

Understanding Mutual Fund Strategies and Fundamental Risk

TO MAKE MUTUAL FUNDS work for you, you've got to understand their strategies and risks. Knowing a strategy enables you to properly evaluate performance, adopt reasonable expectations, and build a portfolio of funds that work together. We just discussed how looking at past returns can help you to set expectations. That's really the "what" side of the puzzle, and this is the "why."

This isn't part of the formula we'll use in picking funds, but it's a key piece of qualitative research that you need to know. I'll take you through the risks and the strategies so that you can invest wisely. You'll feel a lot more confident about your ability to invest when you can separate the deep-value strategies from the relative-value funds.

This and the following chapters will help you get a handle on the qualitative part of fund picking. When you buy a fund, you should understand what it does and be able to articulate why you bought it and why you'd sell it. One financial planner told me that when a new client brings him a portfolio, he doesn't know what he owns or why he owns it. The following chapters will help you to be sure you're not in that boat.

Fundamental Risks

All strategies have risks. After all, you don't get returns for taking on zero risk. The key is to understand them and be sure they are worth taking. Here are some key risks:

- ▶ *Concentration risk.* Funds with a high percentage of assets in their top holdings aren't necessarily riskier than other funds, but they can be. Some take on a lot of individual stock risk. For example, if a fund has a stock position over 10 percent or a few over 5 percent, it's more vulnerable to problems at an individual company than other funds would be. See Oakmark Select's (OAKLX) problems from a huge bet on Washington Mutual, for example. The fund had a 16 percent weighting in the stock when it was trading for around \$50, and it didn't get out until around \$3 or \$4 a share, just before regulators seized Wamu. Interestingly, some other funds—such as Fairholme (FAIRX), Longleaf Partners (LLPFX), and FPA Capital (FPACX)—have muted that risk by holding a big cash stake.
- ▶ *Sector risk.* Besides having a lot in a single stock, a sizable weighting in a single sector runs big risks because sometimes everything in an industry goes in the tank at the same time. When a fund has more than 30 percent in a sector, it's courting sector risk. Marsico Focus (MFOCX) has significant stock risk, but manager Tom Marsico is careful to diversify among sectors so that one industry can't take the fund down.

Conversely, a slew of growth funds, including White Oak (WOGSX) had huge technology weightings in 1999 and were barbecued when the bear market hit. More recently, Clipper's (CFIMX) 50 percent weighting in financials hurt it in the financial meltdown of 2007–2008.

- ▶ *Price risk.* When a stock is trading for a high valuation, disappointing news will spur much larger losses than one with a low valuation. Essentially high valuation means high expectations. The 2000 to 2002 bear market was all about price risk. You had some sound companies whose stocks were trading at insane valuations of 75 or 100 times earnings, as though growth were limitless. When their growth slowed, the stocks got crushed, even though they were still growing faster than most companies. The further a fund is to the right side of the Morningstar Style Box, the greater the price risk.
- ▶ *Business risk.* At the heart of every stock fund is the risk that the businesses of the stocks they own will deteriorate. Some lose their competitive advantage; others see their whole industry collapse. Managers devote a lot of energy to avoiding these situations, but it happens to even the best of them.
- ▶ *Market risk.* Stocks and bonds lose money from time to time. That's how it works, so don't fire your manager for losing money in a bear market. Rather, you need to prepare your portfolio for occasional downturns by staying long-term and diversifying.
- ▶ *Credit risk.* Bond funds with corporate bonds or emerging-markets-government bonds are taking on some risk that the bonds will default. You can see this risk in the fund portfolio's overall credit rating. Investment grade runs from BBB to AAA and government. Below BBB are junk bonds. Funds with credit risk tend to enjoy smooth sailing for a few years, and then there will be a shock to the system and credit risk will be punished for a year or two before rebounding. In fact, the fear of defaults can lead to big losses for a fund even if it doesn't suffer defaults. For example,

in 2002, the implosions of Enron and WorldCom led investors to avoid any corporate bond with any perceived weakness, and funds with large corporate bond stakes were hit hard. Most of these funds later rebounded to recoup their losses because the feared defaults didn't happen. Still, it illustrates the point that high-yield funds or any fund with a good chunk of junk bonds are suited for long-term holding periods even though we tend to think of bond funds as fit for shorter time periods.

