Choosing Quality Mutual Funds

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Introduction
The complexities of the investment process are often beyond the grasp of the general public. For many people, multiple competing interests and increasingly busy lifestyles leave little opportunity for learning the basics of investing. Nevertheless, saving and investing for one's future financial security has to be considered one of life's priorities.

Millions of investors in the U.S. and abroad are using mutual funds as their investment vehicle of choice to save for college educations, the purchase of a home and for building a retirement nest egg. Whatever the objective, the mutual fund is an excellent medium to accumulate financial assets and grow them over time to achieve any of these goals.

However, the task of selecting *quality* mutual funds is a daunting one. There are far too many choices, and information overload is a serious problem. In addition, the tactics used in marketing funds are generally more confusing than enlightening - the unfamiliar jargon and technical investing concepts can be challenging, to say the least.

Whether you are a do-it-yourselfer, a client of an investment professional, or a participant in a self-directed retirement plan, you'll need a set of mutual fund evaluative tools that make sense and are easy to use.

Here, we'll attempt to make fund selection and monitoring as simple as possible, allowing you to make informed decisions and ask the right questions when it comes to choosing a mutual fund investment.

Scoring Fund Investment Quality

Overview Of The Mutual Fund Industry
Financial intermediaries become fund sponsors when they create and operate mutual funds. Such funds are a type of investment company that pools money from the investing public and collectively invests this money in stocks, bonds and money market instruments. A mutual fund provides individual investors with a convenient form of investing, professional management, broad diversification and liquidity.

The purpose of this tutorial is to show the investing public how to use a simple eight-point, fund evaluation technique to select and monitor a mutual fund. But first we are going to step back and put the mutual fund business into historical perspective, review the operational workings of a fund and look at some of the broad issues related to today's mutual fund industry. (For background reading, see *Mutual Fund Basics*.)

History Of The Mutual Fund

Historians are uncertain of the origins of investment funds. There are some indications that the idea of pooling assets for investment purposes began in the Netherlands in the late 18th or early 19th century. Closed-end investment funds did take root in Great Britain and France in the 1800s, making their way to the United States in the 1890s. (For more insight, see *Uncovering Closed-End Funds*.)

The creation of the Massachusetts Investors' Trust in Boston in 1924, which went public in 1928, is cited as the arrival of the modern mutual fund in the U.S. In 1929, there were 19 open-ended funds competing with nearly 700 of the closed-end variety. The market crash of 1929 wiped out the highly leveraged closed-end funds, but a small number of opened-ended funds managed to survive.

The creation of the Securities and Exchange Commission (SEC), the passage of the Securities Act of 1934 and the Investment Company Act of 1940 put the mutual fund business on a solid regulatory basis with safeguards for investors. In the early 1950s, the mutual fund count topped 100 and continued to grow through the next two decades. The bull markets of the 1980s and 1990s accelerated this growth, pushing the fund count over 3,000, with total assets surpassing the $1 trillion mark during this period.

In response to the mutual fund scandals of the 2003-2004 period, corrective regulatory and industry practices were, and continue to be, enacted. By the end of 2006, the mutual fund business was still growing and mutual funds in the U. S. numbered more than 8,000 with asset holdings of $10.4 trillion and new markets opening up around the world. (For related reading, see *A Brief History Of The Mutual Fund*.)

How A Mutual Fund Works

A fund sponsor - generally a financial intermediary like Fidelity Investments or Vanguard - organizes a mutual fund as a corporation; however, it is not an operating company with employees and a physical place of business in the traditional sense. A fund is a "virtual" company, which is typically externally managed. It relies on third parties or service providers, either fund sponsor affiliates or independent contractors, to manage the fund's portfolio and carry out other operational and administrative activities.

Figure 1, below, has been sourced from the *Investment Company Institute's (ICI) 2005 ICI Fact Book* to illustrate the organizational structure of a mutual fund.

The fund sponsor raises money from the investing public, who become fund shareholders. It then invests the proceeds in securities (stocks, bonds and money market instruments) related to the fund's investment objective. The fund provides shareholders with professional investment management, diversification, liquidity and investing convenience. For these services, the fund sponsor charges fees and incurs expenses for operating the fund, all of which are charged proportionately against a shareholder's assets in the fund.

The most prevalent and well-known type of mutual fund operates on an open-ended basis. This means that it continually issues (sells) shares on demand to new investors and existing shareholders who are buying. It redeems (buys back) shares from shareholders who are selling.

Mutual fund shares are bought and sold on the basis of a fund's net asset value (NAV). Unlike a stock price, which changes constantly according to the forces of supply and demand, NAV is determined by the daily closing value of the underlying securities in a fund's portfolio (total net assets) on a per share basis. (For more insight, read *What is a mutual fund's NAV?*)

In some instances, investors can purchase shares directly from the fund, but most funds are sold through an investment intermediary: a broker, investment advisor, financial planner, bank or insurance company. These intermediaries are compensated for their services through a variety of sales charge options (loads) or deferred/ongoing 12b-1 fees. The former come directly out of the investor's pocket (deducted from the amount to be invested) and the latter as a proportionate deduction of the shareholder's fund assets. (For more on fees, read *Stop Paying High Fees*.)

Shareholders

Board of Directors
Oversees the fund's activities, including approval of the contract with the management company and certain other services providers.

Mutual Fund

Investment Advisor	Principal Underwriter	Administrator	Transfer Agent	Custodian	Independent Public Accountant
Manages the fund's portfolio according to the objectives and policies described in the fund's prospectus.	Sells fund shares, either directly to the public or through other firms (such as broker dealers).	Oversees the performance of other companies that provide services to the fund and ensures that the fund's operations comply with the applicable federal requirements.	Executes shareholder transactions, maintains records of transactions and other shareholders' account activities, and sends account statements and other documents to shareholders.	Holds the fund's assets, maintaining them separately to protect shareholder interests.	Certifies the fund's financial statements.

Figure 1: *Investment Company Institute's (ICI) 2005 ICI Fact Book*

Today's Mutual Fund Industry

According to the *2005 Investment Company Institute Fact Book*, nearly 600 financial intermediaries in the U.S. and around the world compete in the U.S. mutual fund market. It is estimated that, as of year-end 2004, the top 25 of these firms held 74% of this market's $8.2 trillion total assets under management.

The 8,000 plus publicly traded mutual funds in the U. S. break down by type as follows:

- 4,550 equity
- 2,041 bond
- 510 hybrid
- 943 money market.

It is a huge understatement to say that for the investing public, this number of fund choices is absolutely overwhelming.

It is important for fund investors to appreciate the importance of investing in funds that are sponsored by financial intermediaries in good standing. That is to say, that they are not saddled with regulatory problems resulting from questionable management practices and governance problems. The serious mutual fund scandals of 2002 and 2003 are, hopefully, behind us. However, it is prudent for fund investors to maintain a watchful eye in this area.

Investors should start by screening for those fund sponsors that are scandal-free and that do a good job of aligning their interests with those of their fund shareholders. Professionals in the mutual fund industry refer to this as good stewardship. The most accessible source of stewardship grades is a Morningstar Fund Report. Morningstar's grading of fund sponsor stewardship has become an important part of its evaluative reporting on the mutual fund industry. (For more insight, see *Morningstar's Stewardship Grade Service A Welcome Addition*.)

It is natural that opinions will differ on fund-sponsor quality. However, it is worthwhile to note that there appears to be a connection between high quality fiduciary management at the fund sponsor level and high quality investment performance at the individual fund level. (For related reading, see *Picking The Right Mutual Fund*.)

Fund Investment Qualities

Investment research firms use data provided by the fund sponsor to generate a variety of analytical perspectives. These are used by professional and non-professional investors in selecting and monitoring mutual funds. For funds that are publicly traded and the object of significant investor interest, this information is distilled into fund research reports. These are available to the investing community through a number of services such as Morningstar and Value Line.

The content of such a report is comprehensive, containing dozens of data points, ratios and informational perspectives that reveal the investment quality of a fund. To make things simple for the average investor, we'll take this abundance of information and focus on eight fundamental indicators of investment quality. An investor can use this perspective to make intelligent decisions on whether to buy, sell or hold a mutual fund.

These eight evaluative fund investment qualities are listed below. Subsequently, you will find in-depth discussions of each of these investment quality indicators, including where to find them, what they mean and how to use them). Armed with this know-how, you will be equipped to make informed mutual fund investment choices.

- Fund I-Q No.1: Investment Style Considerations
- Fund I-Q No.2: Risk-Return Profile
- Fund I-Q No.3: Fund Size and Style Compatibility
- Fund I-Q No.4: Manager Tenure and Structure
- Fund I-Q No.5: Portfolio Turnover Ratio
- Fund I-Q No.6: Fees and Expenses
- Fund I-Q No.7: Comparative Total Returns
- Fund I-Q No.8: Analytics

The Fund Investment Quality Scorecard (FIQS) is a tool to record your findings on a given mutual fund. We've avoided suggesting the use of any type of quantitative ranking with the scorecard, preferring instead that the investor use his or her best judgment to arrive at a qualitative "score."

A fund does not have to be perfect in all aspects to be top rated. For example, what we are looking for is a fund that has a composite investment quality score from above-average to high. Completing a scorecard will be relatively easy once you learn how the system works from the instruction provided herein. A little experience and some common sense will serve you well.

Fund Investment Quality Scorecard

Below is a sample of the Fund Investment Quality Scorecard. The FIQS might look confusing to you at this point, but do not despair. After you absorb the lessons provided in the following chapters, its simplicity and practical application will be readily apparent. Readers may reproduce this form for their own use by downloading the Fund Investment-Quality Scorecard PDF.

Fund Investment-Quality Scorecard

(Data as of)

Fund Name & Ticker Symbol:

Investment Category: Web site:

I-Q# 1: Consistency of Management's Investment Style: Stated Style: Current Style: Style Changes: Yes ___No___ Summary Analysis for I-Q# 1: Stable: ___ Minor Change ___ Major Change ____

I-Q# 2: Positive Risk-Return Profile: Morningstar Rating: Return (Circle) High Above-Average Average Below-Average Low Risk (Circle) High Above-Average Average Below-Average Low Summary Analysis for I-Q# 2: Very Positive ___ Positive ___ Matched ___ Other___

I-Q# 3: Compatibility of Fund Size and Investing Style: Total Net Assets (millions $): Number of Portfolio Holdings: Three-Year % Growth of Net Assets: Fund Closed: Yes ___ No___ Summary Analysis for I-Q# 3: Analyst Concern: Yes ___ No___ Analyst Warning: Yes ___ No___

I-Q# 4 Managerial Tenure and Structure: Single Manager ___ Co-Managers ___ Team Management ___ Indexed___ Current manager tenure and fund performance match for ______ years Manager(s) investment in fund: Significant ___ Moderate ___ Low ___ None___ Summary Analysis for I-Q# 4: Very Positive ___ Positive ___ Sub-Standard___

I-Q# 5 Low Portfolio Turnover: Current Percentage: _______ Historical Percentage: Comparable ___ Higher ___ Lower___ Peer group percentage: _______ Summary Analysis for I-Q# 5: Very Positive ___ Positive ___ Average ___ Sub-Standard ___

I-Q# 6 Reasonable Fees and Expenses: Load: 12b-1: Expense Ratio: Trend: Up ___ Down ___ Steady___ Peer Group Expense Ratio: _______ Summary Analysis for I-Q# 6: Low ___ Below-Avg. ___ Avg. ___ Above-Avg. ___ High ___

I- Q# 7 Total Return Performance:

Annualized Total Return (%)

1 yr 3 yr 5 yr 10 yr

Fund ___ ___ ___ ___

Peer Group

Peer Group Benchmark ___ ___ ___ ___

S&P 500 Benchmark ___ ___ ___ ___

Load-Adjusted

Yearly returns: Fairly Steady ___ Moderately Irregular ___ Irregular ___ Very Irregular ___

Summary Analysis for I-Q# 7: High ___ Above-Avg. ___ Avg. ___ Below-Avg. ___ Low ___

I- Q# 8 Positive Analyst Commentary:

Fund Stewardship Grade: Morningstar Analyst Pick:

"Morningstar's Take:"

Other Comments:

Summary Analysis for I-Q# 8: Very Positive ___ Positive ___ Sub-Standard ___

Composite Fund Investment-Quality Scorecard Rating:

High ___ Above-Average ___ Average ___ Below-Average ___ Low ___

Sources of Evaluative Data

Finding Mutual Fund Data

When it comes to mutual fund data, there is a huge information overload. But do not despair. To effectively determine the investment quality of a mutual fund, you are only going to have to deal with eight items and we'll show you how to do this in a simple, yet effective, manner.

