How to Pick Better Mutual Funds?

* PEOPLE + PROCESS + PHILOSOPHY = PERFORMANCE * October, 2011

Dear friends,

If you have the time, desire, experience and knowledge of building your own investment and retirement portfolios, this newsletter is for you!

At BFM, we are very analytical and we believe that **asset allocation is more important** than stocks or mutual fund selection… but many of you have asked us to share **our disciplined due diligence process** to selecting investment managers and mutual funds.

Selecting a good mutual fund is extremely difficult. Only 20% of funds may outperform their benchmark over the long run. 40% of funds that were in business 10 years ago are now gone. A fund can be at the top one period and be at the bottom the next one.

As you can see, mutual fund returns can be very different (international fund category).

Name	10-year Return	Value of $10,000
Old Mutual Copper Intl Sm Cap	50%	$14,988
Invesco International Sm Cap	**417%**	$51,716

The debate between active and passive management (investing in index, passive funds and ETFs) is a constant discussion among individuals in the financial world. There are qualitative and quantitative factors that need to be understood and analyzed correctly before picking a good fund.

You should decide to be either **patient with active managers** or seek a passively managed approach. The vast majority of long-term top performing managers will endure periods of lousy performance.

· 85 percent of all ten-year top quartile funds spent at least one three-year stretch in the bottom half of their peer group (they spent about 23 percent of all their three-year periods in the bottom half of their peer groups).

· 62 percent of ten-year top quartile funds spent at least one five-year stretch in the bottom half (19 percent of rolling five-year periods in the bottom half of their peer groups). Source DiMeo.

Short-term greed and impatience will lead investors to fail. Before investing you should **develop confidence in the fund and the patience required for long-term success**. Otherwise, you should invest in index and passive funds (low costs).

"Do not wish for quick results, nor look for small advantages. If you seek quick results, you will not attain the ultimate goal." Confucius.

Human emotions are the biggest obstacle to investor success. Proper research goes well beyond the numbers. It also requires regular meetings or calls with the managers. Natural human behavioral tendencies during the manager selection and termination process generally leads to failure so we recommend a rigorous process. We believe that qualitative metrics for selecting mutual funds are as important as quantitative metrics.

What traits and factors do we look for, review carefully, and monitor constantly?

Qualitative factors:

1. **People**: education, qualifications, experience, depth, stability, diversity, quality and diligence of the investment team (portfolio managers, analysts, traders, auditors…)

2. **Investment philosophy** that is consistent, clearly articulated and understandable

3. **Investment process** and style based on meritocracy that are transparent, repeatable, consistent, and definable with good buy and sell discipline and risk management procedures

4. **Stewardship**: a corporate culture of excellence, with clean regulatory history, board integrity, independence, ownership and compensation who will put your interests first

5. Firm **ownership structure**

6. Manager **compensation and incentives** structure (salary, bonus, stocks, shares…) that reward individual contributions

7. High conviction approach that is distinct and with potential to outperform. "Worldly wisdom teaches that it is better for reputations to fail conventionally than succeed unconventionally." J. M. Keynes.

8. What percentage of research is generated internally (vs. sell-side research from Wall Street)?

We also review the portfolio composition, size (small or large cap) and style of the funds, manager concentration, and if a manager has closed a fund to new investors in the past and ask how they decide to close it in the future.

Such data may not available by directly looking into sources like Bloomberg, Morningstar, and Lipper. This requires contacting every fund and requesting them to provide the data.

Quantitative factors:

1. **Fees***/ Expense ratio: Funds in the cheapest quintile were more than twice as likely to beat the average for their categories than the most expensive quintile

2. **Tenure** / Experience / Track Record of the Portfolio Managers and Analysts. The average tenure maybe close to 6 years only…

3. **Fund ownership**** by the portfolio management team

4. **5 and 10-year Information Ratio** (IR) and peer ranking. The IR measures the risk-adjusted return for assessing the performance of active portfolio managers

5. Long-term **after tax return / performance**: GMO Emerging Country Debt had a 10-year annual return was 14.54% ($10,000 became $38,880) but after tax, the post-tax return was 9.80% ($10,000 became $25,468 or 35% less)