- ▶ *Interest-rate risk.* This is the other side of bond fund risks. Interest-rate risk measures the extent to which a fund will get hit if interest rates rise. We measure this with duration. Typically, the lower the yield and the longer the maturity, the higher the interest-rate risk. Interest-rate and credit risk are sort of two sides to a teeter-totter. A junk bond fund has muted interest-rate risk because its yield compensates you for a pop in interest rates. A long-term Treasury fund has no credit risk but tons of interest-rate risk, as its low yield is little compensation when rates surge. Too many investors have made the mistake of thinking a fund with little or no credit risk has no risk at all.
- ▶ *Liquidity risk.* This is a more arcane concept, but when it does appear, it's ugly. The problem happens when a fund manager finds she can't sell her holdings easily and quickly. A fund with losses can slip into a terrible downward spiral if its holdings are so illiquid that its losses spur redemptions and then the redemptions spur more losses because the fund manager has to sell securities at fire-sale prices, and the cycle gains steam. In March 2008, you could see this happening at Schwab Yield-Plus (SWYPX), because its net asset value fell every single day, even when similar bond funds were up. The scary thing is that the fund's holdings were once quite liquid, but the market dried up.
- ▶ *Emerging-markets risk.* Emerging markets have outsized returns and outsized losses because they are based on rickety economies that work well in some environments but can fall apart in others. Every emerging

market has been through brutal sell-offs. The risks are special because emerging markets tend to have less dependable rule of law where governments can seize company assets. Consider what the Russian and Venezuelan governments have done to oil companies that they don't like. Other times, we've seen emerging markets collapse because they were too dependent on outside financing, and once that money started to run away it had a domino effect.

- ▶ *Currency risk.* As I'm writing this, it doesn't feel like a risk from here in the heart of the United States. Currency risk means that if you have money in foreign currencies and they fall against the dollar, you lose money. Lately, the dollar has been pummeled and that has been a boon to foreign-stock and foreign-bond funds, most of which don't hedge their currency exposure. Still there are other times when the dollar has risen and taken a bite out of foreign-stock investors' returns. Before you invest in a foreign fund, find out if it hedges its currency exposure so you'll know what to expect.

Key Stock Fund Strategies

Now let's talk about strategies. When you read a description of a strategy or listen to a manager, pay particular attention to selling criteria. Depending on your personality and investing background, some strategies will sound clever and some will sound a little crazy. I have my own biases, but I've been watching long enough to know that most strategies have their merits and none are foolproof. Even the best strategies can be screwed up.

Likewise, every strategy is going to have ups and downs. The markets rotate favor among different strategies and sectors and no manager is immune to a down year or two. From Warren Buffett to Peter Lynch to Michael Price to the best team-managed funds at American and Dodge & Cox, you can find years when they were in the red or lagged the market by a wide margin. That's usually the best time to buy.

Regardless of the strategy, there are a few things to look for in every case. You want managers that stick to their guns and do not chase what's trendy at the moment. Yet you want them to remain diligent and keep an eye out for fundamental changes. The same goes for fund companies. Whenever value managers start getting fired and replaced with growth managers, you know value is about to have a great run, and vice versa. In short, you want discipline. If a fund is supposed to buy companies with accelerating earnings but it buys a distressed stock with declining earnings, it may be time to head for the exit. In addition, you want to see the manager excel at executing that strategy. If deep-value funds are having a great run but yours isn't keeping up with its peers, you should take a close look at whether there's a good reason for that.

