8 Tenets When Picking a Mutual Fund

The Retirement Group LLC
PARTNERS IN RETIREMENT

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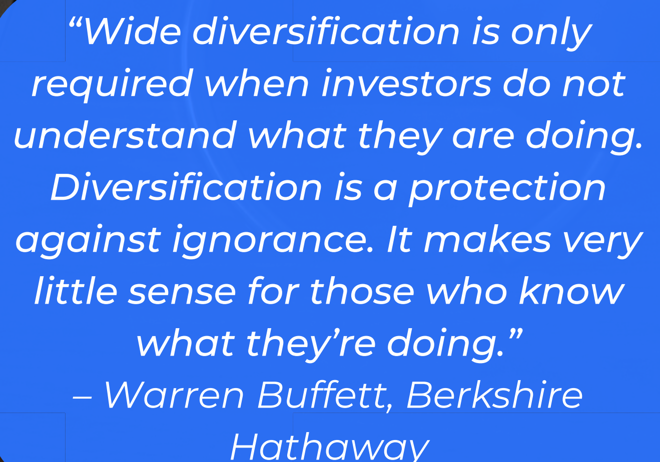
Introduction

When hiring active managers, some advisors look for the star rating on Morningstar rather than using the criteria TRG recommends. (Please read the article “Why buy Morningstar when you should be buying a Value Star”) We believe that advisors and investors should focus on active managers who skillfully allocate capital to their best investment ideas. Passive investment options are widely available to investors who want market returns with low fees. Active managers must add value and act in clients’ best interests by allocating capital to attractive investments to increase risk-adjusted returns and justify fees. We propose an alternative method to the Morningstar rating system that we believe provides structure that protects the downside while maintaining significant performance upside.



List of Criteria

We want Value managers that fit the following criteria. They are:

1. At least 10 yr performance history

2. Low expense ratios.

3. A single manager or a clear lead manager because it demonstrates ownership of fund and avoids group think

4. Manager does not over diversify and is a best idea or focus fund

5. Ability to go to cash/high cash positions - Shows that a manager can wait for better ideas if none are available and is actively searching for the best opportunities

6. Consistently low P/E ratio on holdings (ex. S&P 500 P/E = 34)

7. Managers who eat their own cooking - meaning that they have their own money invested in their fund

8. Low turnover rate - demonstrates convictions in holdings

We will briefly cover each of the 8 criteria in the next section:

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01 Long term survivability:

A minimum of 10 years of performance history gives us a long term look into how the manager performs through varying market cycles. We prefer to see at least one market crash and rebound to see how the manager reacts and makes their investment decisions.

02 Low cost of management:

We expect low cost management of the fund just like we would expect low cost management for a company. The more value that can be driven from the fund the more profitable the fund is for its managers and its shareholders. High expense ratios can be one of the biggest drags on returns (see table below), but quality managers with low turnover and high conviction may be able to achieve higher performance at a lower cost.

03 Single Vision and Responsiblity:

Single managers, or a team with a clear lead manager, are less likely to be convinced and/or moved from their originating ideals. When a lead manager makes a decision he/she alone is responsible for that decision. When a committee of managers make a decision, it is difficult to place blame or praise (identify ownership) for an investment decision. Lead managers by definition have more riding on their decisions and thus spend more time during the due diligence portion of their investment hypotheses.