6. Consistency of portfolio returns with the investment process (attribution reports)

7. Funds concentration

8. Tracking Error and Active Share: these numbers represent how much the fund returns deviate from the benchmark

9. Beta and Correlation with the fund's true Benchmark (R square)

10. Inflows/Outflows and total assets in the fund today and 5 years ago

11. Up/Down capture ratio and maximum drawdown

12. Sortino Ratio which measures the risk-adjusted return

13. Volatility

14. Turnover which measures the number of times securities/shares are replaced/traded

The quantitative data is available from a variety of sources like Morningstar, Lipper, Bloomberg, fund prospectus, fund statement of additional information, shareholder reports, fund companies…

You can see that these lists could include many more factors. Also important is that these factors are not available easily. **You need time and a good network to obtain all the necessary information.**

It does not end there. You may want to look at a fund's correlation with other assets/funds in your portfolio to optimize your portfolio risk level and decide what capital allocation would be best to minimize your downside risk. Short-term performance is not important.

*: Of domestic stock funds, 47% in the cheapest quintile beat the average over a 10-year period, while just 19 percent of the most expensive quintile beat the category average. The cheapest quintile of domestic-stock funds survived and beat the cheapest index fund 29% of the time, compared with just 17% of the most expensive quintile. There is a **high correlation between costs and survivorship**, as high-cost funds have a large attrition rate. Looking at rolling 5 and 10-year periods for US stock funds, the cheapest group had an attrition rate of 13% over 5-yr periods and 25% over 10-year periods. The attrition rate for the most expensive group was double that: over 5-year periods, 29% of the high-cost funds had merged or liquidated and 49% had merged or liquidated over 10-year rolling periods.

: We like managers to have **skin in the game. Does your Manager eat his own cooking? Would you invest in a fund when its portfolio manager does not even invest in it? 46% of the US stock funds managers report no ownership! 59% for international foreign funds managers. This information can easily be found at www.morningstar.com/goto/fundspy or in the fund prospectus (statement of additional information. Higher investment levels aren't a guarantee of success or an ethical manager, but it shows that managers believe in the funds.

DETAILS

The world is a mix of different professionals. Every professional has his or her own duty to perform well, be it as a teacher, mechanic or bartender. Many times individuals try to experiment with ideas outside their expertise. There is nothing wrong in learning new ideas; they rejuvenate you and can bring a fresh perspective to your daily routine. But what is important is that **you should not be over confident in pursuing activities beyond your expertise.** For example, practicing skydiving without a professional skydiver or dancing Ballet without a ballerina's guidance can harm your body.

Investing your wealth, just like skydiving and ballet dancing, is an art. **Investing without knowledge is like jumping into a valley without a parachute.**

There are two main categories of investments:

- Equity
- Fixed Income

Investment knowledge is imparted by investment and finance professionals. These professionals include individuals with professional degrees like an MBA, Masters, CFA, CFP, CPA...

But in spite of the experience and education professional investors possess it is difficult to attain the highest skills in all the different investment arenas. So, being a common person who does not work intensively in the world of finance, you can see the complexities in making investment decisions.

What Are Mutual Funds?

A mutual fund is a company that pools money from many investors and invests the money in a combination of stocks, bonds, and other securities or assets. The combined holdings that the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate.

Which Strategy to Choose: Active vs. Passive Management?

Passive Management is an investment strategy that attempts to replicate the returns of an index or benchmark by owning the same assets, in the same proportions, as the underlying index. Passive investing does not seek to capture any excess returns, but rather tries to match the performance of the index. Indexed Mutual Funds and ETFs are common vehicles used for passive investing.

Active Management, on the other hand believes the market can be inefficient sometimes. Managers attempt to add value over the returns of an index by picking assets based on models, insights, and analytical research. Managers aim to achieve a higher return then the benchmark by selecting a superior stock, currency, market, or sector, etc. Active managers will try to exploit pricing inefficiencies to obtain excess return. (Source: SPDR University).

Percentage of Active Funds are Underperforming the Benchmark

Efficient wealth management is a tedious and time-consuming activity. It requires a psychological self-understanding along with excellent analytical and technical skills. Here we look at how actively managed mutual funds have performed across the years compared to their respective benchmarks and the numbers are very surprising.

