Qualitative Guidelines for Mutual Fund Selection

by John Deysher and Michael Walters

Article Highlights

- Shareholder letters can not only reveal what a manager thinks of current market conditions, but how open he is about his mistakes.
- An annual review of the top holdings shows whether the fund is adhering to its objectives or if it is guilty of "style creep."
- A fund manager who is also a large shareholder has a vested interest in strong performance.

Many articles exist on AAII and other investor education sites on how to use financial data to pick solid mutual funds.

Using historical return data, expense ratio information, peer rankings and risk/return metrics is relatively straightforward. Annualized average returns, standard deviation, and three-, five- and 10-year performance are well understood and widely published.

But what comes after screening based on quantitative metrics? What about the other side of fund selection—the qualitative criteria that can help investors better understand and select investments to fill their portfolios? Many of these questions require reading prospectuses and manager letters and digging into a few years' worth of data to fully comprehend. This can be a bit more laborious than picking funds based on a "top 10" list, but the time spent is well worth the effort. Let's talk about qualitative guidelines for fund selection—some of the factors that should be considered that an investor can't assess with a calculator or spreadsheet.

Shareholder Letters

Letters from mutual fund companies are perhaps one of the best ways to evaluate a fund manager's orientation toward shareholders. As a bonus, some of them are excellent reading! You'll find fund managers who write thoughtful commentary, dissect their wins and losses, comment on the state of the market, and offer insight into exactly how the fund is managed. It's too bad that many of these letters are never read by shareholders.

Depending on the manager, these communiqués may even offer perspective as to whether or not they think that their corner of the market is inexpensive or temporarily overpriced—an important consideration if you are doing your quarterly or semiannual fund rebalancing. Over a period of several years, you will also be able to ascertain—and this is a key consideration for active managers—whether or not the manager is forthright and clear about their mistakes. Over the long term, a down year or a period of underperformance is virtually guaranteed to occur. When this occurs, ideally you'd like to see a letter that addresses both what caused the lag and what (if anything) the fund is doing to address it.

Consistent Strategy, Clearly Articulated & Correctly Labeled

"Go anywhere" funds notwithstanding, most securities in a portfolio are there for a specific reason. For example, you want to own large-cap growth stocks, or high-yield bonds, or gain exposure to smaller international companies. The fund's strategy should be consistent and clearly articulated, and the description of the ponds the fund fishes in should match the holdings in the portfolio.

"Style drift" and "market-cap creep" occur more often than you might think. It's worth looking at the 10 top positions in your funds at least yearly and pulling up a summary page on the stocks in question. Check that the fund's holdings pass the laugh test: They shouldn't be so surprising that they make you laugh! As an example, if a small-cap growth fund owns shares of Apple Inc. (AAPL) or Google Inc. (GOOG), a full review of the fund might be in order to see if it has strayed too far from its stated purpose.

Manager Background

Generally, the fund manager's background will be one of two flavors. The most common is the manager who has worked in finance or accounting for his or her entire career. The manager's résumé will usually contain some mixture of research, analysis, trading and accounting positions. Another, less common manager background involves expertise around a specific field. A specialty biotech fund might have a portfolio manager whose background includes positions in research and development labs and drug companies. Both types of backgrounds make sense, intuitively. A manager who has a wildly different background from these isn't necessarily a dealbreaker, but you might want to make a note to see if you can find a bit more info on the team running the fund and what their qualifications are.

We are aware of two memorable examples that didn't end well. The first is a doctor who decided to start a fund in his spare time. The fund's literature even said, "The manager is of the opinion that running the fund will not interfere with his medical practice." The second is a fund company that put a college student at the helm of their very real fund after his 'virtual portfolio' won an online contest in the prior year.

Steady Hands at the Wheel & Consistent Leadership

A fund with a great long-term track record is a wonderful starting point. But if the fund's star manager and top two analysts left last year to start their own firm, you may find that the team that currently manages the fund is very different from the team that established the track record. Slow and steady are the watchwords here. You want managers who have worked on the fund for several years, and you want a minimum of turnover at the helm of the fund. Ideally, manager changes should be amicable and brought about slowly.

For example, over a period of several years, a fund might go from having a single manager to having co-managers, as one or more longtime analysts are groomed to take over the portfolio. This isn't a guarantee of outperformance, by any means, but it's a great signal that the fund's methodology and process are likely to remain consistent despite a new name on the shareholder letters.

Alignment of Interests

What's a simple way to ensure that a manager is on the same page as the shareholders? For starters, you'd like to see that the manager "eats their own cooking." When the manager is a large fund shareholder, it sends a clear signal that your fund is being run by someone with a vested interest in strong performance.

Information on manager and director fund ownership is found in the Statement of Additional Information, which, together with the prospectus, is filed with the Securities and Exchange Commission (SEC) annually. If your fund managers believe in their own strategy, they're likely to have their own money in it and they'll probably make that fact clear to investors.

Manager Communication

Some portfolio managers are fairly reticent, communicating with clients just once per year in their annual letter. Other portfolio managers are extremely social: letters every quarter, conference calls, articles online, and maybe even a blog or regular tweets.

There's no right answer here, but you should have an idea of how communicative your fund's management is before committing a decent chunk of your money to it. If you expect lots of disclosure and market commentary on a quarterly basis, you'll be pretty disappointed when you get a thin letter in the mail once a year containing your statement and "Thanks for your continued investment in the fund. Sincerely, Mark Manager."

You want a communication style that matches your preferences. If you're someone who devours quarterly letters and enjoys reading interviews with fund managers, it's a good idea to favor a fund that has a track record of communicating often with its shareholders. If you pick up one of the "strong, silent types" for a manager, you may find that you're unhappy hanging onto the fund during a rough patch due to its lack of communication—even if the fund itself is a fine long-term pick.

Expense Ratio Caps

Sometimes, a fund's actual expenses (adviser fees, back office, legal and accounting costs, etc.) aren't spread across a large enough asset base. This usually happens in smaller funds (a few hundred million or less in assets) with devotions to small, higher-cost niches—an international small-cap fund or a biotech sector fund, perhaps. To be competitive with low-expense-ratio funds, a high-expense fund may limit or "cap" expenses at a certain level. For example, a fund with expenses of 2.1% of assets may cap the expenses at 1.4%, with the adviser absorbing the difference.

The expense ratios before and after the cap are shown in the Financial Highlights section of a fund's annual and semiannual reports. While it's no guarantee, an expense cap suggests the adviser is looking out for the shareholders and is willing to absorb expenses until the fund is large enough to absorb the expenses directly.

Funds that don't cap expenses during years with a small asset base are usually the ones you'll find atop the "most expensive funds" lists, with crazy sounding expense ratios of 5% or higher. Buyer beware! These funds

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Mutual Funds

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probably aren't long for the world. It's likely the adviser will choose to close or merge the fund with another, larger fund in order to lower the expense ratio.

Conclusion

Finding fund managers who make the grade both quantitatively and qualitatively can take some investment of your time.

These data points can't necessarily be pulled up on a single summary page, and you'll find that you sometimes have to do a bit of digging in order to find them all. But the time spent is well worth the effort.

Taken individually, not one of these points is necessarily significant. But taken as a group, the results of this due diligence can help an investor further narrow the universe of potential funds to come away with a list of strong choices. ➤

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