		Expense Ratio				
Year	10% Gain	0.5%	1.0%	1.5%	2.0%	2.5%
0	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
1	$11,000	$10,950	$10,900	$10,850	$10,800	$10,750
2	$12,100	$11,990	$11,881	$11,775	$11,668	$11,563
3	$13,310	$13,129	$12,950	$12,780	$12,610	$12,443
4	$14,641	$14,375	$14,116	$13,874	$13,632	$13,397
5	$16,105	$15,739	$15,386	$15,064	$14,742	$14,430
6	$17,716	$17,233	$16,772	$16,360	$15,947	$15,551
7	$19,487	$18,867	$18,281	$17,769	$17,254	$16,765
8	$21,436	$20,657	$19,927	$19,304	$18,675	$18,083
9	$23,579	$22,614	$21,720	$20,973	$20,217	$19,510
10	$25,937	$24,758	$23,676	$22,791	$21,894	$21,059
11	$28,531	$27,104	$25,808	$24,770	$23,714	$22,740
12	$31,384	$29,672	$28,131	$26,925	$25,693	$24,562
13	$34,523	$32,483	$30,666	$29,273	$27,843	$26,540
14	$37,975	$35,558	$33,427	$31,828	$30,179	$28,686
15	$41,772	$38,924	$36,438	$34,611	$32,718	$31,015
16	$45,950	$42,608	$39,722	$37,643	$35,480	$33,544
17	$50,545	$46,639	$43,302	$40,946	$38,482	$36,289
18	$55,599	$51,050	$47,204	$44,544	$41,746	$39,269
19	$61,159	$55,877	$51,460	$48,464	$45,296	$42,506
20	$67,275	$61,159	$56,100	$52,736	$49,157	$46,022
$ Less		-$6,116	-$11,175	-$14,539	-$18,118	-$21,253
% Less		-9.1%	-16.6%	-21.6%	-26.9%	-31.6%

**For illustrative purposes only, not indicative of any specific investment product

04 Does not Over-diversify:

Volatility-aversion of investors and lack of in-depth research influence fund managers into creating over diversified portfolios, diluting the alpha of their best ideas. This leads to the widespread underperformance of mutual funds compared to their benchmark indices after deducting the expenses and fees. Our definition of risk, defined as "permanent capital impairment", forces us to disregard short-term volatility and focus on making the best investment decisions based on fundamental research.

> *"There is no sense diluting your best ideas or favorite situations by continuing to work your way down a list of attractive opportunities." -Joel Greenblatt, Gotham Capital*

05 Holds cash when deals are unavailable:

Good managers stay true to their ideals and hold fast when markets do not provide good investment opportunities. In elevated markets we see good value manager's portfolios increasing their cash positions. When managers cannot find good companies to re-invest their capital into, they will hold cash because they are unwilling to deviate (drift) from their investment objective. For example, some fund families will not allow their managers to go to cash mandating that they stay fully invested at all times. This may force managers to buy into companies that they don't feel as strongly about and may force them into buying a larger basket of investments. This dilutes the best ideas while their investors are often left paying a higher expense ratio due to additional trade and turnover costs.

06 Focus on finding "On Sale" companies:

Value mangers are always trying purchase companies at a price that is lower than what their intrinsic value is. One way of identifying these companies is through the Price to Earnings Multiple. A low market price in relation to a company's earnings signifies a cheaper price than if the market realized the company's intrinsic value. In a white paper by Tweedy, Browne Co, they identified that (as a group) stocks with low valuations (P/E, P/B, and P/CF) and high dividend yield consistently outperform their counterparts over the long term [3].

07 Eat their own cooking:

We place high importance on whether or not a manager has any of his/her own money invested along-side their shareholders. If the manager's compensation is only tied to the size of the fund, there is little incentive to beat the benchmark and keep costs down. In fact, a study by Morningstar found that 85% of balanced-fund managers who succeed have at least $1 million of their own money invested in their fund, versus just a 32% success rate if they hold no stake [4]. We find it hard to invest with a manager who does not believe in their own product.

08 High Level of Conviction

Low turnover signifies a high level of conviction in the positions within the fund. When a manager has low turnover he/she is not transitioning in and out of specific positions because he/she is confident in their research and investment hypothesis.

"It talked about a couple of studies, including the best-performing fund from 2000 to 2010, which was up 18% a year even when the market was flat. The average investor in that fund went in and out at the wrong times on a dollar-weighted basis to lose 11% per year. Meanwhile, the statistics for the top-quartile managers for that decade were stunning: 97% of them spent at least three of those 10 years in the bottom half of performance, 79% spent at least three years in the bottom quartile, and 47% spent at least three years in the bottom decile."

-Joel Greenblatt, in reference to his book The Big Secret for the Small Investor during an interview with Barron's.com

Our proposed alternative to the star rating system is simple, easy to use, and is based on methods that have been proven to work.

Sources

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[4] Russel Kinnel. “Why You Should Invest With Managers Who Eat Their Own Cooking.” Morningstar Advisor, 2015.

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