The first step in this process is to provide you with the "maps" that you can use to find the evaluative data you need to complete a Fund Investment Quality Scorecard. Among the various sources of mutual fund data, the fund reports provided by Morningstar and Value Line are of the greatest practical value. These three independent investment research firms are universally respected for the quality and objectivity of their reporting. And, most importantly, for the vast majority of individual investors, these firms' mutual fund reports rank at the top of the list in terms of their affordability and general accessibility.

Using a technique akin to the paint-by-the-numbers approach used by beginning artists, the information points you need to focus on in these reports are keyed to the eight investment qualities that are evaluated in a Fund IQ Scorecard.

Morningstar Fund Report

Based in Chicago, Morningstar Inc. has a 20-year history as a reliable provider of one of the most comprehensive one-page mutual fund reports presently available. The company has expanded into several other fields of investment information but is still best-known for its analytical coverage of mutual funds.

In terms of one-stop shopping for fund evaluative data, the Morningstar fund report essentially covers all the bases. By focusing on just eight of the some 100 information points in a report, you can find all the data you need to complete the Fund IQ Scorecard.

While the Value Line fund reports are competitive in terms of content, Morningstar's "accessibility factor" ranks it number one for many investors. Most public libraries in the U.S. have a print and/or an online subscription to *Morningstar Mutual Funds*, which provides fund reports on more than 2,000 funds. Library patrons, therefore, can tap into this resource free of charge. If you want to have direct access to Morningstar fund reports, you can do so through an online premier membership, which is available for a nominal yearly fee. (For related reading, see *Morningstar's Stewardship Grade Service A Welcome Addition*.)

Value Line Report

In terms of accessibility, the *Value Line Mutual Fund Survey* fund reports are not as easy to obtain as the reports from Morningstar. These reports are also substantially more expensive. However, if you have, or aspire to have, a mutual fund portfolio in the $75,000 to $100,000 range, the Value Line fund reports are worthwhile. Their analytical commentary feature is not as strong as Morningstar's, but their "Past Market Cycle Performance" and "Portfolio Manager Rating" are unique, valuable report components.

The *Value Line Fund Survey* can be subscribed to either in print or electronically.

For related reading, see *Picking The Right Mutual Fund* and *Can You Pick The Winners At The Mutual Fund Track?*

Retirement Plan Documentation and Other Sources

Mutual fund companies and retirement plan providers generate a huge amount of fund literature. While marginally useful, this material cannot come close to providing individual investors with what they need to know when it comes to making a buy, sell or hold decision on a mutual fund. (For more insight, see *When To Sell A Mutual Fund*.)

The material provided by the fund companies (prospectus, annual, semiannual and quarterly reports, and the statement of additional information) is obligatory disclosure information. However, even investment professionals feel that a great deal of this documentation is mostly unintelligible. The glossy brochures and fund profiles produced by retirement plan providers usually get an "A" for the graphics but are short on substantive, insightful content. In fact, many of them have a certain boilerplate quality about them.

According to David Swenson's book, "Unconventional Success: A Fundamental Approach To Personal Investment" (2005), a typical mutual fund has volumes of reading material. Figure 1, below, shows the number of pages from five typical mutual funds.

Prospectus	SAI	Periodic	Reports	Total
Fidelity Magellan	22	37	68	127
Capital	32	70	36	138

AMCAP				
Vanguard 500	37	46	66	149
Aim Premier	32	113	57	202
Pimco T.R.	54	143	39	236

Source: "Unconventional Success" (2005) by David Swenson

These items total a mere 852 pages for five mutual funds! Compared to five one-page fund reports available from the investment research firms mentioned above, the alternative choice is an easy one.

To find investment quality in a mutual fund, non-professional investors need the analytical perspectives provided by Morningstar and Value Line. These reports, and their targeted evaluative data (which is used in a Fund Investment Quality Scorecard), enable an individual investor to make smart mutual fund choices.

Informational Websites
Without doubt, a fund report is the most efficient and effective way to research a mutual fund's investment quality. However, there are also a number of good general investment information websites that can help investors improve their overall mutual fund investing skills.

The American Association of Individual Investors (AAII) publishes its *Guide to the Top Investment Web Sites* annually in its September issue of the *AAII Journal*. Its picks for top sites for mutual fund data in 2007 included the following free - either totally or partially - sites:

- Morningstar
- MSN Money
- SmartMoney
- Yahoo!Finance
- Zacks.com

A Fund's Investment Objective

Mutual Fund Categories
"Mutual funds aren't horses. You don't pick them by name, color or the celebrity who is involved in the ownership group." - Chuck Jaffe, MarketWatch.com, February 27, 2006

Here, we evaluate a mutual fund's investment objective, also referred to as its style, as an indicator of investment quality. In general, analysts look favorably on fund investment managers who maintain a consistent investing style. However, this view, depending on other fund investment qualities, is subject to some flexibility.

After an overview of fund categorization, as determined by investment objective, we will discuss the use of a mutual fund style box. In addition, various aspects of a fund's investing objective and the role these play in determining a fund's investment quality will be analyzed.

Using the fund reports from Morningstar, Stand & Poor's and Value Line, we will identify and pinpoint where to find the relevant fund objective data from these sources. The input of this evaluative information into the Fund I-Q Scorecard is then explained. (For related reading, see *Understanding The Style Box*.)

We cannot predict which way the markets will move next or which investments will go up or down. However, we can spread our money around in a reasonable mix of mutual funds with a variety of risk and return characteristics that define their investment objectives. Fund categorization helps us do just that.

All mutual funds are established to be managed within the framework of a defined investment style. You can't always tell by the name of the fund which style that is, but they all have one. Figure 1, below, provides a list of commonly used investment objectives for mutual funds and their principal investment characteristics.

Size Categories for Stock Funds

Generally, portfolio managers divide up their investment objectives into nine different approaches, which are categorized by three company sizes and three investing styles. In the case of the former, size is determined by a company's market capitalization, commonly referred to as market cap. One would think that sales, assets or the number of employees would be more logical measurements of company size. Not so in the investment business, where market capitalization is the measure of choice.

Fund Objective or Style	Investment Considerations
Aggressive Growth Stock	High risk-return. High price volatility and very high market valuations. No dividends.

Growth Stock	Above average risk and price volatility. Fast-paced price appreciation. Above market valuations. Low or no dividends.
Equity Income Stock	Moderate growth and modest dividends. Average market valuations.
Value Stock	Average to below average risk. Reliable, dividend-paying companies with relatively low valuations. Modest price appreciation.
Blend	A mix of growth and value stocks.
Sector or Specialty Stock	Narrow focus on an industry sector.
Stock and Bond Index	Broad market or market segments. Passive management.
International/Foreign Stock	Foreign companies and world, regional and country markets.
Ultra-Short Term Bond	Very short maturities. High credit quality.
Short, Intermediate and Long Term Bonds	Government, corporate and foreign issues. Maturities from one to 30 years. Yields vary accordingly. Duration and credit quality matter.
Municipal Bonds	Long, intermediate, and short-term maturities. Tax-exempt. Generally of high credit quality.
High-Yield Corporate Bond	High risk-return ("junk bonds").
Hybrid	A blend of stocks and bonds. Includes balanced, targeted and life-cycle type funds.
Money Market Fund	For liquidity and safety. Cash and cash equivalent securities. Low risk-return.

Figure 1

A company's market cap is computed by multiplying the number of shares outstanding by its stock price. There are no exact definitions of market caps, but this is generally the rule of thumb:

- Large Cap (big company): Over $10 billion
- Mid Cap (medium-size company): Between $2 billion and $10 billion
- Small Cap (small company): Below $2 billion

What's important for mutual fund investors to know is that in the investment community, company size and risk are related. Supposedly, risk decreases as a company moves from the small cap to large cap category and vice-versa. While exceptions to this rule are plentiful, it does provide a useful guideline and is widely accepted in investing circles. Large companies are perceived as safer; small companies more risky and medium-sized companies fall somewhere in between. (For background reading, see *Market Capitalization Defined*.)

Of course, on the other side of the coin from risk is return. Here, the general perception is that small companies grow faster, are more agile and, therefore, are capable of producing out-sized investment returns. Large companies are viewed as less spectacular, but steady performers.

Style Categories for Stock Funds

There are three broad mutual fund equity investment styles: value, growth and blend (a mix of value and growth strategies). Each objective performs somewhat differently and has its own risk-return characteristics. Specialty or sector funds, such as healthcare or real estate, fall into categories of their own because of their special, industry-specific investment characteristics.

Types of Bond Funds

Bonds are issued by the U.S. and foreign governments, U.S. government agencies, municipal jurisdictions and corporations. Like the stock funds, investment analysts use nine broad styles to categorize bonds, which reflect three maturity periods (short, intermediate and long term) and three levels of credit quality (high, medium and low). (For more insight, see *Evaluating Bond Funds: Keeping It Simple*.)

In terms of a bond fund's risk, the longer the maturities and the lower the credit quality, the greater the risk and return. Conversely, short- to intermediate-term maturities and medium- to high-credit quality produce more moderate bond returns, but with a higher level of safety.

In summary, mutual funds with different investment objectives provide a variety of investment risk and return opportunities to the investor. Therefore, it is important for fund investors to thoroughly understand and identify the investing style employed by the funds that they choose to use to build their portfolios.

Mutual Fund Style Box

Several years ago, Morningstar's Don Phillips invented the so-called "style box," which is now widely used as a reference tool for determining the investment objective, or style, followed by a fund's investment managers. The details of these broad category investing strategies were covered in the previous section.

In summary, an equity style box is divided up into nine, equal-sized boxes in tic-tac-toe fashion. In the nine categories used to classify a fund's investment style, this graphic presentation shows where a stock fund's risk-return characteristics place it compared to other funds. The vertical axis classifies risk by three company sizes and the horizontal axis has three investment strategies. In similar fashion, a bond style box reflects a bond mutual fund's risk-return characteristics by using credit quality (vertical axis) and maturity periods (horizontal axis) to indicate a bond fund's investment style.

Mutual fund reports and literature use style boxes to determine a fund's current investment objective and to track its style over extended periods of time. In the following section, we will discuss how investing styles impact a fund's investment quality.

Figures 1 and 2, below, show the style box for stock and bond mutual funds. (To learn more, read *Understanding The Style Box*.)

