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Mutual Funds: Analyzing

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Introduction

Investors who pay attention only to a fund's return are missing out on valuable information. Determining how a fund achieved its returns can be just as important as analyzing the returns themselves. Evaluating a fund properly not only helps you compare it with other funds, but lets you see whether a fund matches your investing needs and how it would complement your other investments.

Caution: *Before investing in a mutual fund, it's important to analyze and carefully consider a wide range of factors, including the fund's investment objective, risks, fees, and expenses. These can be found in the prospectus available from the fund. Before investing, obtain a copy and read it carefully.*

Analyzing a fund's investment objective

For some investors, analyzing a mutual fund basically consists of looking at historical returns. However, any analysis really should start with a fund's investment objective. More than any other factor, this will determine the role a specific fund might play in your portfolio and how well it fits with your financial goals.

There are three basic investing objectives: growth, income, and capital preservation. Growth investments are typically expected to appreciate in value over the long term. Income investments offer regular payments of income--for example, as interest payments. Investments that focus on capital preservation won't increase much in value, but are the least likely to lose value and typically can be easily converted into cash. Within each category, a mutual fund may have various ways of achieving its objective. A fund also may combine objectives; for example, it might focus on income as a primary objective, with capital preservation as a secondary objective.

Within each of these three broad objectives, there are many subcategories; in fact, the Investment Company Institute compiles data for funds in roughly 40 separate investment objectives.

Considering the type of securities in which the fund invests

A fund's investment objective will determine what type of specific securities it includes. A fund may invest in a single asset class; for example, a stock fund concentrates on stocks, a bond fund on bonds, and so on. Such a fund may be relatively broad-based and invest in a wide variety of stocks or bonds, or it may narrow its focus even further and concentrate on a specific type of stock or bonds.

Tip: *Even though a fund may focus on a single type of investment, it may still have multiple investment objectives. For example, a stock fund might attempt to provide both growth and current income by concentrating on companies that have a history of consistent or increasing dividend payments. However, all investing involves risk, and there can be no guarantee that any investing strategy will be successful.*

A fund also may invest across asset classes, combining several types of investments in an attempt to use the strengths of each to achieve its investment objective. For example, a balanced fund usually includes both stocks and bonds. Such a combination fund may have a so-called "neutral mix," which represents the percentage or range of percentages that will be allocated to each asset class over time. As a hypothetical example, a fund might have a 55-45 neutral mix of stock and bonds, or a neutral mix of 50-60 percent for stocks and 40-50 percent for bonds, though (depending on the fund guidelines outlined in the prospectus) the fund may also stray from the neutral mix.

Some funds even invest in other funds; a so-called "fund of funds" would be an example.

Learning about investing style and strategy

Even funds that invest in the same type of securities and have a similar investment objective may have different ways of trying to achieve that objective.

One of the key factors in a fund's methodology is whether it is actively or passively managed. A passively managed portfolio attempts to match the performance of a given benchmark index and minimize expenses that reduce an investor's net return. With an actively managed portfolio, a manager tries to beat the performance of a benchmark index by using his or her judgment in selecting individual securities and deciding when to buy and sell them. Each camp has strong advocates who argue that the benefits of its style outweigh the other's; you need to understand which best suits your overall investing strategy.

Another point of differentiation for stock funds is whether its manager leans toward either growth investing or value investing. A growth fund focuses on companies that are growing quickly and that seem to have greater than average potential for appreciation in share price. A value-oriented fund focuses on buying stocks that appear to be undervalued by the market relative to the company's intrinsic worth. Some fund managers blend the two approaches; this is sometimes known as a "growth at a reasonable price" (GARP) approach.

In some cases, a fund's strategy is not only a method for attempting to produce a return but the core of why the fund was created to begin with. For example, a lifecycle or target date fund is a specific type of asset allocation fund that adjusts its mix of stocks, bonds, and cash alternatives over time based on a specific time horizon. A distribution fund's strategy may be designed to produce a specific percentage rate of return each year, or make regular payments of income over time based on how long the portfolio is expected to last. In each case, the strategy is the core of how that specific fund functions.

Note: *The target date of a target date fund is the approximate date upon which an investor plans to withdraw his or her money. The mix of investments in a target date fund becomes more conservative as the date grows closer. The principal value is not guaranteed at any time, including at the target date, and there is no guarantee that a target date fund will meet its stated objectives. It's important to note that no two target date funds with the same target date are alike. Typically, they won't have the same asset allocation, investment holdings, turnover rate, or glide path, so it's important for an investor to look beyond the target date to determine if a particular target date fund is an appropriate investment.*

You'll also need to analyze the impact of whether a fund is an open-end or closed-end fund. With an open-end fund, you can buy and sell shares directly from the fund itself, and new shares are issued or redeemed constantly based on the flow of assets into or out of the fund. Closed-end funds have a fixed number of shares, determined when the fund is launched. Also, those shares are not redeemed by the fund but must be bought from or sold to other investors, much as shares of stock are. And unlike an open-end fund, the shares of a closed-end fund typically trade at a premium or discount to their net asset value (NAV).