The figures below are Equity and Fixed Income mutual funds style boxes after adjusting for survivorship bias. We see that all the categories have more than half of the funds underperforming the benchmark. Also, except for large-cap value and large-cap growth, all the other categories have more than **75% of the funds underperforming the benchmark**.

By looking at the numbers we can say that **selecting a good mutual fund is extremely difficult.** Thus, effective organized financial planning is important. The finance professional cannot guarantee above average returns but some of them will be more adept and skillful in managing investments than a layman.

EQUITY % below benchmark	Value	Blend	Growth
Large	56%	83%	73%
Mid	99%	96%	98%
Small	84%	93%	76%

FIXED INCOME % below benchmark	Government	Corporate	GNMA
Short	94%	99%	100%
Intermediate	80%	91%	N/A

Sources: Vanguard calculations, using data from Morningstar, Inc., MSCI, Standard & Poor's, and Barclays Capital

Why do active managements underperform benchmarks so poorly? An indexing investment strategy performs favorably in relation to actively managed investment strategies because of indexing's low costs, broad diversification, minimal cash drag, and, for taxable investors, the potential for tax efficiency. Combined, these factors represent a significant hurdle that an active manager must overcome just to break even with a low-cost index strategy over time.

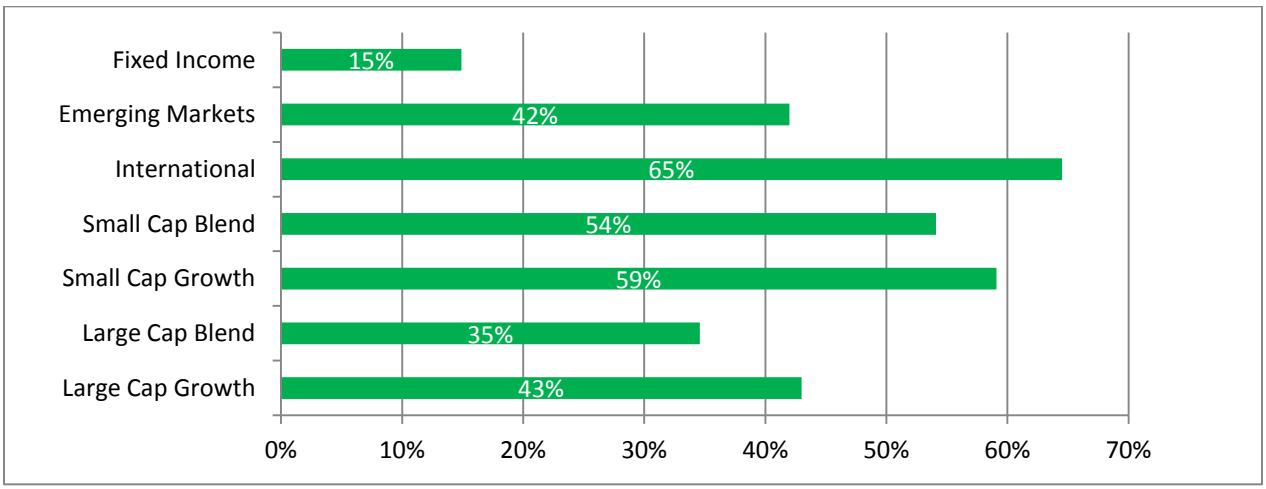
Some studies support the notion that active funds can sometimes outperform passive funds in less efficient markets over certain down market periods and sustained time horizons.

A research report by State Street Global Advisors and SPDR® ETFs for the 15-year period ended December 31, 2010 found that more than 50% of active managers outperformed the relative indexes only in three asset classes—small cap blend, small cap growth, and international as shown in the figure below.

Research conducted in the 1960s by Jensen (1968), Sharpe (1966) and Treynor (1965) found that, on average, active funds underperform their benchmarks on a risk-adjusted basis and that the magnitude of underperformance directly relates to the level of expenses.