For example, I was optimistic that Bob Stansky could do well at Fidelity Magellan (FMAGX) with his contrarian growth strategy. It wasn't on our recommended list, but I thought it was a pretty good fund. Essentially, the fund was so big that Stansky aimed to go against the flow on growth, so that he was buying when others wanted to sell. Thus, the fund's footprint would be fairly small. So, I was tolerant of weak returns from 2000 to 2002 because growth stocks were getting crushed and the fund was only a little off the pace of other growth funds. In addition, he had made a smart move into tech during a previous sell-off. But then in 2003, tech stocks were so cheap that they had a big rally, and Magellan was nowhere to be found. Stansky missed the boat, and that's when it was clear things were not working at Magellan.

Every manager will make mistakes, but if the manager makes a bunch of mistakes in an area that is supposed to be his expertise, that's a problem. If a fund's calling card is in-depth accounting analysis so that the managers know a company's balance sheet and business better than the rest, I'm going to worry if some major holdings have accounting scandals. Janus was supposed to be a fundamentals-driven growth shop, but it lost its shirt on Enron. Janus managers were buying near the top, which means not only

did they miss the accounting tricks but also they looked at Enron's rapid growth rate and its huge P/E and said it could grow even faster to justify that huge valuation. They showed poor judgment in evaluating management, in understanding valuation, and in assessing risk.

It's also worth asking if the fund's past success can be repeated. When a strategy is working well, it often attracts lots of imitators who go after similar stocks and drive down the returns of the strategy. To get a fund with staying power, you need to find one that can do something better than others. Usually, that means something that is difficult or expensive to replicate. For example, Dodge & Cox, Wellington, and American Funds do better fundamental research than other big fund companies because they have a huge number of smart, experienced analysts who take ownership of their contributions to the firm. Everyone knows that and would like to be like them but it takes a ton of money and about 30 years to get there. Or in other cases, managers have developed a complex strategy that isn't easily imitated. That's what you want.

A Guide to Top Stock Fund Strategies

Let's take a look at some of the most important schools of thought on stock investing. I'll tell you some of the key adherents, the basics of the strategy, the usual sector biases, and the finer points of sell strategies. Some of these strategies are closely associated with a founding father, while others came from a few different investors, so I've labeled the latter with clear genealogy after the founding father.

Ben Graham's Deep-Value School

Ben Graham cut his teeth in the Depression when fundamental analysis was an unusual thing. So, he was focused on protecting against losses and found there was a lot of safety in buying very cheap stocks where you got something for almost nothing. A company with an asset such as land or

cash worth \$100 million whose market capitalization valued it at only \$25 million was a good bet in Graham's eyes. Thus, buying a really undervalued, crummy company could be much safer than buying an apparently strong company whose shares could fall sharply just with a mildly disappointing earnings report. The catch today is that it's easy to run screens for some of those bargains so that they tend not to last. In addition, some of those deep-value stocks are cheap for a good reason, and therefore may not have the upside of better companies.

Typically, deep-value managers are buying industries when things look bleak and betting on a return to past norms. Thus, a deep-value stock doesn't have to transform into the greatest company in America to be a winner. At one of Morningstar's annual investment conferences, Jim Barrow said he hated many of the companies he owned. To make money, Barrow has to be able to figure out which companies are so poorly run (or inclined to cook the books) that management will run the company into the ground from those companies that have mediocre managers who won't miss the layoffs that come their way when the industry's fortunes turn for the better.

Nonetheless, this is a strategy that generally protects the downside pretty well, at the cost of some returns. Some of the best funds in this group have low-risk but marketlike returns. That sounds boring, but in down markets it can be beautiful, and over the long haul it can win. Many academic studies have found that value stocks outperform growth stocks over the long haul, although I wouldn't assume that it's guaranteed to be true over your particular investment horizon because what's in favor tends to rotate from year to year.

Selling

Most deep-value managers are patient, low-turnover investors, but when a stock rallies, they typically sell in order to keep price risk in check. Some, like Bob Rodriguez of FPA funds, are more willing to let their winners ride,

and will hold stocks even as they move into the growth side of the Morningstar Style Box.

Risk

Business risk is a key risk. Managers' greatest fear is called a *value trap*. That refers to stocks that look like values based on their price relative to past earnings but the catch is that those earnings are going to continue to shrink rather than rebound. Low prices provide some margin for error, but if the business is a dud, it's still a bad investment. Think about airline stocks. One manager once quipped that it would be worth the money to pay someone full-time to remind him never to buy airline stocks. They often look cheap, but the industry's cutthroat pricing has made airline stocks a horrible investment.

