought to measure the role merit plays in careers of mutual fund managers. They analyzed 2,846 funds with solo managers. These were managers who had the sole responsibility to oversee their respective funds. Managers were tracked based on both performance and the length of time they were solely responsible for running their respective funds.

The tenure for a solo fund manager is short. Nearly one out of five solo managers managed their funds one year or less. More than 50% of funds saw their managers' run as the sole head end within three years. By year five, more than 75% of solo fund managers were replaced or began sharing duties with another manager. Just 6.85% of solo fund managers lasted at least 10 years.

Solo fund managers with tenures of at least 10 years did outperform their peers with shorter tenures. Some managers were given a grace period. Two- and three-year managers, for example, underperformed long-term managers during each year of their tenure before being replaced.

Commenting on the results, the study's authors wrote, "Our methodology does not directly address whether performance is the result of skill or luck, but it is clear that avoiding multiple years of poor performance is an important determinant of longevity for a mutual fund manager."

Unfortunately, manager longevity did not always lead to good returns for shareholders. Rather, even among managers with the longest tenures, nearly half trailed their category averages in a given year while at the helm. The study's authors viewed their findings as suggesting that "in a given year, even the longest-surviving solo managers are unlikely to produce significantly more positive style-adjusted monthly returns than negative ones."

The results imply fund manager tenure is not based on the ability to create value for the fund's shareholders by beating the market. Rather, mutual fund managers keep their jobs by not underperforming their peers.

Source: "The Career Paths of Mutual Fund Managers: The Role of Merit," Gary E. Porter and Jack W. Trifts, Financial Analysts Journal, July/August 2014.