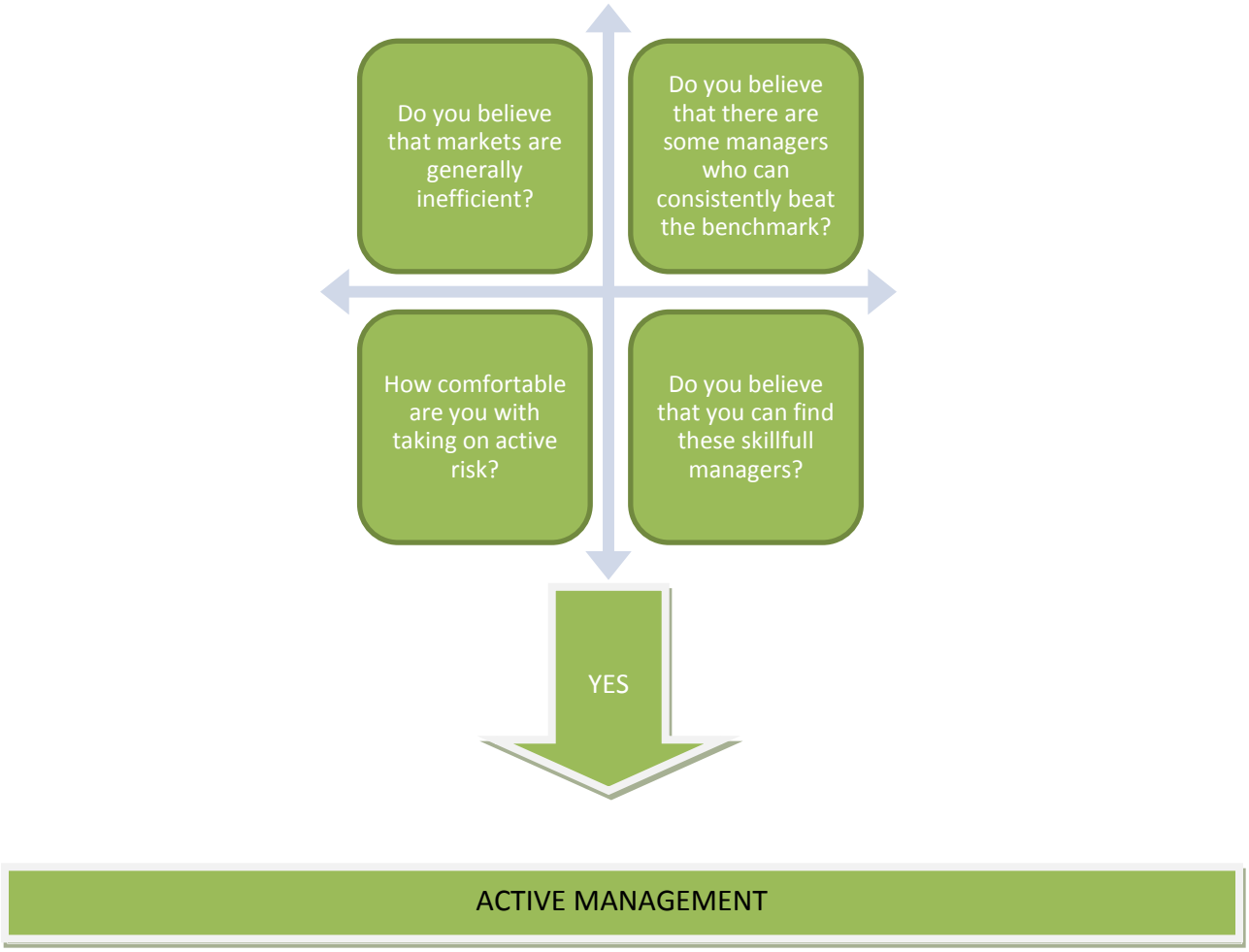
This debate about Active and Passive Management is of constant discussion among individuals in the financial world. Thus, instead of trying to find the winner the fundamental approach should be to ask: "How can I make the best decisions with respect to my goals and objectives?"

Percent of Active Managers Outperforming Indices ~ 15-Year Annualized



Source: Morningstar Direct, SSgA Global ETF Strategy & Research as of 12/31/2010.

The decision to pursue passive or active management strategy should be decided based on understanding your objectives by asking certain questions as shown in the figure below.