Practitioners

These are Tweedy, Browne; Barrow Hanley (Vanguard Windsor II, VWNFX); Wellington's Philadelphia branch (Vanguard Windsor, VWNDX); Oakmark, except Bill Nygren; Charlie Dreifus (Royce Special, RYSEX); Bob Rodriguez of FPA, FPACX; John Rogers of Ariel, CAAPX; and Southeastern Asset Management (Longleaf, LLPFX).

Momentum Investing

This is the polar opposite of deep-value investing. Stocks that rise sharply have a tendency to continue rising for a while. In addition, companies whose earnings beat Wall Street quarterly earnings estimates tend to beat them the next quarter. These key observations are at the heart of momentum strategies.

The study of behavioral finance provides an explanation for why this works, even though it sounds kind of silly. Researchers have found that people consistently underestimate change in the investment world and elsewhere.

Say a company has a hot new product, and you expected profit margins to be 50 percent and earnings growth to be 15 percent. Instead, the company

reports margins of 60 percent and profit growth of 20 percent, and the stock takes off. So, you might split the difference and boost your expectations to 55 percent and 18 percent for the next quarter, but instead you see 65 percent margins and 22 percent growth, and the momentum investors get a quick reward. Next, that hot product starts to cool off (see what happened to Motorola and the RAZR phone), and the trends worsen much faster than investors expected. The momentum investor gets out quickly, though not at the top because they waited until the first round of bad news came out.

Momentum managers are in a constant arms race. Lots of hedge funds, mutual funds, and day traders are testing out new wrinkles in momentum. Once something works, others pick up on it and the advantage is quickly squandered. In fact, some momentum models stop working as soon as they go from backtesting to the real world, so fickle is the world of momentum.

Watch how a fund sells stocks for a clue as to whether it's a momentum fund. Do stocks get tossed for even minor disappointments or fear of a minor disappointment? I once moderated a panel of growth managers and I asked them what they would do if they expected a holding to miss the next quarter's earnings estimates by one penny per share. The two growth-at-a-reasonable-price managers said they'd hold on, but Brandywine's Foster Friess said he'd dump it and look for something better. That's momentum in a nutshell.

Risk

Momentum can deliver big returns quickly, but man, is it risky. The reason is that these funds are loaded with price risk. When a momentum stock disappoints, it gets absolutely crushed. If you look at the track records of momentum funds, you'll see a wild mix of huge gains and big losses. So you either have to have great timing or a high pain threshold to make any money in them.

Practitioners

The Stowers of American Century were among the pioneers of this practice, and most of American Century's growth funds still have momentum components. Other prominent examples are Turner funds (Vanguard Growth Equity, VGEQX, Turner Mid Growth, TMGFX); Brandywine, BRWIX; and John Bogle Jr., BOGLX.

Valuation-Sensitive Growth

Looking for companies that are well run, growing at a healthy rate, and trading for less than the value of their businesses is hardly a novel concept. Scores of funds do some variation on this theme. Only a few do it really well. These sorts of stocks are the easiest ones for funds and brokers alike to sell their clients on, and they are researched heavily. The key is to find managers who dig deeper than the rest and have shown some skill at staying ahead of the curve despite the fact that the whole world is watching the same stocks.

The strategy is less risky than momentum, and in general, you get market-like downside. The only time I can recall these funds really getting hammered was from 2000 to 2002, when there were no growth stocks available at reasonable prices so that you had an unusual level of price risk in the stocks. Here are the characteristics of valuation-sensitive growth funds:

Risk

You get a little price risk and business risk here, but nothing extreme.

Selling

As you'd expect from this Goldilocksian strategy, some stocks should be sold because they are too hot and others because they are too cold. By that, I mean that some have rallied to where valuations are too pricey and others get tossed due to declining fundamentals.

