Enhancing Fund Selection and Monitoring

By Craig Watanabe, CFP® AIF®
Learn how to enhance fund selection and monitoring
Identify indicators supported by academic research
Understand the limitations of point-scoring methods
Book Smart and Street Smart
We will take a **CRITICAL** look at point-scoring systems and drill down to the individual components.
The Need to Improve
In the study, “Absence of Value” by Stewart, Neumann, Knittel and Heisler, the authors concluded that “much like individual investors, who seem to switch mutual funds at the wrong time, institutional investors do not appear to create value from their investment decisions.”
“How Do Employer’s 401(k) Mutual Fund Selections Affect Performance?”

This study found corroborated the findings in the previous study: “plan sponsors chase returns but add no value.”
LAKE WOBEGON
U.S.A.
The fi360 Fiduciary Score®
“The FI360 Fiduciary Score represents a suggested course of action and is not intended, nor should it be used as the sole source of information for reaching an investment decision.”
Point-scoring systems are ubiquitous in the retirement space but does anyone know of these systems being used in wealth or asset management?
Components of the Score

- **Regulatory oversight** – no unregistered investments
- **Minimum track record** – at least three years
- **Stability of the organization** – manager turnover
- **Assets in the investment** – at least $50 million
- **Composition consistent with asset class** – at least 80% of the fund
Components of the Score

- **Style consistency** – correlated to Morningstar style box
- **Expense ratio** – not in bottom quartile of peer group
- **Risk-adjusted performance** – above peer group median
- **Absolute performance** – 1, 3, 5 year above peer group median
Academic Research
Required Reading: MUTUAL FUNDS: Fifty Years of Research Findings by Seth C. Anderson and Parvez Ahmed.
It is **reasonable** and consistent with fiduciary best practices to exclude private funds
Minimum Track Record

• “New Equity Funds: Marketing and Performance” by Arteaga, Ciccotello and Grant, Financial Analysts Journal, 1998 v54
  – Concluded that due to the common practices of incubation and selective attention, new funds tend to outperform in their first year, however, performance reverts to the mean in the second year

Concluded that manager changes were highly correlated with poor performance and outflows. “Star Manager” defections also had little impact that could not be explained by other factors (reversion to the mean.)
“Luck vs Skill in the Cross-Section of Mutual Fund Returns” by Fama and French, *Journal of Finance* 2010 v65

Results are consistent with the premise that the loss of a star manager is not predictive of future returns.
Younger managers outperformed older ones by an average of 8.6 bps for each year of age difference.

Manager tenure is predictive but NOT in the way most people believe.

Fund performance was linear and inversely correlated with fund size.

The smallest quintile of funds outperformed.
Funds tend to underperform prior to the shift and revert to the mean after the shift.

Funds with superior performance usually have lower expense ratios
“Do Winners Repeat? Patterns in Mutual Fund Return Behavior” by Goetzmann and Ibbotson

*Journal of Portfolio Management* winter 1994

Documented that performance persists in the short-run but diminishes with longer time frames.
Morningstar
Fund Spy by Russell Kinnel should be required reading
Monthly newsletter

$125/year

Morningstar Analyst Ratings

Fund Investor 500
Forward looking instead of backward looking (Star Ratings)
Distribution of Morningstar Analyst Ratings
As of 6/30/12

- Gold: 12%
- Silver: 20%
- Bronze: 22%
- Neutral: 27%
- Negative: 19%
The Five Pillars

Process
Performance
People
Parent
Price
## Tracking Gold-Rated Funds

<table>
<thead>
<tr>
<th>Asset Group</th>
<th>Trailing 10 Years Batting Average</th>
<th>% Picks in Top Quartile</th>
<th>Trailing 5 Years Batting Average</th>
<th>% Picks in Top Quartile</th>
<th>Trailing 3 Years Batting Average</th>
<th>% Picks in Top Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Stock</td>
<td>68.38</td>
<td>56.0%</td>
<td>69.43</td>
<td>38.1%</td>
<td>62.53</td>
<td>38.7%</td>
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<tr>
<td>Taxable Bond</td>
<td>82.03</td>
<td>81.8%</td>
<td>85.54</td>
<td>60.0%</td>
<td>69.33</td>
<td>37.8%</td>
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<tr>
<td>Intl Stock</td>
<td>72.05</td>
<td>47.7%</td>
<td>74.11</td>
<td>12.8%</td>
<td>75.4</td>
<td>24.4%</td>
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<tr>
<td>Muni Bond</td>
<td>93.75</td>
<td>76.0%</td>
<td>89.74</td>
<td>56.3%</td>
<td>60.64</td>
<td>22.2%</td>
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<tr>
<td>Balanced</td>
<td>89.87</td>
<td>60.5%</td>
<td>91.12</td>
<td>40.6%</td>
<td>88.82</td>
<td>53.3%</td>
</tr>
</tbody>
</table>

Data through Dec. 31, 2012. Batting Average and % picks in top quartiles are for Gold/Picks funds only. The results are compared with category average.
Point-Scoring Overlay
Point-Scoring Overlay

Morningstar 500

Morningstar Fund Investor

Fund Spy

Point Scoring System

Analyst Ratings
Questions?