MUTUAL FUNDS WORKSHOP

Mutual Fund Selection: How to Use AAII's Low-Load Guide Effectively

By John Markese

In the mutual fund realm, the key word is "more": more mutual funds—the count is well over 6,000 and still climbing; more information—the fund prospectus and annual report provide increased fund coverage; and more sources of information—in the mail, on-line, on a disk. And computer-based fund information offers the opportunity for greater coverage and more rapidly updated information.

"More," however, is "better" only if you know what to do with it.

Unless you develop a systematic approach to mutual fund evaluation, identifying important pieces of information and acquiring the ability to judge the data, you will most likely find yourself more confused, more rapidly.

AAII's "The Individual Investor's Guide to Low-Load Mutual Funds" is designed to provide a structured approach to evaluating mutual funds. For that reason, this article on mutual fund evaluation is also a summary of how to use the upcoming 1997 Low-Load Guide most effectively, with a focus on the full-page individual mutual fund summaries. AAII members will receive the 1997 Guide in early March.

Performance

The Low-Load Guide's full-page summaries begin where most investors place most emphasis—the fund's performance, which encompasses both return and risk.

How should return and risk figures be evaluated?

Return

This section reports not only the fund's historical return performance, but also comparative data. Historical return figures capture how a fund performed during various market environments and conditions, but without a close look at how these funds performed relative to some market benchmarks, the analysis may easily be misleading.

- **Definitions & Interpretation**

The Low-Load Guide's ***return*** figure is total return, which includes reinvestment of all distributions, income and capital gains, and takes into account net change in investment value after all expenses, but before sales loads and taxes. Aftertax return assumes the highest individual federal tax rate on income distributions and short-term capital gains and the capital gains rate on long-term capital gains distributions.

Three-, five- and 10-year compound average annual returns compress a great deal of information into one number. Although this compression provides a quick summary of performance, it may mask other important information. For example, a three-year compound average return that is high may hide the fact that one year of the three produced a return so high it more than compensated for two sub-par, or even loss, years. And while five-year and 10-year numbers are less affected, any judgment on the consistency of performance is lost in the annual averages.

The solution? Don't fail to look at the year-by-year returns, noting any extreme performance years and remembering generally the market conditions that prevailed during those years.

Is 10 years of performance data better than five years, five years better than three years, and so on? You need enough years of data to observe how a fund has performed in different market environments, but if you go too far back you may be looking at a fund that differs greatly from the one you are considering now. What then is the ideal time period to examine? One year is clearly too short, while at the other end of the spectrum 10-year figures may be misleading. At a minimum, look at the three-year figure, but spend more time with the five-year figure. Are they significantly different? What is the reason for a difference and what is the trend? Similar comparisons should be made with the 10-year number, if available. Funds with less than three full years of data are a blind bet unless the portfolio manager has prior fund management experience that you can evaluate.

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For investors holding mutual funds in taxable accounts, the ***tax-adjusted return*** indicates what you are able to keep, at least before any state and local taxes. Large and constant differences between return and tax-adjusted return numbers should not disqualify a fund from your choice list, but may make it a candidate for a tax-sheltered account. As a reminder however, all eventual withdrawals from a tax-sheltered account are taxed at ordinary income tax rates, the capital gains tax advantage is forfeited.

The ***bull market*** (July 1994 through December 1996) and ***bear market*** (February 1994 through June 1994) performance numbers are most useful when examined as a team. The returns are total returns for the period, and when compared to each other, add to an intuitive feel for performance and risk. It is an unusual fund that leads in a bull market and avoids a bear market. Usually, a fund does well in one but not the other.

While examining all these return figures is informative, ultimately you need a standard or benchmark to judge performance. The ***differ from category*** statistic is just such a benchmark. The performances of all funds in the same investment category, growth for example, are averaged for each performance number and subtracted from the return of the individual fund to arrive at the difference from category average. A positive number indicates that the individual fund's return is higher than the category average and a negative number indicates the fund's return is lower than the average. In addition, the difference from category performance is ranked and divided into quintiles (top 20%, next 20%, etc.), and then classified as either high, above average, average, below average or low. Of course, a fund that ranks high in all of these time periods is ideal, but rare. The year-by-year differences from category probably are the most informative—any fund that performs above its peers year-in and year-out with only an occasional lapse should be prized for its consistency.