Practitioners

Janus, T. Rowe Price, Fidelity, Putnam, American, MFS, Primecap, Ron Baron, Columbia Acorn, and Montag & Caldwell are among the many who have some funds that invest this way.

Black Box/Quantitative Strategies

Is it a good strategy to buy stocks with price momentum, low price/book, high levels of debt, CEOs near retirement age, and twice the volatility of the S&P 500? I have no idea, but you can be sure that someone has tested it, and if it worked in backtesting they are running it now. Companies have to report a tremendous amount of information to the investing public, and today there are legions of smart programmers armed with enormous computing power to crunch the data almost instantaneously. In fact, some funds are run using scores of models complete with another model to adjust the weightings of the other models based on how well they are performing. Quantitative strategies have to constantly evolve to keep ahead of the competition.

Quantitative managers don't like to reveal exactly what's in their models for fear that a competitor will use it. That makes such funds challenging for investors to use: You have to take a lot on faith. Some funds will at least tell you what part of the Style Box they aim to invest in, but they won't tell you their inputs, so when evaluating the fund, we have to place more emphasis on past performance than we're normally comfortable with.

When you're shopping for a quantitative fund, don't forget about the manager. Because the models need constant updating, quant-managed funds are just as likely as other funds to suffer declining performance when a manager leaves. Humans might not send in the trades at a quant fund, but they are responsible for adjusting the strategy. When longtime manager Chuck Albers left Guardian Park Avenue, the fund became mediocre rather quickly. Here are the characteristics of quant funds.

Risk

Quant strategies can go anywhere from value to growth, so the risks vary. However, there is one risk that really clobbers quantitative strategies across the board: Market shocks make beautiful quant models look really bad. The strategies are largely based on the idea that the past has some predictive value. They look at a company's past earnings and project trends, but sometimes the markets react faster than a model can. For example, quants had a tough go of it in 2007 and 2008 when oil prices exploded and financial giants melted down overnight. The spike was awful news for industries like airlines and autos and great news for oil companies and other energy companies. Traders quickly made back-of-the-envelope calculations on what each spike meant for those industries, but quantitative models were still going off past data. These data failed to reflect the current situation so that even flawed adjustments by humans were superior to programs using stale data. Making matters worse, the fact that hundreds of hedge funds use quant strategies meant that when leveraged hedge funds got squeezed, they were forced to sell en masse, and many quant mutual funds with similar holdings took it on the chin.

Practitioners

Some of the top quant managers are John Montgomery of Bridgeway, John Bogle Jr., Fidelity Disciplined Equity (FDEQX), and some American Century funds.

Warren Buffett: Great Companies at Fair Prices

Warren Buffett is probably the greatest investor in history, so it's kind of surprising that the number of managers trying to emulate Buffett is fairly small. Buffett began as a Ben Graham disciple, but his strategy evolved to tolerate paying a slightly higher price in exchange for a better company. In Buffett's words, he'd rather pay a fair price for a great company than a great

price for a fair company. The reason is that a great company is a wise steward of its cash and can compound its earnings at a powerful rate over many years. That compounding will result in good long-term stock performance, provided you didn't pay too much to get the stock.

Buffett values a company based on the value of future cash flows and the barriers to entry, or *moats*, that keep competitors from doing the same thing. Two other key tenets are valuable whether you want to emulate the rest of his philosophy or not. First, you don't get many chances to buy great companies at fair prices and the damage from buying poor ones can be severe, so be patient and wait for the chance, no matter how long it takes. (He likes to say that unlike a baseball player, you can take as many pitches as you want until you find one you want to hit.) Second, he invests only in things he understands, so Dairy Queen, Coca-Cola, and GEICO qualify, and tech companies don't.

Selling

True Buffett followers sell only in extreme cases, such as when valuations get to sky-high levels or they simply acknowledge that they blew the call on fundamentals. Fund company executives and shareholders alike aren't always that patient. They want results now, and some managers find it hard to follow a strategy where success is measured in increments no smaller than a decade, while others are measuring quarters and years.