Analyzing performance figures and other metrics

Once you've decided whether a fund's objective, style, and strategy make it a good potential candidate for your portfolio, it's time to look at metrics that can help you determine how successful a fund is at achieving its goals, and what you might expect as an investor. Though past performance is no guarantee of future results, information on such metrics as returns, risks, volatility, and expenses can give you a basis for comparing one fund to another. Carefully consider not only a fund's returns, but also how it achieved those returns.

Tip: *When evaluating a mutual fund's performance, make sure you're comparing it to an appropriate benchmark, or to funds that have similar investment objectives and that invest in similar securities. For example, comparing a large-cap stock fund to one that invests exclusively in small-cap stocks won't give an accurate picture of either one.*

Some of the most popular metrics used to evaluate mutual funds include:

- Performance/returns: The fund prospectus must include 1-,- 5-, and 10-year (or life of fund) historical performance figures. It also must compare those figures to those of an appropriate benchmark index. Consider both short-term returns for specific time periods--for example, a bear market--and longer time periods. Considering only short-term results can be misleading (for example, if a fund's market segment, asset class, or investing style is temporarily out of favor). Also, be careful about what's known as "chasing performance"--investing in funds solely because they have recently experienced high returns. Those high returns can sometimes (though not always) mean a market sector may be at a peak and about to rotate out of favor, as all sectors do periodically. Consider how a fund has performed in both bull and bear markets. A fund must include in its prospectus its best and worst quarterly performance during the past 10 years.
- Risks: Be sure you understand the various types of risk a given fund may face, such as market risk, interest rate risk, inflation risk, default risk, liquidity risk, currency risk, and political risk. All mutual funds face the same risks associated with their underlying securities. Understanding how a fund may be affected by such factors as a change in interest rates or fluctuating currency exchange rates can help you either be a better long-term investor or trade more effectively.
- Fees and expenses: Because investing costs can have a substantial impact on your net returns--especially over time--you need to investigate how much you're paying to invest in a particular fund. Potential fees and expenses may include shareholder fees that you pay directly, such as sales charges or redemption fees, and operating expenses that are paid from fund assets and are thus an indirect cost. A fund's turnover rate can be used as an indicator of the level of a fund's trading

expenses. Check a fund's expense ratio, which shows its annual costs as a percentage of its assets (remember that some types of funds often have higher expense ratios than others, so it's important to compare a fund to its peers). Find out if a fund has a required minimum initial investment, and whether there may be breakpoints that can help reduce sales charges.

- Historical volatility: Though past performance is no guarantee of future results, you should also find out how volatile a fund is. Again, it's important to gauge a fund relative to an appropriate benchmark and/or comparable funds, since some asset classes and market segments have historically been more volatile than others. Some common metrics often used to gauge volatility include standard deviation (measures how much a fund's returns have deviated from time to time from its own average) and beta (measures the extent to which a fund's return is correlated with movements of the overall market).
- Fund management: Statistics about a fund's returns in the past are less useful if they were not generated by the fund's current manager. Check on a fund manager's previous experience with the asset class or market segment in which the fund invests, and how long the manager has been at the fund.

Analyzing tax considerations

Taxes can have a substantial impact on your net return. All mutual funds are required to distribute capital gains to shareholders each year; those gains are subject to capital gains tax in the year they're distributed. However, some funds are managed to minimize those distributions by trading relatively infrequently or taking capital gains into consideration when selecting individual securities to sell. The higher your tax bracket, the more attention you should pay to determining the tax efficiency of a fund held in a taxable account.

Taxes also can be a factor in the timing of your purchase or sale of a mutual fund. If you plan to hold the shares in a taxable account, find out when the fund is scheduled to distribute any dividends or capital gains to shareholders. Consider delaying a purchase until after that date, which often is near year-end. If you buy just before the distribution, you'll owe taxes this year on that money, even if your own shares haven't appreciated. And if you plan to sell a fund anyway, you may minimize taxes by selling before the distribution date.

Also, some funds specialize in holding municipal bonds, which are generally free from federal income tax (though they may be subject to the alternative minimum tax). A municipal bond fund reduces the impact of potential default by any single bond issuer. However, unlike an individual bond, there is no maturity date at which your principal will be returned to you. When evaluating a mutual fund, consider whether you intend to hold it in a taxable or tax-advantaged account.

Note: *For municipal bonds held by a fund and issued by a municipality outside the state in which you reside, the interest could be subject to state and local income taxes. Also, municipal bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.*

Mutual fund rating services

In addition to doing your own research into mutual funds, you may find mutual fund rating services helpful. These services provide ratings and reports on virtually all of the major mutual funds. Much information is available online, either for free or by subscription. Your public library also may have a subscription.

Many investors prefer to leave the task of plowing through all the data described above to a financial professional, who has experience comparing multiple funds and analyzing how each one might fit your overall portfolio and fill specific investing needs.

To schedule an appointment with Faye Sykes, click here .

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