

# Building wealth: 11 keys to picking a great mutual fund

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It is no surprise that mutual funds have become the choice investment vehicle for the majority of today's investors.

What is a surprise is how even after decades of their existence, many people seem to be confused by the sheer amount of available information. Full-page advertisements touting a particular mutual fund and its most recent performance are commonplace in order to garner more dollars for the fund in question.

But many a time people do not recognize that a mutual fund repeating its great performance year after year is less common and more challenging than presumed. Consistency in performance is a rare quality achieved by few.

Depending on a particular year, more than two thirds of institutional money managers, which include mutual funds, are unable to beat their benchmark index, such as the S&P 500. But surprisingly, or maybe not so surprisingly, through the marketing muscle of these very institutions, billions of dollars pour into their coffers even though results are mediocre or worse. It seems harder for people to pull the plug once they own a mutual fund or to ignore their self-serving promotions.

Given this background, is there a way to pick wheat from the chaff or a diamond in the rough? Although this is not easy, it may be possible. So, here are some rules for the road for mutual fund investors.

1. Go beyond the name -- Mutual funds are notorious for misconceived names. Balanced Fund, Value Fund, Growth Fund, Mid Cap Fund. These names may give you a clue to the objectives of the fund, but you would be wise to look under the hood. It may turn out to be different than what the name suggests.

Look at what kinds of investments it holds. Are there stocks you recognize? Read through the description in the quarterly reports or management commentary. What is the allocation of stocks and bonds if it is a balanced fund? What does equity income really mean? Does a dividend fund really pay out any sizable dividends or is it in name only?

2. Load vs. no-load funds -- Load is another name for a sales charge. Unless you are interested in paying a sales commission to a broker, it makes no sense to buy a load fund when there are thousands of no-load funds available, covering every strategy and almost every market niche -- from bond funds to emerging market funds to sector funds.

3. Performance over the long haul -- Is the fund touting its recent performance? How is their performance over the long run, three years, five years or even 10 years?

4. Management team -- How long have the current managers been managing the fund -- one year, three years, five years? What other experience do they bring? Is there a team or is the fund managed solely by a star manager. Star fund managers achieve celebrity status and attract a lot of attention and assets, but sometimes many of them leave sometime after their stellar record to start their own hedge funds.

5. Expenses -- How much does the fund charge per year in expenses. How do the annual expenses compare to other competitive funds? Everything being equal, high expenses are only going to detract from performance.

6. Volatility -- Volatility is the variability of a fund's return and is measured by a number called standard deviation. Higher standard deviation means higher volatility. There are funds that provide great long-term results even though they are volatile but in general, the lower the volatility, the smoother the results and less anxiety in up and down markets. So look for lower standard deviation when selecting funds

7. Alpha -- This is a measure of performance, which basically indicates the performance attributed to stock or other security selection. Each fund has an expected return based on its makeup. However, if the fund performs better than expected, it will have a higher alpha. So look for higher alpha when comparing funds.

8. Fund size -- Fund size becomes an issue and generally weighs down performance. This is particularly true for funds that invest in small- or medium-sized stocks. As funds get larger, managers have a difficult time finding stocks to invest in and putting money to work profitably. Therefore, many popular and large funds suffer from mediocre performance.

However, the management of some fund companies is willing to keep the funds open because earning additional fees is a greater incentive despite the potential for mediocre performance in a large fund.

9. Turnover -- This simply means how much trading does the manager engage in. For example: a turnover of 100 percent (which may not be uncommon) means that the manager turns over stocks completely in a year. Again, everything being equal, high turnover means higher trading costs and potentially higher taxes due to capital gains. More confident managers generally stick to their stock picks and engage in much less trading.

10. Special charges -- Fund companies are notorious for charging investors 12b-1 fees to cover their marketing expenses. There is no reason why you, as an investor, should pay them when there are a large number of alternative funds available without such fees.

11. Concentrated vs. diversified -- A fund is concentrated when it holds fewer stocks. A concentrated fund is generally more volatile and may reflect the manager's preference for holding fewer companies in which they have more confidence. This may mean that the fund will be volatile but it may also have better performance if the stocks work out.

A concentrated fund sometimes may have fewer than 20 stocks. On the other hand, a diversified fund may have as many as 100 stocks or even more. A diversified fund is likely to be less volatile and safer. So depending on your objective, look carefully at the number of holdings and concentration of holdings in the fund.

These are some of the basic yet critical factors to check when selecting a mutual fund.

There are some great mutual fund Web sites such as Morningstar.com, which offer investors a wealth of information on different funds. There is no excuse for holding on to mediocre or sub-performing funds when detailed information on the funds is both available and accessible -- all it takes is a bit of diligence, but that is a fair price to pay for benefits that can last for years and can amount to huge gains over time.

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