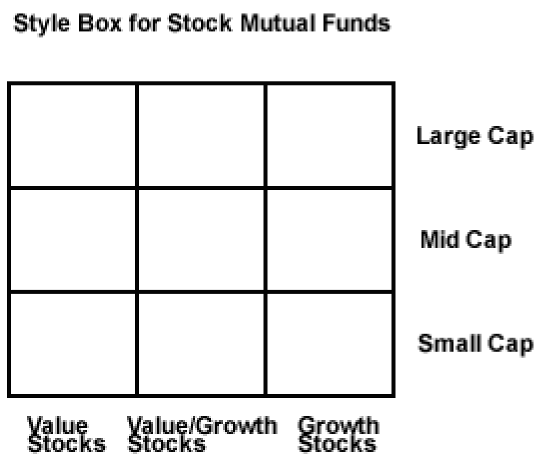


Figure 1

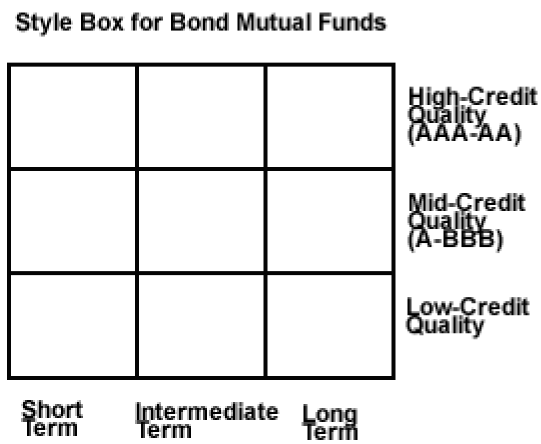


Figure 2

Fund I-Q No. 1: Investing Style

An accurate determination of a mutual fund's investment objective is important for several reasons:

- When building an investment portfolio, it helps to diversify the risk and return profile of your asset allocation.
- It helps to avoid duplication in investment categories.
- It allows the investor to monitor the manager's strategy performance over extended periods of time.

Fund Investment-Quality No.1 relates to the fund manager's ability and commitment to managing a mutual fund's assets according to the fund's stated investment objective over the course of several years.

For obvious reasons, consistency in this particular area is a very positive investment quality. Changes in fund management can trigger a change in investing style and should be closely monitored. Managers chasing performance have been known to resort to using different investing strategies, which often are counterproductive and change the risk profile of the fund. (For more insight, read *Focus Pocus May Not Lead To Magical Returns*.)

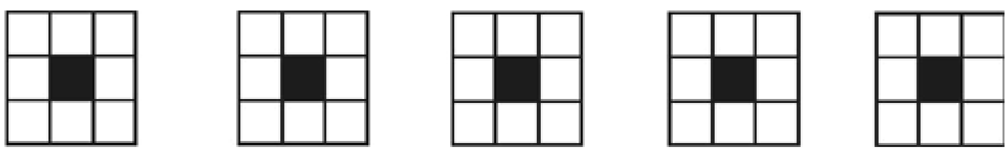
Nevertheless, fund investors need to exercise some flexibility when making judgments of a mutual fund's investment objective stability. According to an a June 2006 article by Chuck Jaffe, Don Phillips, Morningstar's managing director, was quoted as saying:

"You need to know where the funds are deployed, but it doesn't make sense to fire a great manager - or to ignore one - for using their discipline to make money. The key is knowing what a manager does and asking questions if you see a radical and unexpected change. But if you are paying for active management, let it happen, and don't worry so much that your large-cap value fund let some winners run and is now more of a large-cap blend fund. You're paying the manager to make those decisions."

The lesson to be learned from Phillips's remarks is that while the consistency of a mutual fund investment objective is undeniably an important investment quality, circumstances can justify giving the fund manager some leeway. Certainly, a history of consistent, above-average total returns would override any questions about style drift.

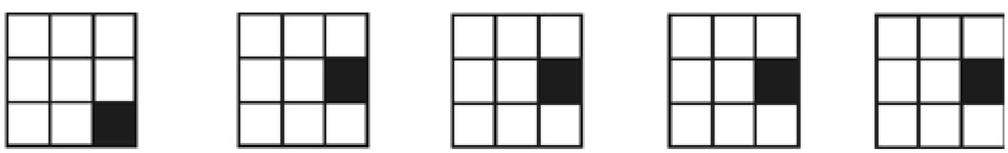
Using Morningstar's style boxes, here are some examples of investment style consistency, or lack thereof, over the 2001 - 2005 period, from a selection of mid cap blend mutual funds.

TCW Galileo Value Opportunities Fund (TGVOX)



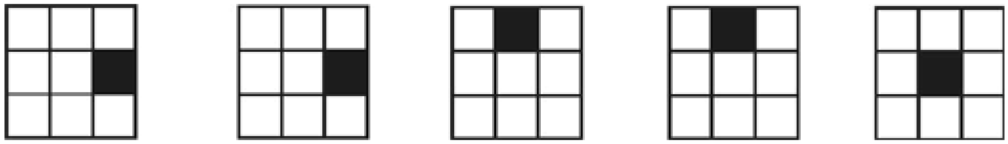
Absolute perfection. Five-year annualized total return: 10.81%.

FPA Paramount Fund (FPRAX)



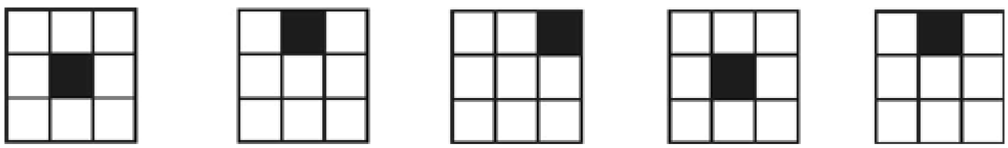
Nice consistency over the past four years, but it's falling into the mid cap growth style category as opposed to the fund's stated objective as mid cap blend. That said, it's hard to argue with the fund's five-year annualized total return of 14.9%.

Selected Special Shares Fund (SLSSX)



Better late than never! It took five years to make it to Selected Special's stated investment style category. The Fund's 2005 total return was 12.7% compared to the inconsistent five-year annualized total return of its style drift years of 1.3%.

Fairholme Fund (FAIRX)



This is a good example of a fund, which, at first glance, looks like the manager is all over the board when it comes to investment style. However, because the portfolio turnover rate is in the low 20s, this doesn't look like a conventional case of style inconsistency. The style drift is undoubtedly due to the fund's typical low holding of 15 to 25 stocks. With this level of portfolio concentration, just one significant transaction could easily change its style category. The fund's five-year annualized total return is 14.8%. This shows that there can be exceptions to the rule that requires style consistency to produce top-rated performance. (For related reading on this topic, see *Understanding The Style Box*.)

Scoring Investment Style Data

This is the entry we need to complete in the Fund Investment-Quality Scorecard for an analysis of a mutual fund's investing style:

Fund I-Q# 1: Consistency of Management's Investment Style:

Stated Style:
Current Style:
Style Changes: Yes ___ No___

Summary Analysis for I-Q#1: Stable ___ Minor___ Major____

When seeking the information needed to complete the scorecard, Morningstar's fund report shows a fund's stated style in the "Master Category" box in the upper right-hand corner of its report. Its take on a fund's current style is disclosed in the "Current Investment Style" section, which also provides a fund style box graphic, value measures and growth measures. Lastly, year-to-year style changes are clearly seen in its multi-year style box graphics at the top of the report.

Value Line's report has its version, which differs from the norm, of a style box that only provides a fund's current categorization.

Making a style drift analysis decision is an empirical exercise. There is no doubt that a consistent investment style over many years is a solid fund investment quality. However, some style drift over an extended period of time is not an unusual occurrence, and should not be viewed too harshly. A fund's investment style behavior should not be looked at in isolation. Investors should also look at turnover, management tenure and total return results. If these investment qualities are positive, some style drift is easily tolerated. In other words, fund style changes are often acceptable when when management delivers the goods. (For more insight, read *Don't Panic If your Mutual Fund Is Drifting*.)

Lastly, it is worth noting that not all investment qualities are created equal. Of the eight indicators used in the Fund Investment Quality Scorecard, some carry more weight than others. The analogy of a baseball team's batting can be used to illustrate this point. Those batters hitting in positions one to six ("top end") are expected to provide most of a team's runs. Not much offense is expected from those batting in positions seven to nine ("bottom end") in the order.

Similarly, among the factors on the Fund Investment Quality Scorecard, investment style consistency falls more into the bottom rather than the top of the batting order. Of course, style drift should be investigated, but as long as the investment managers produce results, it's OK to be flexible on this mutual fund factor.

Measuring a Fund's Risk and Return

Risk-Return Relationship

"The history of the stock and bond markets shows that risk and reward are inextricably intertwined. Do not expect high returns without high risk. Do not expect safety without correspondingly low returns." -William Bernstein, "The

Four Pillars of Investing" (2002)

Investment research studies throughout the years have confirmed that the general investing public, or non-professional investors, have a pronounced tendency to focus on an investment's return. While risk is not necessarily ignored, it certainly seems to play second fiddle to return in most individual investors' decision-making processes.

As applied to mutual funds, you will learn the importance of the risk-return relationship in selecting quality mutual funds. In addition, we will explain the importance of understanding the concept of total return, which is the key component of a fund's investment performance. (For more insight, read *Determining Risk And The Risk Pyramid*.)

We'll also identify an discuss the significance of a favorable risk-return profile as one of the more valuable investment qualities to be considered in selecting a mutual fund.
In the investing world, there are a number of highly technical, sophisticated metrics that are used to measure investment risk-return. The most commonly used of these indicators include alpha, beta, r-squared, standard deviation and the Sharpe ratio. (For background reading, see *Five Stats That Showcase Risk*.)

Calculating and Interpreting Risk Measurements
It is safe to say that few, if any, non-professional investors, have the faintest idea how to calculate and/or interpret these measurements. That is the so-called bad news. The good news is that Morningstar and Value Line fund reports do all the statistical analysis for us and provide easy-to-understand risk and return evaluations. Essentially, these come in five different varieties: high, above-average, average, below-average, and low, or words to that effect.

It is a universally accepted principle of investing that risk and return are commensurate. This fancy terminology simply tells us that the level of risk determines the level of return. As a result, it is unusual that a low-risk investment will produce a high return. Of course, the inverse of this relationship is also true.

Asset Allocation and Diversification
Prior to selecting individual mutual funds, or any other investment, for a portfolio, an investor should decide on an appropriate asset allocation. For the sake of this discussion, let's say that a moderate 60% stock and 40% bond apportionment is made. Diversifying within these allocations then requires that the investor select investments (funds, stocks, and/or bonds) that are complementary this moderate risk-return investing strategy. (For more insight, see *Achieving Optimal Asset Allocation*.)

Risk is an inherent part of investing. In order to get a reasonable return on an investment, risk has to be present. A riskless asset will produce little or no return. The intelligent investor manages risk by recognizing its existence, measuring its degree in any given investment and realistically assessing his or her capacity to take risk. There is nothing wrong with investing in a high-risk fund if the fund's return is equally high. The questions to ask are: Can I afford the loss if it occurs? Am I emotionally prepared to deal with the uncertainties of high-risk investments? Do I need to take this kind of risk to achieve my investment goals? (To help answer these questions, read *Personalizing Risk Tolerance*.)

A prudent investor will seek to match and/or offset risk by assembling a reasonable number of mutual funds with favorable risk-return profiles in a diversity of fund categories. This is done by first identifying a mix of mutual funds according to company size (market-cap), investing style (value, growth, and blend) and asset allocation (stock and bond). By choosing from these funds, you can find those that are characterized as having returns that exceed their risks, or at least match them. This would represent a favorable risk-return profile, or spread, and is a key fund investment quality.

Understanding Mutual Fund Returns

The return on any investment, measured over a given period of time, is simply the sum of its capital appreciation and any income generated divided by the original amount of the investment, which is expressed as a percentage. The term applied to this composite calculation is total return.

However, there is a difference in this simple concept as applied to stocks and mutual funds. Unfortunately, a great many mutual fund investors do not seem to have a clear understanding of a fund's total return. The relationships between a fund's net asset value (NAV), yield (income) and capital gains distributions can be confusing. For stock investors, calculating and understanding their total return is relatively easy. By comparing how total return is derived for both stocks and mutual funds, you'll be able to better understand how this measure works for mutual funds.