Risk

Looking only at return numbers ignores the other half of the performance equation—risk. The ideal fund that consistently bests the competition may simply carry relatively high risk.

• Definitions & Interpretation

Simply stated, risk is variability of return measured absolutely or relatively. The greater the variability, the greater the risk; greater risk should be accompanied by greater returns.

Total risk, with rankings from low to high, compares the risk of the fund to all other funds, no matter what the investment category or types of investments the fund makes. Typically aggressive growth stock funds tend to fall in the high total risk classification, while short-term bond funds populate the low total risk classification.

Standard deviation is an indication of how much a fund's return has fluctuated over the last three years. It is specified in return percentage, with the higher the value the greater the risk. Adding and subtracting the standard deviation from the fund's average return provides the range where most of the fund's historical returns have fallen; the greater the range, the greater the risk.

Category risk relates the standard deviation of a fund to the standard deviations of all other funds in the investment category; the ***risk index*** shows this relationship numerically. A risk index above 1.0 indicates above category-average risk and a risk index below 1.0 indicates below category-average risk. A 1.3 index value, for example, would identify a risk level that is 30% higher than the average fund in the category.

Beta relates the sensitivity of a stock fund to changes in the stock market. A beta of 1.0 indicates risk equal to the overall stock market, while a beta below 1.0 indicates less risk and a beta above 1.0 indicates greater risk. A stock fund with a beta of 1.5 would be 50% more volatile than the overall stock market. However, not all risk is related to the stock market and that is why beta is not always an appropriate risk measure. For well-diversified common stock funds, beta serves as a useful measure of risk; for sector funds that concentrate in one industry and are not particularly diversified, beta may be close to zero, indicating almost no market risk, yet the fund may have a high total risk as measured by standard deviation. That's why it is important to also examine a total return risk measure, such as standard deviation. Remember, risk is the factor to check if you find a fund with outstanding performance. Make sure it doesn't have extraordinary risk compared to its peers.

For bond funds, beta is replaced by ***average maturity*** of the bond portfolio in years. While not a perfect indication of risk, average maturity gives a relative indication of how sensitive the bond fund is to interest rate risk—the risk that arises from the relationship between interest rates and bond prices (when rates rise, bond prices fall). The longer the average maturity, the greater the sensitivity to changes in market interest rates, and therefore the greater the volatility.

	3yr Annual	5yr Annual	10yr Annual	Bull	Bear
Return (%)	15.1	14.2	13.5	55.1	-5.5
Differ from Category (+/-)	1.0 abv av	-0.4 av	0.0 av	2.9 abv av	1.2 abv av

Total Risk	Standard Deviation	Category Risk	Risk Index	Beta
av	9.0%	blw av	0.9	0.90

	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987
Return (%)	13.2	35.3	-2.9	5.8	12.6	41.9	-4.9	24.5	17.9	-0.8
Differ from Category (+/-)	0.4	5.1	-2.4	-8.1	0.4	6.1	1.4	-1.5	0.0	-2.8
Return, Tax-Adjusted (%)	11.8	32.4	-5.1	4.6	10.8	40.5	-5.8	22.4	16.0	-6.1

Per Share Data

The Low-Load Guide's per share data section reports important numbers that investors should be aware of.

• Definitions & Interpretation

Per share data is derived by taking fund finan-

PER SHARE DATA

	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987
Dividends, Net Income ($)	0.14	0.62	0.70	0.81	0.71	0.67	0.79	0.92	1.02	1.84
Distrib'ns, Cap Gain ($)	2.61	4.03	3.31	1.04	2.01	0.82	0.22	1.05	0.45	4.03
Net Asset Value ($)	65.15	60.03	48.03	53.64	52.47	49.17	35.76	38.61	32.63	28.94
Expense Ratio (%)	0.74	0.77	0.78	0.76	0.78	0.81	0.82	0.86	0.86	0.86
Yield (%)	0.20	0.97	1.37	1.49	1.30	1.35	2.19	2.32	3.09	5.58
Portfolio Turnover (%)	25	29	33	10	15	22	21	24	32	27
Total Assets (Millions $)	3,812	3,505	2,820	3,179	2,772	2,103	1,379	1,385	1,107	1,028

cial totals and adjusting them for the number of mutual fund shares outstanding. As mutual fund investors invest more money, more shares are issued. The number of new shares issued to each investor is essentially the amount invested divided by the value per share.

