

Enhancing Fund Selection and Monitoring



By Craig Watanabe, CFP® AIF®

CHECK LIST

1 Understand the limitations of point-scoring methods

2 Identify indicators supported by academic research

3 Learn how to enhance fund selection and monitoring

A black silhouette of a human head and neck in profile, facing right. The text "Book Smart and Street Smart" is centered within the head area.

**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

“Absence of Value”

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.”**

NEW WOBESON

U.S.A.



The fi360 Fiduciary Score®

From the fi360 Fiduciary Score Methodology Updated March 1, 2012

“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



Click to **LOOK INSIDE!**





It is reasonable and consistent with fiduciary best practices to exclude private funds

Minimum Track Record

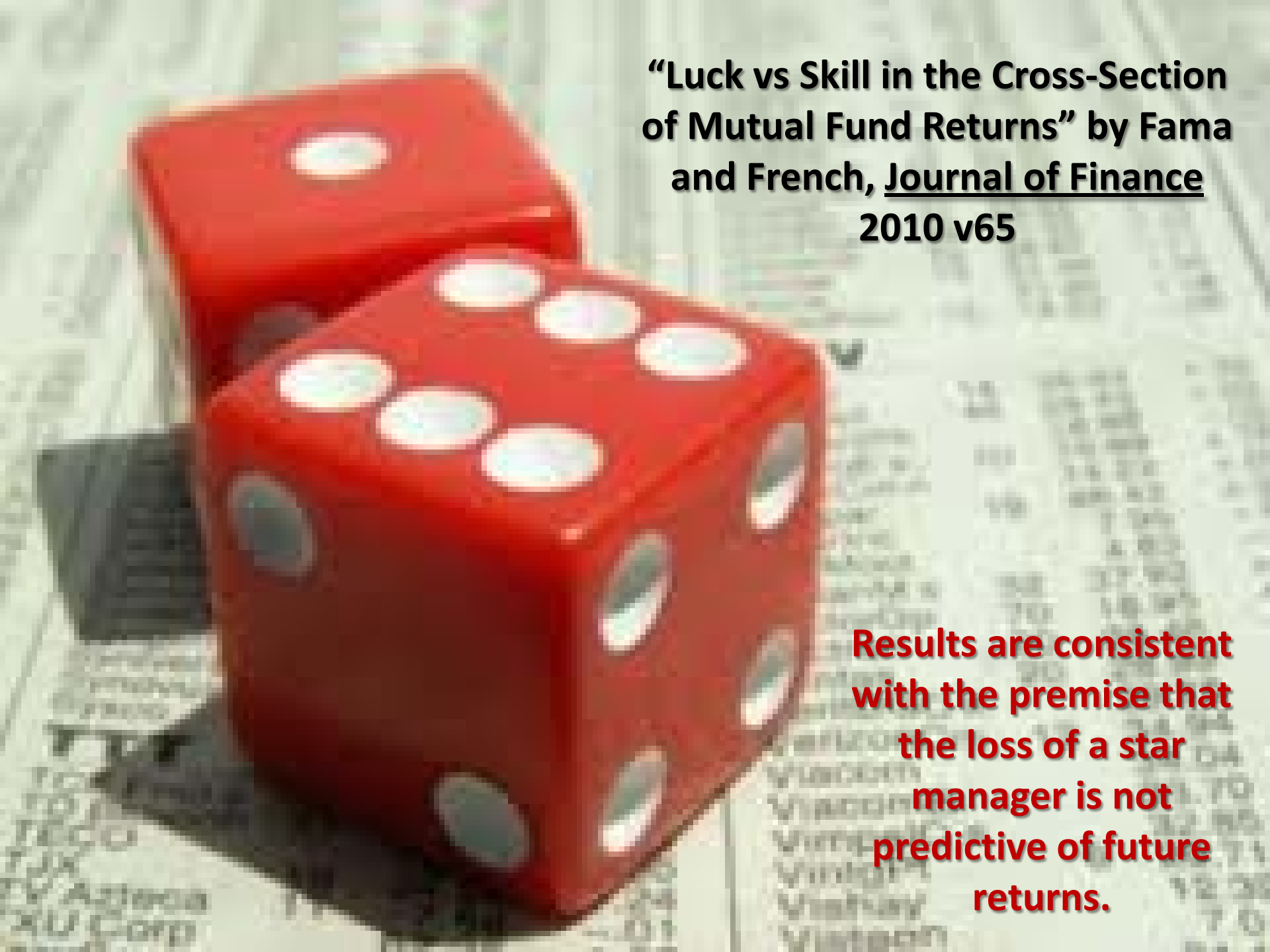
- “New Equity Funds: Marketing and Performance” by Arteaga, Ciccotello and Grant, Financial Analysts Journal, 1998 v54
 - *Concluded that due to the common practices of incubation and selective attention, new funds tend to outperform in their first year, however, performance reverts to the mean in the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