Risk

Buffett, and most who emulate him, courts a lot of concentration risk. Just one stock can really take a bite out of returns. Buffett argues that over the long haul, this concentration actually reduces risk because he's putting money into only the most attractive investments that should pay off over the long haul. That's true, but you have to be patient and also recognize that investing like Buffett isn't the same as investing as well as Buffett. There's only one Michael Jordan, and there's only one Warren Buffett.

Practitioners

Among the Buffett followers are Sequoia fund (SEQUX), which has long ties to Buffett, Chris Davis and Ken Feinberg of Davis/Selected and Clipper funds; Bruce Berkowitz of Fairholme Fund (FAIRX); Oak Value (OAKVX); Faye Sarofim of Dreyfus Appreciation (DGAGX); and Mario Gabelli, Wally Weitz, and Bill Nygren of Oakmark (OAKMX). And of course, you can buy shares of Berkshire Hathaway and invest with the Oracle himself.

Peter Lynch: Buy Stocks That Go Up

The Fidelity school comes in many variations, but it really just comes down to buying stocks that go up. The firm has an army of analysts who uncover information that might not be reflected in stock prices. Some managers simply buy whatever stock has good prospects or has good news that is not priced in, regardless of whether it's a value or a growth stock. Essentially they want to invest anywhere they have information that the market does not. Maybe an analyst has found a pharmaceutical company with a promising drug that's misunderstood by the Street or maybe another portfolio manager sees signs that a bank's CEO is close to retirement and may be inclined to accept a merger proposal.

Risk

Like the strategy, the risks are all over the map depending on how each manager invests. Besides the usual stock fund risks like price risk and business risk, there's the risk that a manager will rotate out of a sector at the wrong time or the fund will end up with a lot of overlapping holdings with other investments in your portfolio.

Practitioners

Peter Lynch is one of the most influential managers at Fidelity, even though he has been retired for about 15 years. Today, managers like Will Danoff,

Joel Tillinghast, and Fergus Shiel have done a fine job of making this strategy work, although many more at Fidelity have produced mediocre results trying to do the same.

Vulture Investing

You could make a case for putting Marty Whitman and the rest of Third Avenue Value Funds in the Ben Graham camp, except that Whitman says Graham was wrong. So, Whitman and Third Avenue get their own little group. I'll include Michael Price disciples Mutual Series and David Winters, too, due to their vulture leanings. The strategy is to find super-cheap stocks—even distressed securities—that are so cheap that there is little downside. Most cheap and distressed stocks are in that state because they are awful, so it takes a lot of expertise and legwork to find the handful of good stocks that can be rehabilitated. The biggest difference with most Graham disciples is that Whitman buys companies that are near bankrupt or even buys the debt of those that are bankrupt. I like the approach because almost no one tries to do it. That's partly because it takes a lot of effort and partly because big fund companies don't want to have to explain to shareholders why they own shares of companies teetering on bankruptcy.

Risk

When a vulture investor is wrong, a holding often goes bankrupt. In addition, the strategy tends to have a fair amount of sector risk because adherents don't attempt to look like the market. On the plus side, price risk is minimal.

Selling

"We're not so sure how good we are at selling," Whitman once told me. As a result, he doesn't do much of it. He tends to hold until valuations get really high. He'll happily sit on a stock that could take years before its value is unlocked.

Practitioners

Third Avenue, Mutual Series, and David Winters (Wintergreen Fund, WGRNX) are included in this investing strategy.

Indexing

Indexing is all about costs. Index funds save money on two fronts. First, they don't have to pay for research, and second, they usually pay very little in trading costs because indexes are pretty stable. By paying less, you generally get better returns in the end. On average, an index fund will beat two thirds of its actively managed peers in a year but over time it can do a little better than that as the advantage compounds.

Indexing boasts a couple of other advantages. Index funds are very low-maintenance because you don't have to worry about manager changes or strategy changes. You can buy an index fund and forget it for a decade. Second, the low turnover of index funds means funds typically don't realize much in the way of capital gains, so they make good investments in taxable accounts.