Stock Total Return

We begin our illustration with a share of XYZ Company that is bought for $30 at the beginning of the year. During the year, its price fluctuates, but it closes the year at $33, which represents a nice percentage return on the investment of 10% ($3/$30).

But, things get even better because XYZ paid an annual dividend of $1 per share. This dividend equals an additional 3.3% return ($1/$30). Adding together the capital appreciation (price increase) of 10% and the income return (dividend) of 3.3% gives us a one-year total return for XYZ Company stock of 13.3%. However, remember that unless you sell XYZ stock, the price appreciation gain remains in the stock price, or is unrealized. (For more on this concept, see *What are unrealized gains and losses?*)

Fund Total Return

With mutual funds, explaining total return is a bit more complicated. We begin with a share of the ABC Fund, which is purchased at its net asset value (price) of $16 per share. A fund's NAV is derived by dividing the value of its portfolio securities (the fund's assets), less any accrued fees and expenses (the fund's liabilities), by the number of fund shares outstanding.
Here's an illustration of the computation of net asset value for the ABC Fund:

The fund's cash and cash equivalents = $200,000
The fund's stock holdings at market prices:

- 10,000 shares of Company X @ $50 = $500,000
- 20,000 shares of Company Y @ $30 = $600,000
- 50,000 shares of Company Z @ $8 = $400,000

Total market value of stock holdings	=	$1,500,000
The fund's total assets	=	$1,700,000
Less the fund's liabilities	=	$100,000
The fund's tolal net assets	=	$1,600,000

The fund's total shares outstanding: 100,000

The fund's NAV: $16 ($1,600,000/100,000)

Remember that mutual funds are priced once a day, at the end of the day. Unlike stocks, where prices are moved by the supply and demand forces of the marketplace, fund prices are determined by the value of the underlying securities in the fund.

In our example, ABC is a hybrid stock/bond fund with a growth-income orientation. Apart from capital gains, its individual portfolio holdings will generate dividends and interest. By law, mutual funds must distribute these to the fund's shareholders. ABC's income distribution (its dividends to shareholders) for the year amounted to $1 per share. In addition, the fund's trading activities (the buying and selling of securities) generated a realized capital gain of $3 per share, which ABC also distributed to its shareholders.

The ABC Fund passed along all the earnings and capital appreciation it generated - $4 ($1 in dividend distributions and $3 in a capital gains distribution) to its shareholders for a total return of 25% ($4/$16). Here again, unlike a stock, by paying out all its capital gains, the ABC Fund's price, or NAV, remains at or close to $16. In this scenario, if a fund investor only focused on the movement in ABC's NAV, the results would not look very good. It's even possible for a fund's NAV to decline, but still have good income/capital gain distributions, which will be reflected in a positive total return.

Obviously, a fund's NAV does not tell the whole mutual fund performance story, but its total return does. It captures a fund's changes in NAV, its income distribution and capital gains distribution, which, as a whole, are the true test of fund's return on investment.

Fund I-Q No. 2: Favorable Risk-Return Profile

As mentioned previously, a mutual fund's risk-return profile is important for a number of reasons:

- Common sense tells us that a fund investor should get a return equal to or better than the fund's risk rating.
- A risk-return profile helps an investor to make individual fund choices that are consistent with the over all risk profile of his or her portfolio.
- A risk profile is a handy screening device to determine whether a fund's investment advisor is chasing risky investments to boost fund performance.

Investment Quality No.2 relates to the fund manager's ability and commitment to managing a mutual fund's assets according to as a positive a risk-return spread as possible over the course of several years. (For related reading, see *Why Fund Managers Risk Too Much*.)

As is always the case with any financial indicator, fund risk-return ratings should not be looked at in isolation. It would be prudent to correlate these findings with the long-term (five to 10 years) total returns and the management costs of the fund. For example, in comparing two funds with equal performance records, the one with less risk would warrant a higher investment quality rating than the other.

It is worthwhile to look at the risk-return relationship of some mutual funds to see this fund criterion in action. Morningstar's fund report provides an easy-to-use rating, which is the one we will apply here to a selection of stock and bond funds.

After perusing the following fund information, which fund do you think goes to the head of the class for the best positive risk-return spread?

Large-Cap Stock	Return	Risk
Fidelity Contrafund (FCNTX)	High	Below-Average
Janus (JANSX)	Average	Above-Average
Vanguard U.S, Growth (VWUSX)	Average	Average
Marsico Focus (MFOCX)	Above-Average	Average
White Oak Select Growth (WOGSX)	Average	High
Bond	**Return**	**Risk**
Pioneer High-Yield (TAHYX)	Average	Above-Average
Fidelity Intermediate (FTHRX)	Average	Below-Average
Davis Appreciation & Income (APFCX)	High	Low

If you chose the Davis Appreciation & Income Fund, you have grasped the concept behind fund investment quality. In general, most mutual funds will have but one positive "notch," or spread, between their return and risk rating spread. The Marsico and Fidelity Intermediate funds are examples of this status, while the stellar Fidelity Contrafund has a two "notch" positive spread. The Janus, White Oak, and Pioneer funds all show negative spreads, which is a circumstance that should raise some serious concern for fund investors.

Scoring Risk-Return Data

This is the entry we need to complete in the Fund Investment Quality Scorecard for an analysis of a fund's risk-return profile:

Fund I-Q# 2: Favorable Risk-Return Profile:

Morningstar Return Rating:	Morningstar Risk Rating:
High	High
Above-Average	Above-Average
Average	Average
Below-Average	Below-Average
Low	Low

Summary Analysis for I-Q# 2:

Very Positive ___ Positive ___ Matched ___ Other___

Obviously, the greater the positive risk-return spread, the more favorable the rating. Negative spreads fall into the "other" classification and are not indicative of investment quality in the Fund I-Q Scorecard.

It is important to understand that all mutual fund investment research services use similar risk-return qualifiers. These indicators measure a fund's risk-return relationship within the context of its investment category (large cap value, small cap growth, etc.) and not the whole mutual fund universe. Each fund category has differing investment characteristics, making a universal risk-return qualification impossible - and inappropriate. With mutual fund risk-return classifications, as well as other types of investments, it is simply a necessity to make "apples to apples" comparisons.

Morningstar's well-known star ratings reflect historical risk-adjusted performance and are extremely popular with investors shopping for mutual funds. However, while helpful in this process, even Morningstar cautions the investing public that "the star rating is a useful tool, but it's no substitute for doing your homework. Investing is much too complex for any single measure to sum up the entire merit of a security."

Therefore, serious fund investors should embrace the use of the Fund Investment-Quality Scorecard in making fund investment decisions. While this approach does require a bit of "homework," it will allow for a solid, thorough treatment of mutual fund analysis.

Fund Size and Performance

Mutual Fund Asset Size

Bigger is not necessarily better when it comes to the size of a mutual fund. The key to investment quality lies in the compatibility of a fund's asset size and its investment style.

Russell Kinnel, editor of Morningstar's Fund investor newsletter, has written (February 13, 2006) that "one of the key challenges for fund investors and fund companies alike is asset growth in mutual funds." A lot of funds are growing, which has prompted an increasing number to close their doors to new investors. Kinnel's research found that during the 2001 - 2005 period the number of $1 billion-plus funds grew from 730 to 1,123. And, among small cap funds, the figure went from 36 to 81.

Size and Style

This so-called "asset bloat" is not much of a problem for bond, index and money market funds, which operate in large market segments that are very liquid and not overly impacted by large block trading transactions. With these funds, bigger is actually better because expenses can be spread over more investment assets. Fund investment advisors have little trouble managing large amounts of money in accordance with the investing objectives of the aforementioned funds.

However, in the case of managed stock funds, it is a different story. Oftentimes, when a fund gets flooded with new money, the investment managers find it difficult to invest expeditiously and/or effectively. As fund assets rise, the number of appropriate new stock prospects shrink, transaction costs increase and maintaining the fund's investment style becomes difficult. (For more insight, read *Watch Out For The Mutual Fund Metamorphosis*.)

New York Times financial reporter Norm Alster put it this way (December 4, 2005): "When it comes to actively managed equity funds, there appears to be real disadvantages to asset size. As managers have to invest ever larger sums of cash, they face a choice: to buy a wider variety of stocks or to increase positions in stocks they already own." Coming up with new ideas and/or fattening previously established investment positions can be problematic.

That is when fund management decides that it is better to close the fund to new investors to stem the flow. Nevertheless, existing fund shareholders can continue to put new money in and reinvest their dividends and capital gains distributions.

What this means for investors, as well as investment advisers, is that some really top-rated mutual fund investment opportunities have been taken off the table. As a consequence, the search for quality replacements is an ongoing effort.

Asset Size and Small Cap Funds
The problem of asset size is particularly acute in the small cap stock category. There is little doubt that an overly large asset base in this type of fund complicates performance - it may even be damaging. A look at Morningstar's Fund 500 database of 71 small cap value, growth and blend stock funds shows that in 2005, 32 of the 71 funds were closed. Obviously, super-sized asset bases impact negatively on the performance of small-stock funds.

Unfortunately, there's no magic number to tell us what asset size is optimal for a given fund. Kinnel's suggestion is to "let fund managers' decisions guide you." He looked at the median point at which funds closed and came up with these indicators: $800 million for small caps, $3 billion for mid caps and $18 billion for large caps.

Fund I-Q No.3: Size and Style Compatibility

As a fund investment quality, the asset size issue is really a question of at what point is a fund too big. There is no unequivocal answer for investors to grab onto other than to be aware of the following conditions that accompany a mutual fund as it increases in size:

- As mentioned previously, there is little concern about size with money market, bond and index funds. They can adsorb and efficiently manage large amounts of investors' money.
- Managed stock funds, particularly in the small-cap category, can encounter problems. Trading costs go up, the availability of appropriate stocks goes down and managing the portfolio according to its investment objective becomes complicated. All these factors can adversely affect fund performance.
- There is no quantitative benchmark that can tell us what amount of assets is too large for a fund to handle. A number of funds that have been questioned about their large asset bases have continued to operate well despite their ever increasing size. (To read more on this topic, see *Are Bigger Funds Always Better?*)

Investment Quality No. 3
Investment Quality No. 3 relates to a fund manager's recognition that it is prudent to make sure that the size of the fund's asset base is compatible with its investing style. If investment performance suffers, this is a clear indicator that size may be a problem. Ultimately, if there is a size issue, it becomes a matter for

management to decide.

The Fund I-Q Scorecard requires you to enter data on a fund's total net assets, its number of holdings, and a three-year asset growth percentage. These numbers are meant to be informative rather than evaluative. They cannot lead you to a reliable answer to the question of how big is too big for the fund you are analyzing. However, they may help to make you more aware of what is happening to the fund's asset base.

Realistically, the best source of guidance on a mutual fund's size is the scrutiny of fund analysts and commentary in the financial press.

Scoring Size and Style Data

This is the entry we need to complete in the Fund Investment Quality Scorecard for an analysis of a fund's size and style compatibility:

I-Q# 3: Compatibility of Fund Size and Investing Style:

Total Net Assets (millions $):
Number of Portfolio Holdings:
Three-Year % Growth of Net Assets:
Fund Closed: Yes ___ No___

Summary Analysis for I-Q# 3:
Analyst Concern: Yes ___ No___
Analyst Warning: Yes ___ No___

All the services we are using - Morningstar and Value Line - provide the numbers for historical total net assets, portfolio holdings and an indication of whether the fund is closed. However, only Morningstar's fund report provides any analytical comment on the issue of asset size. The "Morningstar's Take" section will comment on the compatibility of the fund's size and its investing style, if these are worthy of comment. Morningstar will anticipate a size problem, first at a level of "concern". If the problem persists and/or escalates, this can turn into an outright "warning" that the fund should be closed.