“Top management turnover: An Empirical Investigation of Mutual Fund Managers” by Khorana, Journal of Financial Economics, 1996 v40

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.)

**Stability of the
Organization**



Two red dice are shown on a wooden surface. The die in the foreground is in sharp focus, showing the top face with six white pips and the side faces with two and three white pips. The second die is behind it and is out of focus. The background is a light-colored wooden surface with vertical grain lines.

**“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.**

**“Are Some Mutual Fund Managers Better than Others?”
by Chevalier and Ellison, Journal of Finance 1999 v54**



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**

**“Liquidity, Investment Style and the Relation
Between Fund Size and Fund Performance”
by Yan, Journal of Finance, 2008 v43**

**Fund performance was linear and
inversely correlated with fund size**

**The smallest quintile of funds
outperformed**

Assets in the investment



50 million

Style Map



- Weighted Average of holdings
- 75% of fund's stock holdings

“Fund Management Changes and Equity Style Shifts” by Gallo and Lockwood, Journal of Portfolio Management 1999, v55

Funds tend to underperform prior to the shift and revert to the mean after the shift

“The Relationship Between Mutual Fund Fees and Expenses and Their Effects on Performance” by Dellva and Olson, Financial Review, 1998 v33



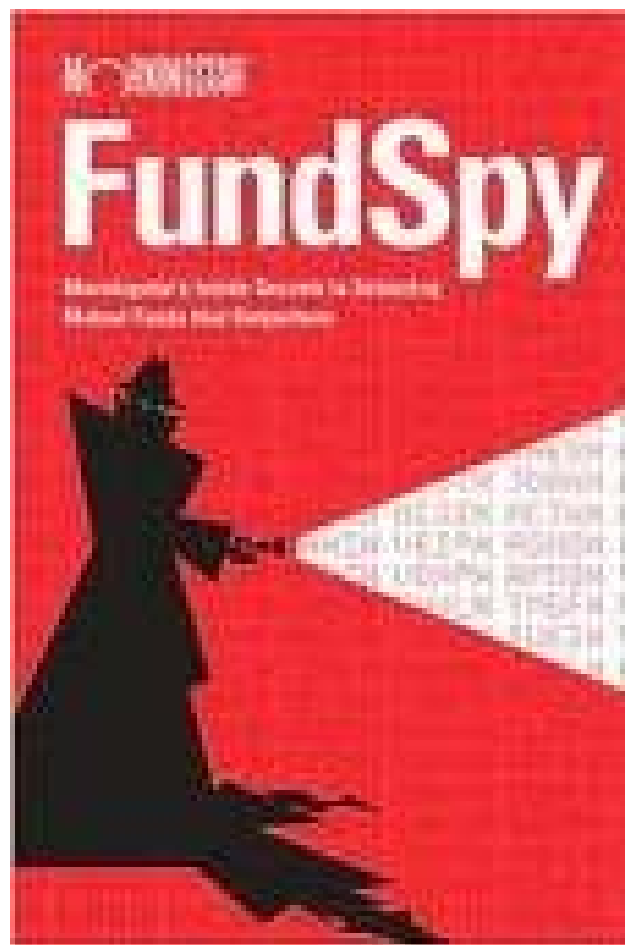
Funds with superior performance usually have lower expense ratios