Dividends, net income—This is what the fund has paid out from interest earned or from dividends after netting out fund expenses, on a per share basis. If you are interested in income from the fund, look for year-to-year consistency. Income and dividends are taxable when paid unless you hold the fund in a tax-sheltered account; if you do not need income or are in a high tax bracket, high dividends may be a negative.

Distributions, cap gains—Again, these distributions are taxable when paid unless the fund is held in a tax-sheltered account. Because of their investment management strategy and style, some funds make frequent and large distributions. Since these distributions are stated in dollar terms, how can you assess what is large? Compare the distributions to net asset value each year, and if it seems large to you, it probably is. Be sure to look back to bear market environments to see what happens to these distributions when the overall markets were in turmoil. The ideal fund makes zero distributions at all times, leaving the decision as to when to take gains up to you, by selling fund shares.

Net asset value—This is the market value per share of all securities held by the fund, and in and of itself is not particularly useful. While net asset value reflects changing markets, it is also reduced when distributions of income and capital gains are made; a decline therefore doesn't necessarily mean the fund has done badly. Don't spend much time with net asset value; instead, look at performance figures.

Expense ratio—This includes management fees, fund expenses, and any annual 12b-1 charges (essentially a load charge to pay for advertising and sales activities), which are stated as a percentage of average fund assets; the ratio doesn't include brokerage costs incurred by the fund, or front-end loads, back-end loads, redemption fees or other account activity charges. High expenses are hard to overcome and will drag down performance. Stay away from high expense funds. What is high? Compare your fund to the averages for each fund category in Table 1.

Yield—This is only a part of total return. Net income distributions for the year are divided by end-of-year net asset value plus any capital gains distributions and expressed as a percentage. Table 1 gives yield averages for various categories of mutual funds. If your fund's yield is much different from the average for its category, it may mean that it is pursuing an extreme strategy—for example, a high yield for an aggressive growth fund might indicate the fund is holding large cash balances or investing in higher dividend-yielding stocks rather than maximum growth potential stocks.

Portfolio turnover—This ratio indicates how much of the portfolio by value is traded by the fund over the year. Technically, it is the lower of purchases or sales relative to average assets, but the interpretation is straightforward: Higher turnover usually translates into more transaction costs incurred by the fund, which may lower performance if not offset sufficiently by trading gains; it also may translate into more capital gains distributions and thus a potential tax liability for taxable accounts. In the long run, below average turnover is probably more desirable than above average turnover. Check Table 1 to see how your fund compares to the category averages, and be sure to look at the year-to-year turnover ratios for your fund.

Total assets—At first glance total assets may seem unimportant, but there are some concerns. First, are the assets so large that managing them has become difficult, given the fund's investment strategy? Small capitalization stock funds may have trouble operating effectively in thinly traded stocks if the fund has over $1.0 billion or even $500 million in assets. But too small an asset base—for instance, less than $100 million—may produce a very high expense ratio to the detriment of performance. On the other hand, a large stock index fund can handle billions of dollars in assets without difficulty and improve performance by spreading fixed expenses over a larger asset base, reducing the expense ratio.

Second, a rapid increase in assets in the form of cash, usually due to outstanding performance attracting investors, is difficult to deploy quickly, and rising cash balances may sink fund performance or possibly bend proven investment strategies and techniques.

The Portfolio

Getting a feel for what is in your mutual fund's portfolio and who is managing your money should help you develop insights into how your fund might behave as markets change. Also, no matter what the fund's name or what its investment objective is, it is what the fund invests in that counts.

• Definitions & Interpretation

The portfolio is what the fund holds, classed by type of investment, at a point in time usually calculated from the fund's annual report. Since portfolios change as strategies and markets change, it is worthwhile to request the most recent portfolio report from the fund before investing. Much of what can be made of the portfolio is subjective. The purpose is to understand what you are investing in rather than judging the portfolio; the ultimate proof of the portfolio

