Mutual Fund Investing-What Matters?

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Mutual funds offer attractive advantages that can enhance many portfolios. They are professionally managed vehicles that provide liquidity for short term cash needs, while at the same time allow an investor to stay invested in the market. The diversification of mutual funds is a key benefit. It allows smaller investors to gain exposure to markets that would otherwise not be economically feasible via individual stock selections. In addition, they offer the opportunity to invest in unique market segments in which an investor may not have the expertise to invest in single stocks. Further, they are a liquid way to own a less-liquid asset such as bonds. There are a variety of choices when it comes to funds. Here are some points to consider when making a selection:

The fund's investment objective: An actively managed fund is run by a professional manager whose goal is to outperform a certain benchmark, such as the S&P 500. They employ different strategies such as growth, income generation, and asset protection. A fund will typically focus on one, or a blend of these types of strategies. Other funds are passively managed and simply track a particular index, generating a return in line with that index. These objectives dictate what types of companies the fund is looking to invest in and also the fees it charges. These goals determine the risk inherent in one's portfolio and should be considered as part of the overall financial strategy.

Track record: Consider a mutual fund's track record versus its stated objective and versus that of other funds in the same category. Although historical performance is no guarantee of future results, it can give an indication of how a manager has performed under different market conditions. It is best to review performance over the short and long term. Good performance during a one to three year period, during a strong overall market cycle, can be deceiving. Comparison to a benchmark and review over a ten year period will allow one to review performance through market ups and downs.

Fund Managers: The fund manager determines the objective of the fund, its asset allocation and directs the buying and selling of the underlying securities. Does the fund have an experienced team of managers? The tenure of a fund's management is important. Not only does it tell an investor how much experience a manager has in the market, but a new team many bring a new strategy or direction to the fund that may or may not be aligned with one's goals. Past performance is no longer relevant if there is a new manager running the fund.

Fees: A mutual fund's expense ratio is the percentage of an investment paid in fees. A higher ratio directly lowers one's long term return. Consider whether the expense ratio of the fund is reasonable for the fund's objective. In addition, funds may carry sales charges that apply when the fund is bought and/or sold. Sometimes these charges are based on the holding period so bear in mind the time horizon of an investment. According to a Morningstar study, expense ratios are the strongest predictors of performance. Across different asset classes and time periods, the funds with lower expense ratios outperformed. As John Bogle stated, *"In the short term the impact of costs may appear modest, but over the long run, investment costs become immensely damaging to an investor's standard of living. Think long term!"*

Turnover Ratio: This is the percentage of a mutual fund's holdings that have been replaced over the past year. It gives an indication of how much trading occurs within the fund. A fund with a high turnover ratio will have higher trading expenses and may generate higher capital gains, all of which will lower the overall return.

Top holdings: Take a look at the mutual fund's largest holdings. What stocks and sectors have the most exposure? These holdings should fit in well and complement an investor's existing holdings. For instance, if an investor holds a concentration in one particular stock from an employer, then that stock should not a top ten holding in the mutual fund being considered for purchase. The same holds true for industry and sector concentrations.

Risk: The standard deviation of a fund illustrates how volatile the fund's returns are from year to year. The higher the standard deviation; the wider the range between the fund's day to day returns versus the average. More volatility = more risk. Large swings may not fit with an investor's risk tolerance.

Size: For some types of funds, growing too large too fast can jeopardize the manager's ability to maintain its strategy. For example, small cap growth funds tend to hold stocks that are more thinly traded. The larger a fund becomes the more cash it has to invest, which can be cumbersome in a less liquid market. Also as assets grow, a manager is forced to expand its universe of holdings. The fund begins to become more generic and more like an index fund, yet the investor is still paying the higher fees of an actively managed fund. One other potential issue for larger funds is that it can be more difficult to move in and out of a stock quickly based on a change in the investment view of a particular company.

Taxes: Mutual funds must pay out all capital gains and dividends each year, and these are generally taxable to the holder. Determine the best type of account (taxable or tax-sheltered) in which to hold a given fund and consider tax-free funds for a taxable account.

All of these elements are disclosed in a mutual fund's prospectus. To further assist an investor, there are also many independent research firms that can assist with the evaluation process. Morningstar and Standard & Poor's are two examples of such firms that provide a vast amount of in-depth research on funds and provide rankings versus benchmarks and versus other funds within the same style category.