Logic tells us that the absence of concern or warning comments is a good sign and indicative of a positive fund investment quality. With this Fund I-Q measurement, no news is truly good news.

Fund Management Issues

Passive Vs. Active Management

In almost all economic endeavors, the quality of management is generally a key component of a successful operation. Managing a mutual fund is no exception to this rule. The fund investment quality we are going to discuss in this section focuses on two important fund managerial qualities: tenure and structure. However, it is worth noting that a fund's investing style, growth, risk and return profile, trading activity, costs and performance are also all a product of management's efforts. How well management "scores" in all these areas is an important consideration for mutual fund investors.

Managed Funds Vs. Index Funds

To begin with, we need to make a distinction between mutual funds that are managed and those that are indexed. The former are actively managed by an individual manager, co-managers, or a team of managers. The index funds are passively managed, which means that their portfolios mirror the components of a market index. For example, the well-known Vanguard 500 Index fund is invested in the 500 stocks of Standard & Poor's 500 Index on a market capitalization basis.

Which is better, managed or indexed fund investing? Both have their positive aspects. Let us first look at the index variety.

Index Mutual Funds

Index mutual funds are an easily understood, relatively safe approach to investing in broad segments of the market. They are used by less experienced investors as well as sophisticated institutional investors with large portfolios. Indexing has been called investing on autopilot. The metaphor is an appropriate one as managed funds can be viewed as having a pilot at the controls. When it comes to flying an airplane, both approaches are widely used.

Here is how an index fund works. The money going into an index fund is automatically invested proportionately into individual stocks or bonds according to the percentage their market capitalizations represent in the index. For example, if IBM represents 1.7% of the S&P 500 Index, for every $100 invested in the Vanguard 500 Fund, $1.70 goes into IBM stock. (For more on index funds, see *Index Investing*.)

David Swensen, an investment expert, author and former chief investment officer of Yale University's highly successful endowment fund, makes a strong case for indexing. In his 2005 book, "Unconventional Success", he concludes that because "most individual investors lack the specialized knowledge necessary to succeed in today's highly competitive investment markets … passive index funds are most likely to satisfy investor aspirations."

Swensen, and a high percentage of investment professionals, find index investing compelling for the following reasons:

- Simplicity. Broad-based market index funds make asset allocation and diversification easy.
- Management quality. The passive nature of indexing eliminates any concerns about human error or management tenure.
- Low portfolio turnover. Less buying and selling of securities means lower costs and fewer tax consequences.
- Low operational expenses. Indexing is considerably less expensive than active fund management.
- Asset bloat. Portfolio size is not a concern with index funds.
- Performance. It is a matter of record that index funds have outperformed the majority of managed funds over a variety of time periods.

Managed Mutual Funds
Well-run managed funds that have long-term performance records that are above their peer and category benchmarks are also excellent investing opportunities. There are a number of top-rated fund managers that consistently deliver exceptional results. Such well-run funds will register very high on the Fund Investment-Quality Scorecard you are learning about in these pages.

It is worth remembering that despite their impressive long-term records, even top-rated fund managers can have bad years. Such an occurrence is little cause to abandon a fund run by a highly respected manager. Typically, managers will stick to their fundamental strategies and not be swayed to experiment with tactics geared to improving results over the short term. This type of posture best serves the long-term interests of fund investors.

In recent years, a number of fund management-related issues have received more public attention in the financial press than in the past. These fall under the general heading of fund stewardship and include such issues as a manager's financial stake in a fund, performance fees and the composition of a fund's board of directors.

While the discussion on these issues is important, there is no universal agreement as to what constitutes appropriate standards of conduct.

By connecting shareholder and managerial interests, having managers investing significantly in the funds they manage seems like a good idea.
Likewise, compensating managers on the basis of performance rather than as a percentage of a fund's assets also seems like a good thing. However, there are reasonable arguments that take an opposite point of view on both of these issues. Less controversial is the practice of having a majority of independent directors serve on a fund's board of directors. But here too, there continues to be differences of opinion. The good news for fund investors is that the debates surrounding these issues heighten public and regulatory awareness of what constitutes proper mutual fund stewardship.

Fund I-Q No. 4: Manager Tenure and Structure

A long-term fund performance record, preferably over a 10-year period, provides the best indicator of a manager's investing abilities. Accordingly, one of the critical mutual fund investment qualities is to have a match of managerial tenure and this performance period, or at least one that covers a meaningful time span.

To illustrate this point, let us compare two different funds. The XYZ Fund has an annualized 10-year total return of 11% and has been run for those 10 years by the same manager. In the case of the ABC Fund, it has the same 10-year annualized total return of 1%, but it has had two different managers. One's tenure covered the first nine years and the second has only been on the job one year. (To learn how annualized returns are calculated, read *All Returns Are Not Created Equal*.)

Managerial Tenure

On our Fund Investment-Quality Scorecard, the XYZ Fund's current manager and performance would have a highly favorable 10-year match. We know that past results are no guarantee of future performance, but that experience is infinitely better than a crystal ball! In the case of the ABC Fund, the manager who produced 90% of the fund's excellent results is gone. Will the second manager be just as good? We hope so, and oftentimes that's the case - but things can also go in the other direction.

Common sense tells us that the more closely matched a manager's tenure is with a solid fund performance record, the better. Nevertheless, because managerial change is a fact of life in the mutual fund business, the free FundAlarm website can be very useful. This site puts fund manager changes in perspective by providing views on whether the change will be positive or negative for the fund's future performance. (For more on this topic, see *Will A New Fund Manager Cost You?* and *Should You Follow Your Fund Manager?*)

Management Teams

If a fund is run by a management team, the tenure issue becomes moot. There is always someone in the driver's seat that knows the road. And, while index funds have managers, their role is simply that of a technician making sure the mechanics of the index are working efficiently. In the case of a fund run by co-managers, it is assumed that, if there is a departure, there still remains a manager with experience at the helm. If that is not the case, the co-managed fund will have to be looked at as if it were run by a single manager and judged accordingly.

The solo fund manager is still much esteemed in the mutual fund industry, with some of them even reaching celebrity status. However, the trend in fund management is toward multiple managers. In some cases, co-mangers or team management can give a mutual fund higher investment quality than it would have with a single manager. Having said that, it must be recognized that there is a mutual fund managerial elite with outstanding long-term performance records. These managers are highly regarded, and deservedly so.

The Fund I-Q Scorecard includes an entry for a fund manager's personal investment in the fund being managed. Obviously, if a manager has a healthy amount of his or her own money invested in a fund, it would certainly have to be considered a confidence builder by the other fund investors. As alluded to previously, this information is not yet universally available and, admittedly, is not easily obtained by the general investing public. However, oftentimes, comment in this regard appears in the financial press and in Morningstar's commentary. And, if an investor considers it materially important to his or her investment decision, there's no harm done in putting the question directly to the fund's management.

Scoring Fund Management Data

This is the entry we need to complete in the Fund Investment-Quality Scorecard for an analysis of a fund's management tenure and structure:

I-Q# 4 Managerial Tenure and Structure:

Single Manager ___
Co-Managers ___
Team Management ___
Indexed ___

Current manager tenure and fund performance match for ______ years

Manager(s) investment in fund:
Significant ___
Moderate ___
Low ___
None ___

? Summary Analysis for I-Q# 4:
Very Positive ___
Positive ___
Sub-Standard ___

For those funds with a solo manager, a "very positive" rating would go to a tenure-performance match of six to 10 years. A "positive" rating would apply to a three to five year match, and anything less than three years would be "sub-standard." For co-managed funds, at least one of the co-managers would have to qualify accordingly.

If a manager or managers have an investment position in the fund they are running, that's a definite plus. But, because there are circumstances that make the application of this qualifier problematic, it should not unduly influence the managerial analysis.

Value Line and Morningstar do give the name(s) and starting date(s) of a fund's manager(s). Value Line's fund report also provides a very useful numerical (1 highest to 5 lowest) "Manager Rating," measuring the manager's risk-adjusted performance relative to that of the fund's peer group. Morningstar will usually make some evaluative comment on managerial performance in the "Morningstar's Take" section of its report.

Fund Transactional Activity

Portfolio Turnover

"Critics have long said that money managers who buy and sell frequently are confusing motion with progress." -Ian McDonald, *The Wall Street Journal*, August 12, 2005

For investors, a mutual fund's transactional activity, or portfolio turnover, is one of the more easily explained investment qualities. Expressed as a percentage, it tells us what portion of the securities (stocks, bonds, or both) in a fund's portfolio are bought and sold during the course of a year.

This information is readily available from any number of sources, including the fund reports we are using, and tells us a great deal about a fund's operations besides the turnover of its holdings. As you will see in the following discussion, the simplicity of this particular piece of information belies its importance as a valuable measurement of a mutual fund's investment quality.

Just to be sure that the concept of mutual fund portfolio turnover is fully understood, let us look at an illustration of just what takes place. In our simplistic example, the XYZ Stock Fund is reported to have had a turnover rate in 2005 of 50% in a portfolio that held 100 stocks as of January 1, 2005. At year-end 2005, the portfolio still contained 100 stocks, but 50 of the original stocks were sold and replaced by 50 new stocks. If the turnover rate was 100%, all 100 of the original stocks would have been sold and 100 new stocks purchased.

Portfolio Turnover and Investment Quality
In the real world of mutual fund investment management, the buying and selling of securities by a fund's manager is part of the business. The issue that needs to be addressed is how this activity impacts the consideration of a fund's investment quality.

Before getting into the details of this discussion, the views of John Bogle, the founder and former chairman of the Vanguard Group, on mutual fund operations are relevant.

Bogle believes that too many funds trade too much. In "Flying With The Fundamentals," which appeared in *Better Investing Magazine* in January 2006, Bogle is quoted as saying that when he got into finance in 1951, mutual fund turnover hardly varied from 16% per year, representing an average holding period of six years. However, Bogle noted that in more recent years, the average holding period has fallen to between 11 and 13 months, representing a 92% turnover rate.

The problem with increased turnover is that because the cost is coming out of the fund's assets and not the investment manager's fee, there seems to be little incentive for managers to change their ways.

Figure 1 provides some current comparative data on fund portfolio turnover rates. The managed funds category averages mask a wide range of trading activity from low single digit to medium triple digit turnover percentages. The index funds' listing includes individual funds selected from the Vanguard Group for each fund style category. The top-rated funds' turnover rates are for individual funds that have the best 10-year annualized total return from each category.

Stock and Bond Mutual Fund Portfolio Turnover Rates			
Fund Category	Managed Fund Category Average	Index Fund by Category*	Top-Rated Fund by Category**
		(As of December 31, 2006)	
Large-Cap Growth	97%	25%	2%
Large-Cap Blend	77%	7%	68%
Large-Cap Value	63%	22%	8%
Mid-Cap Growth	118%	NA	63%
Mid-Cap Blend	115%	27%	59%
Mid-Cap Value	76%	NA	7%
Small-Cap Growth	117%	48%	50%
Small-Cap Blend	88%	25%	11%

Small-Cap Value	68%	36%	16%
Foreign Stock	90%	3%	201%***
High Quality Bond	196%	64%	16%
* A Vanguard Group index fund was selected for each fund category.			
** Using Morningstar Fund Investor data, the fund with the highest annualized ten-year total return was selected in each fund category.			
*** This is an abnormally high portfolio turnover rate - holding stocks for six months - but true!			
Figure 1			

In Figure 1, portfolio turnover rates are expressed as a percentage. A low percentage figure equates to a longer portfolio holding period and vice versa. For example, 20% turnover means that a portfolio would be completely reconstituted after five years. A turnover of 100% means that a portfolio is completely reconstituted in one year. While most individuals are investing for the long term, it looks like the investment horizon for the average managed mutual fund is closer to one year. The characteristic low portfolio turnover rate of index investing is much in evidence. In all but two fund categories, the top-rated funds have portfolio turnover rates considerably below their respective managed-fund category averages.

