When You're Serious…

by Bradley R. Newman, CFP®

It Pays To Be Finicky

As of late, so much attention has been given to the macro-economic trends; all-time highs for the stock markets, the return of day-to-day volatility, how to cope with the current low income environment, what to do when yields finally do rise, how to prepare for the return of inflation, etc. While each of these items presents a valid concern, the issue of security selection has taken a backseat for many investors.

A critical, but often overlooked component of portfolio management is security selection; i.e., determining which stock, bond or mutual fund to purchase. Even with all of the right choices being made at the macro level (asset allocation, sector weightings, bond durations, etc.), poor security selection can sabotage your portfolio's performance. To narrow our focus, we'll focus on mutual fund selection to quantify the bottom line impact to your portfolio.

Too Many Options

The one thing that you cannot blame poor security selection on is a lack of options. If anything, there are too many options available. Morningstar® presently tracks over 23,000 mutual funds available for purchase; the real question is, how do you separate the good options from the bad options?

What further complicates this information overload problem is that everyone you speak with will tell you that their recommendations, the funds they are selling, are better than the funds everyone else is selling.

How Do You Choose?

Creating a methodology to compare all of the variables that comprise mutual fund performance (cost, manager value, etc.) and successfully analyzing all of the data is a daunting task. However, by using a historic comparison of the net results from a fund versus the net results of other funds in the same peer group (large cap value, large cap growth, etc.), you can begin to determine if a particular fund has done well or done poorly over time versus funds with a similar investment objective.

As you know, past performance is no guarantee of future results; moreover, the goal is not to pick the absolute best fund in a given category for a given period of time, the real goal is to identify funds that are consistently in the top quartile of a give category on a regular basis or more aptly avoid the funds that regularly rank at the bottom of their category.

The Costs of Poor Selection Are Steep

The cost of dealing with a poor performing fund is steep. Consider this, based on December 31, 2012 Morningstar® data for the 1,638 large cap growth mutual funds with a three year history, the differential in return for the median performing fund of the of the top quartile versus the bottom quartile was 4.9% per year (11.7% per year versus 6.8% per year) or almost $50,000 per year on a 1 million dollar portfolio. The question you may be asking yourself right now is, why would anyone own a fund that is regularly in the bottom quartile of its peer group? The most common answer is that is the fund they were sold. If they had requested some independent data for comparative purposes or engaged an independent third party on a fee-for-service basis, their outcome would have been significantly better..

You Need To Be Your Own Advocate

As you make investment decisions yourself or work with a professional in managing your portfolio, don't rely on the sales information provided; you need to gather independent data that can be utilized in making objective decisions.

Bradley R. Newman, CFP® is with Roof Advisory Group, Inc., an independent investment management and financial advisory firm based in Harrisburg. The firm is a fee-only Registered Investment Advisor that provides portfolio management and financial planning services for individual and institutional clientele. The firm's email address is invest@roofadvisory.com.