Table 1.
Fund Category Averages

	Expense Ratio (%)	Yield (%)	Portfolio Turnover (%)	Total Assets ($ mil)	Standard Deviation (%)	Beta	Maturity (yrs.)
Aggressive Growth	1.42	0.3	117	789	15.9	1.18	—
Growth	1.15	0.8	85	1,426	10.5	0.92	—
Growth & Income	0.91	2.2	62	1,719	8.9	0.84	—
Balanced	0.93	3.4	89	1,355	6.6	0.63	—
Corporate Bond	0.72	6.5	175	699	4.5	—	8.1
Corporate High Yield Bond	0.94	8.8	113	852	4.4	—	7.8
Government Bond	0.65	5.7	168	282	5.4	—	7.2
Mortgage-Backed Bond	0.75	6.5	164	868	3.5	—	9.8
General Bond	0.74	6.2	150	372	3.5	—	7.1
Tax-Exempt Bond	0.60	5.0	52	455	5.0	—	12.8
International Stock	1.47	1.0	74	616	13.1	0.77	—
International Bond	1.14	7.8	258	207	7.1	—	7.7
Gold	1.59	0.9	51	275	27.2	0.85	—
Domestic Equity	1.18	1.0	89	1,277	12.0	0.99	—
Small Capitalization Stock	1.28	0.4	76	715	13.5	0.99	—
Domestic Taxable Bond	0.73	6.3	157	502	4.1	—	7.7

Source: AAII/Micropal. Data as of September 30, 1996.

and manager is in the performance and risk numbers.

Portfolio manager—This is important for some funds, those actively managed in faster moving markets, and unimportant for others, such as index funds. When looking at performance records for actively managed funds, it is useful to note whether the current portfolio manager was the manager guiding the fund during the years of outstanding performance. While a new portfolio manager is not a reason to avoid or sell a fund, it can be a tie-breaker between two funds with similar performance records.

Investment category—Aggressive growth, gold, international bond, etc.—these categories are a rough guide as to how the fund will behave. An investment category classification is, on the margin, a judgment call. For instance, some growth funds look more like aggressive growth funds at times. And international funds are not the only ones investing abroad, some domestic funds invest internationally also. The checked categories in this section will give you a quick view as to what the fund is trying to accomplish and how they intend to do it.

PORTFOLIO (as of 9/30/95)

Portfolio Manager: Albert Nicholas - 1969

Investm't Category: Growth

✔ Domestic	Index
Foreign	✔ Sector
Asset Allocation	State Specific

Investment Style

Large-Cap Growth	✔ Large-Cap Value
Mid-Cap Growth	Mid-Cap Value
Small-Cap Growth	Small-Cap Value

Portfolio

5% cash	0% corp bonds
95% stocks	0% gov't bonds
0% preferred	0% muni bonds
0% conv't/warrants	0% other

Investment style—While investment management style is many-faceted, stock fund managers can be usefully slotted by stock size emphasis and the growth versus value investment approach. Large, mature firms, mid-size firms, and small stocks all behave somewhat differently. Small stocks in general tend to have greater growth potential but higher risk; large stocks have less growth potential but lower risks; and mid-size stocks fall somewhere in the middle. And these size distinctions also translate into different industry representations at different points in their development cycle. Size is measured by market price per share times the number of common stock shares outstanding, called capitalization.

The growth approach emphasizes searching for stocks with rapid earnings growth. These stocks often sell for high stock prices relative to current earnings and have high future earnings growth expectations, resulting in more volatile stock prices as expectations change. The value approach style of investing seeks out stocks that have been ignored or overlooked. Value investing tends to concentrate on stocks with higher dividend yields or lower stock prices relative to earnings, for example. Growth and value investing styles often end in the selection of stocks in very different industries.

Many managers, however, are not solely growth or solely value managers—they have a blend of the two styles. And it is common for managers to invest in a combination of large and mid-size firms or mid-size and small firms, for example, rather than stay invested entirely in one stock size range. The most aggressive style is small stock growth. The least aggressive style is large-cap value. Style is particularly useful for diversification, to avoid duplication of styles with fund investments, and to assure that important segments of the stock market are represented in your portfolio.

Portfolio—How does the portfolio breakdown compare to the investment category and the fund's investment objective? For example, an aggressive growth fund with 20% in cash is either engaging in market timing, or has had difficulty investing a large inflow of new money, both situations of concern to investors.

The Starting Point

Does the Low-Load Guide provide all you need to know to select a fund?

No. It is, however, a useful summary of important points and should be used in conjunction with a thorough reading of the prospectus and a review of the annual report that lists all securities held by the fund.