Fund I-Q No.5: Portfolio Turnover Ratio

Why should fund investors be concerned about portfolio turnover? There are four major reasons, and they all impact a fund's investment quality:

1. There is an abundance of research that shows that buy-and-hold fund managers (low turnover) outperform their colleagues who trade frequently (high turnover). One of the reasons for this is that the former spend less on trading commissions than the latter. Trading costs are coming down, but they can still represent a significant fund expense.
2. These trading costs are not included in a fund's expense ratio. Thus, transaction costs are often ignored by investors because they are buried as a dollar figure, as opposed to a percentage of assets, in a fund's Statement of Additional Information (SAI). It is likely that only a tiny fraction of mutual fund investors are even aware of this document, let alone familiar with its content. (To learn more, read *Stop Paying High Fees*.)

According to 2005 Lipper Services data, trading commissions add, on average, an additional 0.15% to fund expenses. While the percentages may seem small, it can significantly ding returns over time. For example, consider two hypothetical $10,000 investments over 20 years in different funds with nontrading (operational) expenses of 1%, one with trading costs of 0.5% and the other with trading costs of 1%. Assuming annual growth of 8%, an investor would end up with just under $34,500 in the first fund and about $31,100 in the second. The $3,400 difference represents a significant 11% bonus in return for fund No.1 over fund No.2.

3. The components of an index fund change infrequently, which puts these types of funds in a low trading mode. However, unlike index funds, managed funds have human beings at the controls. And, the greater the number of trades, the more often the manager has to be making the right decision. A high volume of trading places a lot of pressure on managers to avoid making mistakes in investing judgments. (For related reading, see *The Lowdown On Index Funds*.)

4. A high level of fund trading activity generally occasions a higher-than-average amount of capital gains. Mutual funds must pay out these gains as dividends to fund shareholders, which are then subject to capital gains taxes. For investors in taxable funds, i.e., not in tax-deferred accounts, high portfolio-turnover funds are not tax efficient.

The Benefits Of Low Turnover

A low portfolio turnover rate is a very positive fund investment quality. However, it must be remembered that the nature or investing style of a fund can impose certain "structural" features on portfolio management that influence its trading activities:

- Small-cap stock, international and growth funds tend to have higher turnover rates. These funds are more transaction-intensive as the managers maneuver for competitive advantages.
- Index funds should have low turnover rates, no matter what their category.
- Trading is a natural function of bond funds, which puts their turnover rates way up on the scale. (To learn more about this type of fund, see *Evaluating Bond Funds: Keeping It Simple*.)
- Funds that carry only a small number of securities in their portfolios oftentimes reflect high turnover rates because of the impact of a single trade on a major holding.

Whatever the category of mutual fund being considered, the lower the portfolio turnover percentage the better. While this measurement may vary from year to year, a fund's trading activity is within the control of the manager and should consistently fall, historically, within a reasonable range.

Scoring Fund Turnover Data

The Morningstar and Value line mutual fund reports all present current and historical portfolio turnover figures.

This is the entry we need to complete in the Fund Investment Quality Scorecard for an analysis of a mutual fund's portfolio turnover:

I-Q# 5 Low Portfolio Turnover:

Current Percentage: _______ Peer Group Percentage _______

Current % versus Historical %: Comparable ___ Higher ___ Lower ___

Summary Analysis for I-Q# 5:

- Very Positive ___
- Positive ___
- Average ___
- Sub-Standard ___

Targets for portfolio turnover in a managed stock fund would peg the current percentage at or below 30% for a high evaluation and at or below 60% for an above-average evaluation. In addition, the fund's turnover rate should be substantially below its peer group. The fund's current and historical portfolio turnover rates should be comparable, and if the former is lower, so much the better. If these investment qualities are evident, the fund should get a positive rating in this aspect of its operations.

Hopefully, you now have a better appreciation of what portfolio turnover is all about. This seemingly minor percentage figure tells us a lot about a fund manager's commitment to containing costs, which, if the job is well done, makes a fund more profitable and investor friendly.

Fund Costs and Expenses

Overview Of Mutual Fund Expenses

"In the mutual fund field, costs assume a tremendous importance for the long-term investor. Other things held equal, lower costs mean higher returns." -John Bogle, "Bogle on Mutual Funds: New Perspectives for the Intelligent Investor" (1994)

If you took a vote among investment professionals on the single most important investment quality to look for in a mutual fund, the result would readily confirm Mr. Bogle's position, which he has championed since he founded the Vanguard Group. Simply stated, costs reduce investment returns. While it is impossible to eliminate all fund-related expenses, it is possible, and necessary in this decade's low-return investment environment, to avoid some and minimize others. (To read more about John Bogle, see *The Greatest Investors: John Bogle*.)

So let's take a comprehensive look at all the costs and expenses associated with mutual fund investing and pinpoint key indicators in a fund's expense structure that will score high in a Fund Investment-Quality Scorecard and lead you to top performing, low-cost mutual fund investments.

There are essentially four major components of a mutual fund's overall cost structure: sales charges, expense ratios, transaction commissions and redemption fees. An understanding of what these costs are and how they impact a fund's performance is extremely important in making informed fund investing decisions.

Sales Charges

Among other distinguishing features, mutual funds are acquired with a sales charge (load) or without a sales charge (no load). If there is a load, the charge can be as high as 8%, although it seems that a 3-5.75% range is most common. This charge is paid by the investor (the buyer of the fund) to the seller (a financial intermediary such as a brokerage firm, insurance company, financial planner or investment advisor) for services rendered. The charge is deducted from the amount being invested.

No-load mutual funds are offered directly to the investing public by fund companies, or they are sold to investors by financial intermediaries who have a compensation arrangement (hourly, flat fee or a percentage of assets) with the purchaser. In this case, a sales charge is not involved, and the investor fully invests his or her available money into funds sponsored by a no-load fund company. (For more insight, read *The Lowdown On No-Load Mutual Funds*.)

There are five general aspects of the load/no-load debate worth considering:.

1. Fund investors definitely need to understand that a load is a selling commission paid to a financial intermediary and not the fund company. It does not buy increased investment expertise by fund management. On the other hand, financial intermediaries defend their fees as fair compensation for the investment advisory services they provide to the investor.

2. The load-fund business has complicated things for investors by confusing them with a variety of fund share classes: A, B and C. In brief, these simply represent three different ways of applying a sales charge. With A shares you pay up front and with B shares you pay at the back end. With C shares, called "level-load," the year-to-year costs are usually high but spread out over time. (To learn more, see *The ABCs Of Mutual Fund Classes*.)

3. A fund's load is not included in the computation of a mutual fund's expense ratio (see below) and, therefore, is an additional cost to be considered when investing in load funds. (To learn more, see *Stop Paying High Fees*.)

4. The long historical record on mutual funds shows that there is little difference in the total return performance of load and no-load funds.

5. Employee participants in a defined-contribution, company sponsored retirement plan, such as a 401(k) and the like, generally need not be concerned about loads. In most instances, these retirement plans waive any sales charges on their fund investment options.

Expense Ratio
A mutual fund's expense ratio is the result of a calculation as opposed to a type of expense. The ratio's numerator is the sum of a variety of administrative and operating expenses; its denominator is an average of the fund's assets. It is expressed as a percentage - lower is better - and is a key indicator of a fund's investment quality.

In general operating terms, stock funds are more expensive than bond funds, international funds are more expensive than domestic funds and small and mid cap funds are more expensive than large cap funds.

The largest component of a fund's operating expenses is the fee paid to its investment advisors, or managers. A fund must also pay for recordkeeping, custodial services, taxes, legal costs and accounting and auditing fees.

In addition to these conventional operating expenses, some funds also have a marketing, or distribution, fee commonly referred to as a 12b-1 fee. If this fee is charged, it is included in a fund's operating expenses, unlike a fund's sales charge, which is not considered an operating expense. In the mutual fund industry's early days, a provision in the regulations permitted funds to incur promotional expenses to help develop mutual fund activity. The maximum 12b-1 fee allowable is an annual 1% of a fund's assets. To be considered a no-load fund, the 12b-1 annual charge must be no more than 0.25%.

Many mutual fund observers find it hard to justify this type of fee. With the increasing popularity of mutual funds, how much more "promotion" is really necessary? Today, the 12b-1 fee is used almost exclusively to reward intermediaries for selling a fund's shares. There is a movement underway to eliminate the fee, but the fund industry as a whole is resisting the change.

Lastly, it seems that some mutual fund investors are not all that clear on how operating expenses are paid. The simple answer is that whatever is included in a fund's operating expense is charged against the assets under management. In other words, the fund's investors pay the tab. This is how costs reduce investment returns.

Invisible Charges
Investment experts have speculated that brokerage commissions can add as much as 0.15% to a fund's annual expenses. However, these costs are not included in a fund's expense ratio. They seem to fit the definition of an operating expense but, as of today, are not so considered.

Redemption Fee
Designed to discourage market timers, an increasing number of mutual funds are charging a flat fee, usually 1%, on withdrawals (shares redeemed) made within a certain time frame. Generally, redemption fees are in effect for one year or less following the date of the investor's initial purchase. If you are an investor (in for the long term), as opposed to a speculator (in and out for the short term), this type of fee will have no effect on your fund investment.

Also remember that a mutual fund is a business and seeks to return a legitimate profit to its owners. The fund business is a very profitable one. As such, investors should seek out those funds that run a lean operation and align their interests with those of investors for a win-win relationship.

Fund I-Q No. 6: Costs and Expenses

One of the most important criteria for finding investment quality in a mutual fund is the indisputable fact that low-cost funds outperform high-cost funds. It is that simple. In terms of putting this concept into practice, mutual fund investors should:

1. Avoid funds with sales charges (loads) and 12b-1 fees. Choose funds with rock-bottom expense ratios.
Besides adding to your initial cost of investing, investing in a fund with a load incurs a "hidden fee." To illustrate how this happens, let's compare two fund investments. The XYZ Fund and the ABC Fund are similar in all respects with the exception that XYZ has an up-front sales charge of 5.75% and ABC is no load. The assumed annual total return for both funds is a steady 8% on the amount invested.

Deducting the 5.75% load ($575) from the initial investment of $10,000 in XYZ leaves $9,425 to compound at an 8% rate. With the ABC no-load fund, the full $10,000 compounds at the same rate.
The difference in compounded total returns between the XYZ Fund and the ABC Fund for the indicated time periods are $1,241, $2,680 and $5,786, all in favor of ABC. Looked at another way, the investment in XYZ, because of the lower discounted initial investment amount ($9,425), cost that investor a "hidden fee" equal to the difference of the compounded total returns.

Equating fund investment quality with a low expense ratio is a well established conclusion of a number of investment research studies. According to the Boston-based Financial Research Corporation (FRC), not only is the expense ratio the best predictor of performance, it is the only statistically reliable predictor. In July 2005, MarketWatch's Paul Farrell reported on a then recently completed FRC study:

Details	ABC Fund	XYZ Fund	Differential
Funds to Invest	$10,000	$10,000	-0
Minus Load	-0	$575	$575
Actual Investment	$10,000	$9,425	$575
Compounded Return			
10-year	$21,589	$20,348	$1,241
20-year	$46,610	$43,930	$2,680
30-year	$100,627	$94,841	$5,786

The FRC tested 11 popular criteria investors use to pick funds: Morningstar ratings, past performance, turnover ratios, asset size, expense ratios, manager tenure and net sales, plus four risk/volatility measures - standard deviation, alpha, beta and the Sharpe ratio. FRC's research suggested that the expense ratio was the most reliable predictor.