When you are shopping for an index fund, look for three things: low expense ratios, low trading costs, and broad diversification. Many index funds don't offer all three, so be choosy just as you would with an actively managed fund.

Risk

Needless to say, you have lots of market risk and little concentration risk, unless you buy a sector index fund. So, the biggest risk is that the whole market is out of whack. For example, in 1999, the S&P 500 was a poor investment because tremendous speculation in large-cap tech stocks made the whole index rather pricey and tech-heavy. Fortunately, that doesn't happen too often.

Practitioners

The four best index players are Vanguard, Fidelity, Barclays (through its iShares ETFs), and DFA. Vanguard has the broadest lineup, and all funds boast low cost. Fidelity has four index funds that it is providing at expense ratios below costs. These four, which charge 0.10 percent, are the best deal going, provided you are investing between \$10,000 and \$100,000. They are Fidelity Spartan Total Market (FSTMX), Fidelity Spartan S&P 500 (FSMKX), Fidelity Spartan Extended Market (FSEMEX), and Fidelity Spartan International Index (FSIIX). Above or below those investment levels, and Vanguard is the answer.

DFA is a special case. Its funds are passive, but technically are not index funds because they don't aim to precisely track an index. This flexibility enables DFA to lower trading costs to the point where it actually makes a profit on trades by being a provider of liquidity and putting the bid/ask spread to work for them. This is why DFA's small-cap indexes are the best around. The catch is that they are generally available only through planners who use index funds in virtually all of their portfolios. You can't just walk in to your Schwab or Smith Barney office and buy a DFA fund.

Top-Down and Bottom-Up

If you hear about a fund that's going to cleverly capitalize on major trends like the aging of America, run away. Most of these trend followers are terrible, in part because everyone knows about those trends. However, a few have actually succeeded at blending macroeconomic and industry analysis with individual stock selection. You can find that combination in a value or growth strategy, but it's more common in growth. Tom Marsico has done it brilliantly in his large-growth funds for 20 years. He adjusts sector weights based on his view about whether an industry has the wind at its back or in its face. That has led to timely shifts out of harm's way, but he backs it up with strong stock picking. Conversely, I've seen lots of thematic

funds come out with lots of fanfare and then whimper off. AIM Dent Demographic's goal was to capitalize on big demographic trends, only it seemed more behind the curve than ahead of it.

Risk

You have market and sector risk. When a manager makes a good macro call you get startling results, and when the call is bad, the fund can be in last place. Even the great ones goof it up on occasion. Be sure to look for a long track record of successful execution and the ability to pick stocks well after the managers have identified the right trends.

Selling

Because there are a variety of ways to execute this strategy, the sell criteria won't be a dead giveaway. However, it will help you to see where on the value and growth spectrum the fund fits. That is to say, funds in this strategy usually also employ some selection discipline similar to one of the strategies explained previously. Beyond that, though, the funds' managers may also sell simply because they think a sector's run is over. For example, they might think that a slowing economy will hurt oil prices, leading them to sell all their energy stocks at the same time.

Practitioners

Some of the best at this game are Tom Marsico and others at Marsico funds, the international stock team at Julius Baer, and Oppenheimer's international group.

Top 10 Who Blend Top-Down with Bottom-Up

1. Tom Marsico, Marsico Focus (MFOCX)
2. Pell/Younes, Artio International Equity II (JETAX)

(Continued)

3. Ken Heebner, CGM Focus (CGMFX)
4. Dennis Stattman, Blackrock Global Allocation (MDLOX)
5. Oliver Kratz, DWS Global Thematic (SCOBX)
6. Bill Gross, PIMCO Total Return (PTTRX)
7. Dan Fuss, Loomis Sayles Bond (LSBRX)
8. Mark Yockey, Artisan International (ARTIX)
9. Bob Rodriguez, FPA Capital (FFPTX) and FPA New Income (FPNIX)
10. Steve Romick, FPA Crescent (FPACX)

Measuring Volatility

Now that we've looked at fundamental risks and strategies, let's review a more basic take on risk: volatility.