Passive strategies should be relied upon when the potential to beat the market is relatively poor and to minimize tax liabilities related to capital gains.

Active Strategies should be pursued in those markets which are less efficient and when you have high confidence.

You should make a decision as to which is the correct and advisable strategy after accounting for your objectives, and understanding the factors like taxes, fees and risk tolerance. The best investor would be the one who can identify market segments which are not efficient and employ active strategies among those segments. In addition, one must identify superior active managers in asset classes where the manager has a greater chance of outperforming.

(Source: Passive and Active Management , A Balanced Perspective Thomas Guarini, ETF Strategies, Global ETF Strategy & Research, State Street Global Advisor)

We just saw the strenuous procedure involved into opting for passive or active management. Now the active investor needs to create a universe of Mutual Funds to choose from. Creating this universe of funds involves tremendous skills in all aspects. The active investor needs to have good analytical as well as technical skills. Also important are qualitative aspects like good networking skills and having knowledge of behavioral finance.

Picking the right mutual funds is not an easy task. There are qualitative and quantitative factors that need to be understood observed and more importantly analyzed correctly.

Manager Due Diligence

It is very important to perform diligence on the company and its management, to know whether the management is engaged in costly litigation or is involved in finding innovative ideas for the firm.

The performance of a mutual fund is largely driven by the manager and his/her team.

Investment style, people, philosophy and performance are all carefully reviewed in the manager search and selection process.

The fund's manager tenure period is looked at. You would not want a fund whose manager and team changes every year. We would want the **same management for at least 10 years.** We need to evaluate how a manager has done in the long-term. Why?

Short-term performance is of little use in picking a fund that you're going to hold for the long term. Funds with the top trailing one- and three-year returns may continue well over the next short term period, but may fare poorly over the long term.

How big is the team? We prefer firms with a **strong team of analysts.**

How is the management team compensated? We are more interested in private firms, where managers receive ownership stakes in the firm. We want funds with at least enough assets under management because this will generate enough revenue to pay the salaries of good analysts and keep them for many years.

We like for managers to have skin in the game. We look at a manager's ownership in his or her own fund and like to see ownership valued at $500,000 or more. You wouldn't like to see a CEO who doesn't own any stock in his own company and for that reason we demand it in fund managers.

With regard to the fund's portfolio, we want a low turnover because it gives a low tax impact.

We want funds to have concentrated portfolios with fewer stocks. If the mutual fund owns so many stocks, it may be better to just buy the index which is cheaper. We pay managers to take risks.

What is the investment strategy? Funds that rely on momentum strategies to buy hot stocks incur greater trading costs than those more contrarian strategies that involve buying the stocks that everyone is desperate to sell. **Like Warren Buffett, we believe in buying stocks and holding it for the long-term.**

We prefer no-load mutual funds with low expenses for several reasons. First, it shows that a manager keeps business costs under control. There is a high correlation between costs and survivorship, as **high-cost funds have a large attrition rate**. Second, fees reduce investor return. When the cheapest 20% of equity funds is compared to the cheap index fund, it is twice as likely to beat the index as compared to the most expensive 20% of equity funds. (Source: Fund Spy by Russell Kinnell)

We review how managers performed in the past, during bull markets and bear markets. We like **downside protection**. Once a manager's past performance is understood, expectations can be set for future performance. These performance expectations and an investor's tolerance for risk should be explicitly discussed and accepted when selecting a manager.

Even after a manager is selected, **constant monitoring and reviewing** is a difficult task. Unfortunately, ongoing manager review often becomes an afterthought or is not even discussed.

We review if a manager has closed a fund to new investors in the past and ask how they decide to close it in the future. Closing a fund means a fund company is passing up fee income and hurting its own short-term profits in order to avoid letting asset growth harm performance of the fund.

The managers selected should remain true to the style and asset class for which they are being selected. A large-cap growth manager should not deviate drastically from his/her intended strategy.

Any change to the investment team should be immediately reviewed. Changes to senior management or to the structure or ownership of the firm should also be evaluated with a critical eye as to their impact on the investment team's time, resources and capabilities.

*** People + Process + Philosophy = Performance ***

