Reprinted from: **The Patriot-News** – Business & Your Money Monday, June 22, 1998

CONSULTANT'S CORNER

E. JEFFREY ROOF

Most investors face challenge in picking best mutual funds

Multimillion-dollar retirement plans have long used a diverse array of specialized investment managers to enhance performance and control risk in their portfolios.

By creating a portfolio of mutual funds, you, too, can realize many of the benefits previously enjoyed only by large institutional investors.

However, selecting which mutual funds are best for your situation is a daunting task. The number of funds to choose from currently exceeds 9,000, several times the number of individual stocks available.

The challenge is compounded by the fact that everyone wants to sell you their brand of investment excellence. From financial magazines to television ads, mutual funds vie for your attention. Banks, brokers and friends all claim to have the "right" solution for you.

To truly find the right solution, let's look at the basics.

Why use mutual funds in the first place? It is the most effective way for the majority of investors to manage their money. Here are three reasons why:

- Good funds provide full-time professional management. An individual fund manager, or team, is typically responsible for the day-to-day investment decisions of most mutual funds. If you hire someone to fix your plumbing or repair your car, why choose to be a do-it-yourselfer in an area that is so complex and will ultimately influence your future financial security?
- Most investors simply do not have the assets required to create a truly diversified portfolio using individual securities. Consequently, an investor using individual stocks often has a high exposure to a particular market sector, industry or company. This increases your portfolio risk.

It is said that having a portfolio of individual stocks with less than $1 million invested is the equivalent of making bets, not managing money.

- You can select the best of the best in specific areas of management. Suppose your portfolio requires a value-oriented strategy focusing on large blue-chip firms. Or, you seek to emphasize smaller capitalized companies with significant growth potential. Perhaps you need additional portfolio diversification through some international exposure.

Selecting a top-notch specialist in each area can enhance your portfolio's long-term performance. Mutual funds make this possible.

Don't be misled into thinking all funds are a good investment. Many are not. So how do you separate the good from the bad?

Most financial magazines' "top mutual funds" listings tend to emphasize performance. While a good track record is important, the investment disclaimer "past performance is no guarantee of future results" is used for a reason. Chasing last year's performance almost guarantees modest results.

While fund performance is one of the basic criteria used in the selection process, here are a few additional factors I examine when selecting mutual fund's for my client's portfolios:

■ *Fund focus. What is the fund's emphasis?*

Names can be misleading. You might be surprised at the high proportion of nongovernment bonds found in many "government fixed income funds." Or "equity funds" that routinely carry large cash positions in an effort to time the market.

Even more surprising are funds that change their focus by adding risky investments in an effort to boost performance. Let the buyer beware and look beyond the label.

■ *Style discipline. Is the manager sticking to his/her knitting?*

Fidelity's Magellan Fund provides a classic example. Expecting a market correction in early 1996, Magellan's manager had nearly 30 percent of the fund's assets in bonds and cash. Such a weighting might have been understandable if the fund had a "balanced" style.

However, Magellan's style was clearly growth-oriented. The market downturn never happened, and Magellan's performance took it on the chin, surprising many of the fund's investors, who expected excellent returns in the rising equity market.

■ *Performance consistency. How well has the fund done vs. an appropriate benchmark?*

Let me emphasize "appropriate." Comparing an intermediate corporate bond fund or large-cap equity fund to the 90-day U.S. Treasury Bill index is meaningless. Yet many funds do just that.

Even comparing the results of a small-cap growth fund to the Standard & Poor's 500 index is not a true comparison of that fund's relative performance. There are other indices that are more appropriate. Significant underperformance, or even over-performance, versus a benchmark index should raise red flags.

■ *Load versus no-load.*

Many years ago, the argument could be made that buying a loaded mutual (one with a sales charge) was worth it because of superior performance. Not anymore. There is no reason to take a significant reduction in your investment right from the start. Many mutual funds have responded with a confusing alphabet soup of class share options – A, B, C, etc. Each class of shares has its own unique sales charges. These can range from front-end loads to back-end loads, level charges to deferred charges.

Examine the fund's load structure very carefully. Keep in mind, these charges compensate sales and marketing personnel, not the fund manager.

■ *Expense ratio. Who gets paid what within the fund?*

Internal expenses include management fees, custodian costs, trading commissions, etc. Expense ratios vary dramatically from fund to fund and ultimately impact your return. It is critical to compare the expense ratios of funds with similar objectives and management styles before making any selections.

■ *Fund holdings. Is the manager concentrating the fund's assets in a particular industry or market sector? Is this your intent?*

Some funds clearly communicate their specialized nature, others do not. For example, the Sequoia Fund is a top performing large cap value/blend fund. As of January this year, 82.7 percent of its holdings were in financial stocks, a very large position in a single industry.

This overexposure may not be desirable for your portfolio. You should periodically monitor the concentration weightings in the mutual funds you use, assess the accompanying risk, and adjust accordingly.

■ *Manager tenure. How long has the current fund manager been in place? Is that person responsible for the fund's track record?*

A manager's departure can potentially impact fund philosophy and performance. Consequently, any ongoing personnel changes should be carefully evaluated.

Likewise, does the manager have the expertise necessary to see the fund through inevitable changes in the market cycle? Many managers that have done well in the past several years may not have the ability to sustain performance in weaker markets. If all else is equal, opt for a seasoned fund manager.

E. Jeffrey Roof is president of Roof Advisory Group, an independent investment management and financial planning firm based in Camp Hill.

Roof Advisory Group is a *fee-only* Registered Investment Advisor that focuses on managing assets and growing wealth for individual and institutional clientele.

□ Because the investment markets are very dynamic, fund selection needs to be viewed as a process, not a singular event. Effectively managing a portfolio of mutual funds requires ongoing involvement. In-depth analysis is necessary to assure the individual funds work together to enhance your overall portfolio performance and control risk. Roof Advisory Group specializes in this area of expertise.