**“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

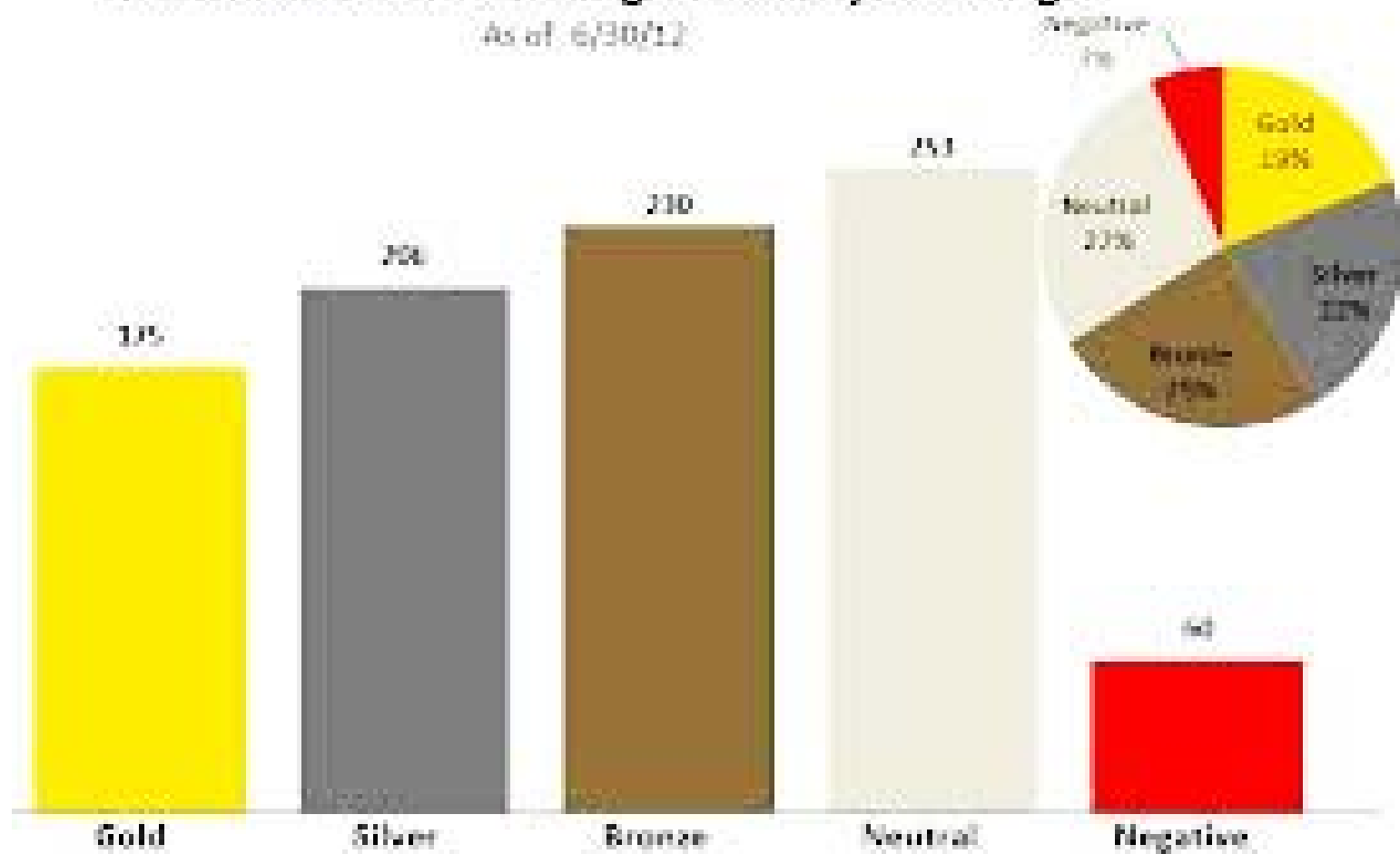
Fund Investor 500



Forward looking instead of backward looking (Star Ratings)