According to FRC, funds with low operating costs deliver above-average future performance across nearly all time periods. Other criteria proved to be statistically unreliable predictors - including Morningstar's popular star ratings and the Sharpe ratio, which calculates risk-reward variables for investments. (To learn more, read *The Sharpe Ratio Can Oversimplify Risk*.)

2. When it comes to mutual fund costs and expenses, a mutual fund's investment quality increases with the absence of sales charges and 12b-1 fees and the presence of low expense and portfolio turnover ratios. Low-cost funds outperform high-cost funds.

To help readers get a quantitative fix on expense ratios, let's look at some averages by broad fund categories as per Morningstar's FundInvestor year-end 2005 fund statistics for its universe of 500 of the most widely traded mutual funds:

Large Cap Stock	1.35% to 1.53%
Mid Cap Stock	1.47% to 1.62%
Small Cap Stock	1.50% to 1.71%
Allocation Funds	1.49%
Foreign Stock	1.71%
Emerging Market Stock	1.98%
High Quality Bond	1.02%
High Yield Bond	1.27%

Most top-rated domestic stock funds are going to have expense ratios around the 1% mark. Those of low-cost fund companies will be at or below 0.75%.

Scoring Fund Cost and Expense Data

The Morningstar and Value Line fund reports have multi-year expense ratio data and information on load and 12b-1 charges. In the case of the latter, you have to search a bit for it in the Morningstar report. It appears at the very bottom of the report after the "Dist." caption.

The Value Line report makes the best comparative expense ratio presentation. On the line below a fund's historical expense ratio, Value Line indicates how the fund's expenses compare to its category average on a multi-year basis. The category average is deemed to equal 1. A figure greater than 1 signifies that the fund has higher-than-average expenses, while a figure below 1 represents proportionately lower expenses:

This is the entry we need to complete in the Fund Investment-Quality Scorecard for an analysis of a mutual fund's fees and expenses:

I-Q# 6 Reasonable Fees and Expenses:

Load: 12b-1:

Expense Ratio: Trend: Up ___ Down ___ Steady___

Peer Group Expense Ratio: _______

Summary Analysis for I-Q# 6:

Low ___
Below-Average ___
Average ___
Above-Average ___
High ___

In looking for high investment quality in the area of fund fees and expenses, it is preferable to not find any sales or so-called distribution (12b-1) charges. Ideally, investors should find a fund with an expense ratio far below its category and peer group averages, with a trend over the past five years that is holding steady or, better yet, declining. In the "Summary Analysis," only funds with "low" or "below average" fees and expenses are going to be worthy of consideration.

Fund Performance Metrics

Historical Performance Vs. Underlying Portfolio Characteristics

Many investors tend to focus on a mutual fund's historical performance as oppsoed to considering its underlying portfolio characteristics. With individual investors, whether these are stock, bond, or fund investors, return is the holy grail of their approach to investing. However, while an investment's return is certainly an important consideration, it would be best to first start with looking at an investment's fundamentals. After all, strong, consistent investment qualities are what produce top-rated investment performance, not vice versa. (For more insight, read *The Truth Behind Mutual Fund Returns*.)

With mutual fund investing, it is particularly important to look at all the components of investment quality and not just performance alone. There is too much hype and misleading information in mutual fund advertising. In this regard, the most abused metric in fund marketing materials is performance data.

The financial media continuously bombard us with what's "hot," be that a particular fund or fund category. The personal finance magazines are filled with eye-grabbing headlines about what to invest in now, next month and next year. The pervasive investment community habit of focusing on the short-term displaces investment fundamentals for big, immediate returns as selection criteria.

Too many mutual funds enjoy a very short period of success. The record books are full of superstars that disappear from one year to the next. Therefore, remember these two key points when considering fund performance as an investment quality:

1. Top performance is the product of favorable indicators.
2. To rely on performance figures, they need to be established over a relatively long period of time.

Mutual Fund Performance Data

Total Return
A mutual fund's performance is always expressed in terms of its total return, which is the sum of the change in a fund's net asset value (NAV), its dividends and its capital gains distributions over a given period of time.

Generally, the time periods used by investment research analysts are year-to-date, one year, three years, five years and 10 years. Of most relevance to investors are the five and 10-year periods, with the latter time frame being considered the best measure of an investment manager's ability to perform.

Total return figures are calculated and expressed net of a fund's expenses, i.e., those included in a fund's expense ratio. Investors in load-funds should note that in fund literature and the financial press, generally, the performance of these funds is reported without adjusting for the impact of the sales charges. However, 12b-1 fees, because they are part of the expense ratio calculation, are included. Morningstar and Value Line mutual fund reports all provide load-adjusted total return figures.

Market Conditions

A fund's true performance potential needs to be evaluated within the context of the market environment prevailing during the different periods used. If, in 2006, we look back at total returns for one year (2005), three years (2003 to 2005), five years (2001 to 2005) and 10 years (1996 to 2005), we are going to get a variety of percentages.

For example, as of March 2006, using a three-year measurement picks up one excellent year (2003) and two fairly good years (2004 and 2005), all of which produce an overly positive take on a fund's total return. A five-year measurement picks up two very poor years (2001 and 2002) and the aforementioned good years (2003-05), making it more representative in terms of fund performance.

Obviously, 10-year measurements of performance will most likely cover a mix of market conditions and translate into a more reliable long-term indicator of a fund's investment management abilities.

Annualized Versus Actual Total Return

For any time period of more than one year, a fund's total return is "annualized" and so reported. Let's assume that the XYZ Fund is said to have an average annual five-year total return of 12%. This does not mean that XYZ delivered an actual annual total return of 12% in each of the five years measured - the 12% is an average, or annualized return. (To get a better understanding of this concept, see *All Returns Are Not Created Equal*.)

While helpful as a general indicator of fund performance, the prudent fund investor will also want to look at the fund's year-to-year, or inter-annual, actual total returns. There is more investment quality reflected in a fairly steady yearly performance rather than one with drastic ups and downs. If we use an amusement park analogy for gauging the investment quality of a fund's performance, a smooth ride on a merry-go-round would be preferable to the thrills of a ride on a roller coaster.

To illustrate this point, let us revisit XYZ Fund's five-year annualized total return of 12%. It would be a fairly reliable performance indicator if XYZ had the following year-to-year results over five years: +9%, +13%, +10%, +15% and +13%. However, XYZ's 12% annualized five-year total return would not look very reliable with these inter-annual total returns: +58%, +9%, +3%, -2% and -8%.

New Funds and Managers Without a Track Record

Unless there are some compelling special circumstances, simply avoid funds with fewer than three years of performance. New managers need time to prove themselves. There are dozens of good funds with long-term track records and managers that have proved themselves. With some exceptions, when it comes to your hard-earned dollars, invest with reliable veterans rather than with the new kids on the block. (For more on this topic, see *Has Your Fund Manager Been Through A Bear Market?*)

The Performance Disclaimer

In the investment business, the oft repeated statement that "performance data represents past performance, which is no guarantee of future results" has become a cliché. Of course, the real purpose of this statement is to provide liability protection to purveyors of investment products as opposed to providing guidance to investors. That said, past performance is what we have to work with - and it's much better than a crystal ball. The real problem here is the phrase, "no guarantee," which should alert investors to the simple fact that future investment performance is subject to many variables.

Benchmarks

Benchmarking is one of the most important aspects of a mutual fund's total return performance. A fund's performance metrics only have meaning if they are compared to appropriate "guideposts," or benchmarks. In the financial field, there are dozens of indexes against which analysts measure the performance of any given investment.

Examples of well-known and much used market indexes include:

- Standard & Poor's 500 Index: Includes 500, mostly large U.S. companies representing a range of industries and sectors of the U.S. economy. The S&P 500 is commonly used as an overall stock market benchmark as well as that for large cap stock mutual funds.
- DJ Wilshire 5000 Index: Includes more than 6,700 U.S. companies of all sizes and is considered the broadest measurement of the U.S. equity market. The Wilshire 5000 is used as a benchmark for the American stock market and all cap stock mutual funds.
- Russell 2000 Index: This index measures the performance of the 2,000 smallest stocks in the U.S. market and is used as a benchmark for small cap stock mutual funds.
- Morgan Stanley Capital International EAFE Index: The broadest international stock benchmark, the MSCI EAFE measures the

performance of stocks in Europe, Australia and the Far East. There are additional MSCI indexes for other regions, specific countries and foreign market segments.

- Lehman Brothers Aggregate Bond Index: This index is considered the best overall benchmark for the U.S. bond market.

Peer Comparisons
In addition to formalized benchmarks, mutual funds are also compared to their peers, or peer groups, and relevant fund categories. For example, it is common for investment research materials to compare a mid cap value stock fund to funds similar in nature (peers or peer group) as well as an index that is used for the mid cap value stock category as a whole. (For more insight, read *Benchmark Your Return With Indexes* and *Is Your Portfolio Beating Its Benchmark?*)

Fund I-Q No.7: Comparative Total Returns

A mutual fund's total return investment quality is evidenced by relatively consistent positive performance as compared to its peers, its category benchmark and an appropriate broad market index, over five- and 10-year periods, preferably the latter.

Historical comparative data is useful to investors as a reasonable basis, albeit not a guarantee, for forming expectations about future investment results. Using historical patterns is better than depending on guesswork about what's going to happen in the future.

Mutual fund investors would be wrong to completely disregard past fund performance as a predictor of future performance. At the same time, do not base a fund selection entirely on past results or be seduced by eye-popping, extraordinary gains, which may be temporary. There are a number of fund investment qualities to be considered in evaluating a mutual fund investment.

To help readers get a quantitative fix on mutual fund annualized total return numbers, below are the fund category averages as per Morningstar's FundInvestor year-end 2005 fund statistics for its universe of 500 of the most widely traded mutual funds:

Fund Type	5-Year %	10-Year %
Large Cap Growth	-3.4	7.0
Large Cap Blend	0.5	8.1

Large Cap Value	4.0	8.9
Mid Cap Growth	0.0	8.5
Mid Cap Blend	8.1	11.7
Mid Cap Value	9.4	11.4
Small Cap Growth	2.2	8.2
Small Cap Blend	9.9	11.2
Small Cap Value	135	2.8
Conservative Allocation	13.7	6.3
Moderate Allocation	2.9	7.4
Foreign Stock	6.8	9.7
High-Quality Bond	4.8	5.2
High-Yield Bond	7.3	5.4

Scoring Fund Performance Data

This is the entry we need to complete in the Fund Investment-Quality Scorecard for an analysis of a mutual fund's performance data:

I-Q# 7 Total Return Performance:

	Annualized Total Return (%)			
	1 yr	3 yr	5 yr	10 yr
Fund				
Peer Group				
Peer Group Benchmark				
S&P 500 Benchmark				
Load-Adjusted				

Yearly returns:

Fairly Steady ___
Moderately Irregular ___
Very Irregular ___

Summary Analysis for I-Q# 7:

High ___
Above-Average ___
Average ___
Below-Average ___
Low ___

All three fund reports - Morningstar and Value Line - provide comprehensive multi-year annualized total return data. The comparisons in the Morningstar and Value Line presentations express a fund's performance as above (+) or below (-) the peer, category, and/or index benchmark annualized total return figures.

For example, if the XYZ Fund has an annualized 10-year total return of 9.5%, and the S&P 500 Index had an equivalent total return of 8.2%, the comparison would be expressed as + 1.3% for the period. This figure indicates that XYZ's performance is above that of the S&P 500 Index by that percentage. Conversely, if the XYZ and S&P total returns were reversed, the comparison would be expressed as - 1.3%.

By looking at the fund's total return numbers in the performance overviews, particularly those in the five-year and 10-year periods, we can readily determine how a fund is performing compared to its relevant benchmarks. Look for managed funds to do better than their peers, category and index benchmarks; with index funds, try to match performance to a fund's tracking index. A positive performance differential between a fund and its benchmarks is a very favorable investment quality.