The handy thing about volatility is that you can measure it precisely and update it daily or monthly. Standard deviation tells you how much a fund moves either up or down. For example, an investor can compare two funds with the same average annual return of 10 percent, but with different standard deviations. The first fund has a standard deviation of 2.0, which means that 67 percent of the time its returns for the past 36 months have been between 8 percent and 12 percent. On the other hand, assume that the second fund has a standard deviation of 10.0 for the same period. This higher deviation indicates that 67 percent of the time this fund experienced returns between 0 percent and 20 percent. With the second fund, an investor might expect greater volatility.

Morningstar Risk is a similar measure, but it penalizes downside risk a bit more and is relative to a peer group. Specifically, it uses something

called the *utility function*, which is based on the premise that investors would trade a little return potential for safety. It measures past performance over the trailing 3-, 5-, and 10-year periods.

Beta is a trickier one. It tells you about volatility relative to an index. By definition, the beta of the benchmark (in this case, an index) is 1.00. Accordingly, a fund with a 1.10 beta has performed 10 percent better than its benchmark index—after deducting the T-bill rate—than the index in up markets and 10 percent worse in down markets, assuming all other factors remain constant. Conversely, a beta of 0.85 indicates that the fund has performed 15 percent worse than the index in up markets and 15 percent better in down markets. The tricky part is that a low beta does not imply that the fund has a low level of volatility; rather, a low beta means only that the funds' market-related risk is low. In addition, betas change over time.

Putting Volatility Measures to Use

Because portfolio risk is the most important lens, I wouldn't rule out a fund just because its standard deviation is over a certain level. What's risky on an individual fund level might provide diversification that lowers risk for the portfolio as a whole. However, within a category where diversification values are similar, it makes sense to avoid those that earn a Morningstar Risk score of High—the top 10 percent—because you don't need to go to extremes, and investors have a hard time holding on to high-risk funds for the long haul.

FAQs

Q. Do fundamental managers employ quantitative screens?

A. Yes. Although I separated the pure quants, nearly every fund runs some screens and uses quantitative tools in other ways.

Q. How do you see what a fund is selling?

A. You can look at a fund's portfolio on www.morningstar.com and look for the stocks with the minus symbols next to their names. In addition, shareholder reports typically show stock sales and occasionally managers will explain why they sold a stock.

Q. Why do funds' turnover rates vary so widely?

A. Some managers use trading systems to move rapidly or will trade around a position as a stock moves up and down. Others say they are not good at selling and tend to hold on nearly forever.

Q. Should I own more than one fund with the same basic strategy?

A. You can, but be careful, because the funds may well move in unison. I'd suggest looking for funds that at least have some variations in the same strategy or possibly favor different sectors.

Q. How do I judge the risks of a new fund?

A. This is a time to lean heavily on the fundamental risk side. You may not have much to go on with volatility measures, but you can at least examine the portfolio and consider the risks. You could also look for a fund with a long track record and similar strategy to see what its downside was.

Conclusion

Diversification and a long-term time horizon mean it's okay to take on some risk. After all, you can't make money without doing so. You need to be smart about it, though. If you understand a fund's strategy and the portfolio, the fundamental risks should be clear. When you put funds together in a portfolio, consider how they will work together. Which will move in the same direction and which won't? Think about whether there are similar risks running through your portfolio. Do all your bond

funds have lots of credit risk because you focused too much on yield? Do most of your stock funds have a bias toward one sector because that sector was hot when you chose your funds?

The value in thinking about fundamental risk is that it points out risks that might not be apparent in recent returns. A high-yield fund can go for years enjoying great returns, and then every once in a while it gets smacked as defaults surge. Knowing the risks will also help you to assess your funds when those risks do come home to roost.

As for volatility, avoid funds that have High Morningstar Risk or extreme risks. Make sure your time horizon matches the risk level. And remember that your investments are for the long term, so when one fund prints red ink you won't bail and miss the upside. For shorter-term needs such as expenditures in the next three years, use a money market account so that you won't have to worry about losing money in the short run. When you think about risks as well as returns, you're setting yourself up to navigate the right course through good markets and rough ones.