Distribution of Morningstar Analyst Ratings

As of 6/30/12



The Five Pillars



Process
Performance
People
Parent
Price

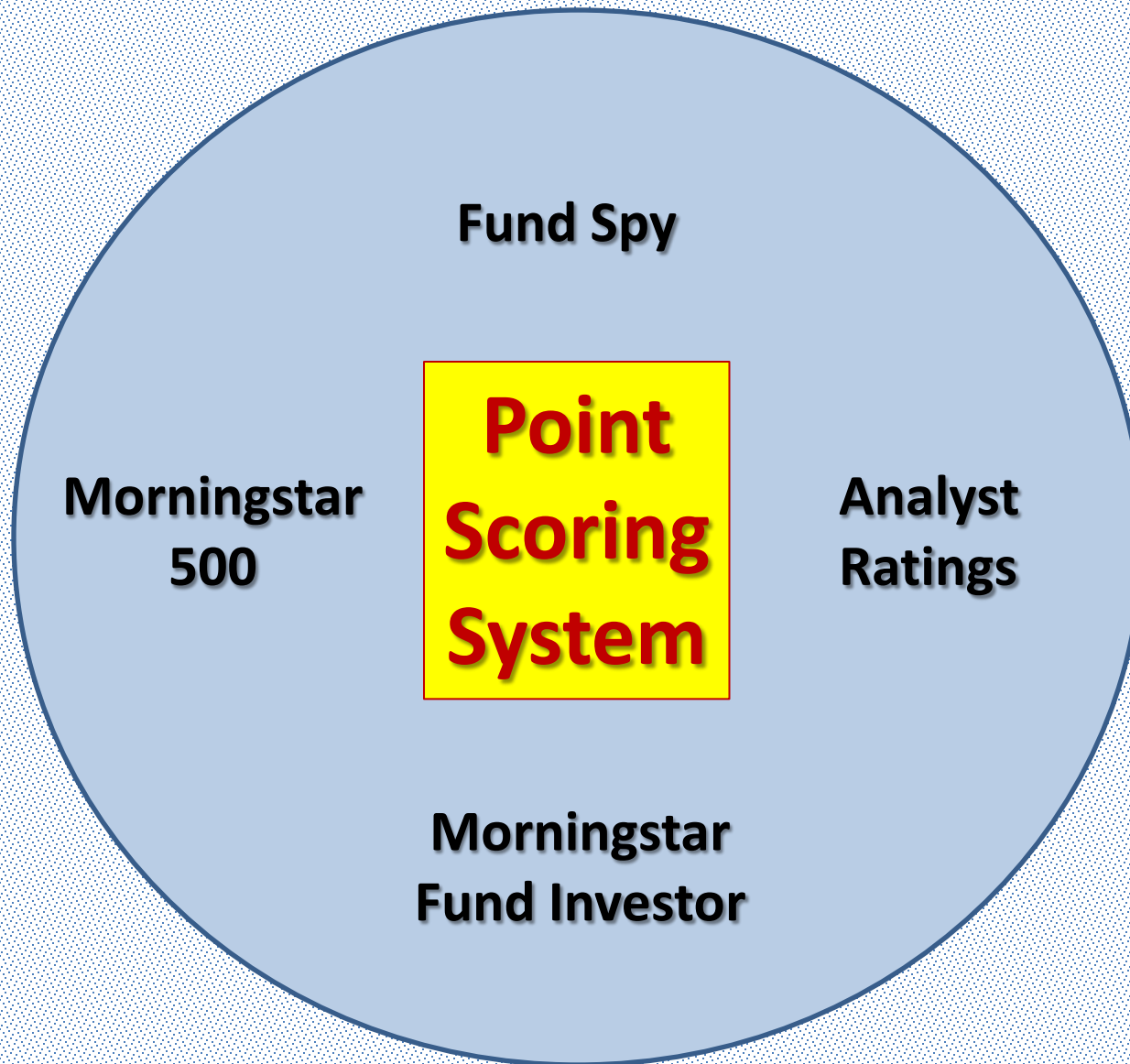
Tracking Gold-Rated Funds

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

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



Questions?

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