As was discussed previously in this chapter, it is prudent to cross-check the annualized total return figure against the fund's year-to-year figures. If XYZ Fund's 10-year annualized total return is 9.5%, the prudent fund investor will look at XYZ's past 10-year annual total returns to see if the annualized return is representative of its mean performance. Fairly steady, above-market tracking performance is indicative of fund investment quality.

Analytical Commentary On a Fund

Fund I-Q No.8: Favorable Analytics

The financial media are major purveyors of information on the mutual fund industry as a whole, as well as on individual funds. The quality of this information varies greatly. Oftentimes, this content is fairly shallow and aimed at the short term, such as covering which particular fund or fund category is "flying high." While interesting and somewhat informative, it would be a mistake for investors to base their mutual fund investing decisions on this rather "lightweight" material, which doesn't come close to substantive analytical research.

So, put aside the personal finance magazines and do not waste any more time listening to the talking heads on CNBC. Familiarity with and the knowledgeable use of independent fund investment research are your keys to finding investment quality in a mutual fund. The fund reports provided by Morningstar and Value Line are outstanding examples of this type of material. They are essential evaluative tools for fund investors.

In this section, we'll look at favorable analytics as a measure of fund investment quality. Favorable analytics is not a measure that can be quantified; it involves analyst opinions and corporate governance issues.

Positive analytical commentary in a Morningstar fund report is an important indicator of mutual fund investment quality. Favorable analyst views, a Stewardship Grade of A or B, and a fund's designation as an "Analyst Pick" would place a fund in the "very positive" (highest) category of this fund I-Q ranking metric. (For more insight, read *Morningstar's Stewardship Grade Scores Big*.)

There are three unique analytical mutual fund perspectives that can be found in mutual fund reports:

1. *Commentary*. This is included in the "Morningstar's Take" section of its fund report. The Value Line reports also contain useful observations, which differ in that they more descriptive in nature than analytical.
2. *Evualuation of governance issues*. As a result of the serious mutual fund scandals beginning in 2002, mutual fund reports are including evaluations of mutual fund company governance issues. Morningstar, for example, has put considerable emphasis on reporting on the "stewardship" qualities of fund management by looking at regulatory issues, board of directors' quality, manager incentives, fees and corporate culture. The ultimate goal of this commentary is to help investors choose funds that are sponsored by fund companies with good corporate governance practices.
3. *Analyst picks*. The third analytical fund perspective is found in Morningstar's two-word designation of a mutual fund as an "Analyst Pick." Behind the simplicity of this qualification is an in-depth selection process by Morningstar's research analysts of the some 2,000 funds it covers. From this universe of funds, approximately 85 stock, 15 hybrid, and 50 bond funds are "picked" as the best of the bunch on a category-by-category basis. The Analyst Pick choices are based on these Morningstar criteria:
    - Successful funds tend to be driven by consistent, repeatable strategies. Most strategies will hit rough patches from time to time; however, by staying focused on their winning formulas, these funds are likely to overcome any temporary setbacks.
    - Experienced, successful management supported by a quality organization.
    - Low expenses, which have greater predictive value than any other data point in the fund universe.

- Good fiduciaries that act in the best interests of the fund's shareholders.

Scoring Fund Analytical Commentary

This is the entry we need to complete in the Fund Investment-Quality Scorecard for an analysis of a mutual fund's analytical commentary:

I-Q# 8 Positive Analyst Commentary:

Fund Stewardship Grade:
"Morningstar's Take:"

Morningstar Analyst Pick:

Other Comments:

Summary Analysis for I-Q# 8:
Very Positive ___
Positive ___
Sub-Standard ___

A mutual fund's stewardship grade is found in the upper left-hand corner of a Morningstar fund report under the heading, "Governance and Management." For investment quality, letter grades of 'A' and 'B' are generally considered to be positive. Letter grades of 'C' or less are substandard. (For more insight, read *Morningstar's Stewardship Grade Scores Big*.)

The Analyst Pick notation in Morningstar's fund report is found in the center at the very top of the page. A "yes" response to this data point makes the fund a top-rated selection, or very positive in terms of its investment quality. A "no" response should not necessarily be interpreted negatively - the fund simply did not make the cut in the elite Analyst Pick circle.

In the "Morningstar's Take" section, look for commentary that is indicative of a positive level of investment quality.

If the fund in question has been commented on by some other reliable investment information source other than Morningstar, take note of this as well and record it here.

Conclusion: Mutual Fund Investment Qualities

Fund Investment Qualities

For the vast majority of the general public, investing means investing in mutual funds. These convenient investment vehicles provide investors with a relatively easy-to-use, effective means to accumulate savings over the long run. Because of the mutual fund's important role in the investment activities of individual investors, it is necessary that they understand how to make informed decisions regarding fund selection and monitoring.

Whether you are a do-it-yourselfer, use an investment professional, or are a participant in a self-directed retirement plan, being reasonably conversant with the ABCs of a mutual fund is a valuable investing skill. Even if you do not have all the answers to the questions surrounding successful fund investing, you should at least be equipped with sufficient know-how to ask intelligent questions.

With the mutual fund universe at 8,000 plus and growing, there are, for many investors, just too many choices. The problem of choice is further complicated by an information overload, which requires investors to sort out what is nice to know and what they need to know.

Let's summarize the main points of assessing the investment qualities of a mutual fund, where to find this information and how to use it to make smart fund decisions.

Fund Investment Qualities

There are dozens of analytical financial metrics that can be used to evaluate a mutual fund. Some are quite complicated and difficult to apply. Here, we've covered just eight fundamental evaluative criteria, or investment qualities.

A fund investor would be well served to focus his or her attention on these summarized criteria:

- **Fund Investment-Quality No.1: Investing Style Considerations**
  Evidence of a fund manager's ability and commitment, over the course of several years, to manage a mutual fund's assets according to its stated investment objective and avoid excessive style drift. (To learn more,

read *Focus Pocus May Not Lead To Magical Returns* and *Don't Panic If Your Mutual Fund Is Drifting*.)

- **Fund Investment-Quality No.2: Favorable Risk-Return Profile**
  Evidence of a fund manager's ability to effectively manage a mutual fund's assets by consistently producing as positive an investment risk-return spread as possible over the course of several years. (To learn more, read *Financial Concepts: The Risk/Return Tradeoff*.)

- **Investment-Quality No.3: Fund Size and Style Compatibility**
  Recognition by the fund's manager that it is prudent to keep the size of a fund's asset base compatible with its investing style. (To learn more, read *Are Bigger Fund Always Better?*)

- **Fund Investment-Quality No.4: Manager Tenure & Structure**
  A long-term fund performance record, preferably 10 years long, provides the best indicator of a manager's investing abilities. Accordingly, it is critical that managerial tenure and fund performance match each other over a meaningful time span.

- **Fund Investment-Quality No.5: Low Portfolio Turnover**
  Whatever the category of mutual fund being considered, the lower the portfolio turnover percentage, the better, in terms of minimizing the cost of transaction commissions, which are not included in a fund's expense ratio.

- **Fund Investment-Quality No.6: Be a Cost-Conscious Investor**
  When it comes to mutual fund costs and expenses, a mutual fund's investment quality increases with the absence of sales charges and 12b-1 fees and the presence of low expense and portfolio turnover ratios. Low-cost funds outperform high-cost funds. (For more on this topic, read *Stop Paying High Fees*.)

- **Fund Investment-Quality No.7: Comparative Total Returns**
  A mutual fund's total return investment quality is evidenced by relatively consistent positive performance as compared to its peers, its category benchmark and an appropriate broad market index over five- and 10-year periods. (A 10-year period is preferable.)

- **Fund Investment-Quality Number 8: Favorable Analytics**
  Positive analytical commentary by investment research analysts is an important indicator of mutual fund investment quality.

Fund I-Q Scorecard

In general, scorecards are a handy tool to record the results of any number of sporting events, be that a round of golf or a baseball game. Essentially, a scorecard collects a variety of quantitative data (numbers), which are used by players, coaches, referees, umpires and judges to keep track, in an orderly fashion, of certain facets and results of the game being played.

So it is with a Fund Investment-Quality Scorecard (FIQS) for mutual funds. When it comes to selecting and deciding to hold mutual funds, investors need to know the "score." The purpose of the Fund I-Q Scorecard is to help fund investors to collect key data in an organized and focused fashion and to make informed judgments as to the investment quality of a mutual fund investment opportunity.

Users of the FIQS need to recognize that, unlike a sporting event, not all of the information in this scorecard is purely quantitative. In other words, there is room for qualitative judgments, which may vary depending on how a given investor interprets the data presented. Investors with different mindsets will see things differently.

This element of subjectivity in evaluating the results of a mutual fund's scorecard rating should not be material. The majority of a fund's investment qualities are quantifiable - the risk-return profile, managerial tenure and structure, portfolio turnover, expense ratio and total returns. The point to keep in mind is that the FIQS is not meant to produce a rigid, numerical rating. What is intended is to provide an informational framework that allows an investor to make a common-sense evaluative judgment on the merits, or lack thereof, of a mutual fund.

As a user of the Fund Investment-Quality Scorecard, do not worry about being 100% correct on each and every data point. The benefit from this investment research tool is that it helps fund investors organize their thoughts on the pros and cons of a mutual fund investment opportunity, which should lead to an informed investing decision.

The Fund Investment Qualities in Action

Let's look at the Dodge & Cox Stock (DODGX) fund in order to provide readers with an idea of how all this theory works in practice. I used the illustrative fund reports from Morningstar (see the PDF of this report here) and Value Line (see the PDF of this report here).

So in terms of the fund investment qualities for DODGX:

Fund I-Q No.1: DODGX's Investment Style

In this regard, while there has been some minor inconsistency, it probably isn't material, and moving into the large cap blend box is not any great departure from the fund's value objective. The consistency of the fund's management investment style appears to be favorable, falling somewhere between stable and minor change. Also, DODGX's superior total return performance indicates that the fund's managers seem to be making smart decisions.

Fund I-Q No.2: DODGX's Risk-Return Spread
DODGX's risk-return spread is positive, which meets an indispensable investing requirement.

Fund I-Q No.3: DODGX's Size and Style Compatibility
The fund's $52.2 billion in assets increased some 272% from year-end 2002 to year-end 2005! There are only 87 holdings in the portfolio, which implies some rather large individual holdings. Morningstar's research analyst comments on this circumstance as a "challenge." The fund has been closed for some time, and returns continue to be high, registering above all the fund's benchmarks. The fund's size is a concern and needs to be watched. As long as the fund's total return numbers do not suffer, the situation seems under control. (To learn more, read *Are Bigger Funds Always Better?*)

Fund I-Q No. 4: DODGX's Management Tenure and Structure
This fund's team management approach assures continuity and obviates any concern over a match of manager tenure and fund performance. (For more on team management, read *Mutual Fund Management: Team Players Or All-Stars?*)

Fund I-Q No.5: DODGX's Portfolio Turnover Ratio
The fund's historical record of low portfolio turnover is very positive; way below industry and peer group percentages. This fund investment quality is important for a fund of this size.

Fund I-Q No.6: DODGX's Costs
DODGX's modest expense ratio makes it a low-cost performer with no sales charges or objectionable 12b-1 fees applied. This is a highly favorable fund investment quality.

Fund I-Q No.7: DODGX's Total Returns
Over all the periods measured, DODGX's total return performance is simply outstanding - a very impressive long-term record.

Fund I-Q No.8: DODGX's Analytics
Lastly, Dodge & Cox's reputation as one of the most respected fund companies in the industry is confirmed by its top-rated fund stewardship. Morningstar's

"Take" on this fund is very favorable, and it is designated as an Analyst Pick. Overall, this fund shows a high investment quality rating.