



What Should a Truly Objective Investment Review Include?

ADEQUATELY EVALUATING AN INVESTMENT FUND involves more than rudimentary steps. Solely comparing its past results to a market index or simply reviewing the fund's Morningstar Rating isn't sufficient. Such cursory evaluations fail to understand the fundamentals driving performance. Therefore, they don't meet the standards for prudent, diligent decision-making.

An ideal fund assessment involves determining and analyzing certain criteria. To simplify this process for you, we've outlined our recommended method below, which incorporates both qualitative and quantitative elements.

Qualitative

This portion of the analysis involves understanding the players, categorizing the fund, and evaluating the fees.

Step One

Understand the people involved, as they often drive the long-term potential for success. This is imperative when evaluating past performance with respect to investment philosophy, strategy and style. Many answers to these questions can be elicited from the fund prospectus or web site. Questions that should be answered include:

- Is the fund team managed or individually managed?
- Is there a lead manager who makes the final investment decisions?

- In the case of a team-managed fund, how does the group decide what investments flow in and out of the portfolio?
- How long has the manager been managing money using the specific strategy or style you're evaluating?
- Are the fund managers partners or equity owners?
- How long have they been with the firm?
- What is their educational background?

Step Two

Categorize the fund by asset type, strategy and style. Start by looking at the fund's investment objectives, which are delineated in the prospectus. With respect to strategy, most funds are broadly diversified, however, some are more concentrated in fewer

stocks. The valuation focus appears in the prospectus' "Strategy" section.

Here's a sample excerpt from a mutual fund prospectus, with key points highlighted:

The ABC Stock Fund

Objectives

The Fund seeks long-term growth of principal and income. A secondary objective is to achieve a reasonable current income.

Strategy

The Fund invests primarily in a broadly diversified portfolio of common stocks. In selecting investments, the Fund invests in companies that, in ABC's opinion, appear to be temporarily undervalued by the stock market but have a favorable outlook for long-term growth. The Fund focuses on the underlying financial condition and prospects of individual companies, including future earnings, cash flow and dividends. Various other factors, including financial strength, economic condition, competitive advantage, quality of the business franchise and the reputation, experience and competence of a company's management are weighed against valuation in selecting individual securities . . .

An objective that reads "long-term growth of principal" as above indicates an equity (stock ownership) as opposed to debt (bond) investment. A secondary objective of "current income" means that the fund buys stocks that pay dividends. "Temporarily undervalued" means that the fund takes a fundamental (or 'buy-and-hold') approach, as opposed to a technical or market-timed approach. These stocks are often represented at least in part by relatively low P/E ratios in relation to their expected "long-term growth."

Step Three

Evaluate and understand fund fees [Bidart & Ross, Inc. categories fees under the qualitative rather than quantitative section because we believe that they reflect an important dimension of the firm's investment philosophy].

The pressure on fiduciaries to properly evaluate and minimize fees has never been greater. To determine a fund's fees, review the fund prospectus: it contains critical and detailed fund expense information. Because many fund companies offer multiple share classes for the same fund, it's imperative that a plan sponsor evaluate any institutional- or retirement-priced share class for eligibility. Remember, a qualified retirement plan should never purchase shares with front- or back-end loads or commissions.

Once the fees are identified, the fiduciary must ensure they are appropriate and reasonable for the asset class. The table below shows the median fund expenses for several asset categories, for general comparison:

Median Fund Expenses by Asset Class					
Non-U.S. Equity	Small Cap Equity	Core Equity	Balanced	Core Bond	Stable Value
1.47%	1.36%	1.29%	1.15%	0.93%	.35%

Other qualitative aspects to consider may include the following (it's acceptable to inquire about these from the fund representative directly if the information isn't otherwise available):

- The firm's reputation
- The company's overall size
- The number and value of assets they manage
- Any turnover in key personnel
- Any pending or historic legal actions from shareholders or regulators



Quantitative

In this part of the evaluation, a fund's performance, portfolio structure and risk attributes are measured using numbers. Keep in mind two important considerations when using quantitative analysis:

- All comparisons must be “apples to apples.” For example, an evaluation of a large company growth stock fund should not use a mid-company stock fund as a benchmark for comparing the fund's performance and portfolio characteristics
- All data should typically be analyzed for multiple time periods, to eliminate any potential time-period bias inherent to the data.

The following are our recommended tools for measuring fund performance and history. We believe that the employment of these metrics constitutes due diligence.

Relative Performance Comparisons

Start by comparing the fund's returns over cumulative and consecutive time periods to an acceptable benchmark. Then rank the fund against a peer group of similarly managed funds. We also suggest using a broad market benchmark that's indicative of asset class, such as the S&P 500 Index for stock funds. Denote each fund's selected market benchmarks and peer group universe in your plan in your written investment guidelines. Further, consider specifically mentioning within your guidelines that the fund performance evaluation should focus on longer-term results and year-to-year consistency.

Quarterly Over- and Under-performance Comparisons

Compare your fund manager's quarterly returns to the appropriate benchmarks, as far back as three to five years. By doing so, you'll be able to determine whether the fund consistently outperformed or underperformed the benchmarks, and for what time period. This can provide a rational starting point for further evaluation of the fund and an objective discussion of its place within your portfolio, as necessary.

Portfolio Asset Allocation

Determine where the fund's assets are allocated. This will help you confirm that your assets are working for you as expected; help you understand why they may be earning any outsized returns; and make you aware of any unexpected risk exposure the assets may have. For example, mutual funds often hold some proportion of assets as cash, which is essentially non-working money. They may also hold other unexpected assets, such as foreign equities in

a so-called US stock fund or convertible securities in a bond fund.

Fund Size

Monitor the fund's total assets. This is important because significant increases in assets can hinder certain investment strategies. For example, micro-cap funds which become too large have a more difficult time finding appropriate investments which are consistent with their strategy, and may be forced to either begin to invest in larger-cap companies, or to hold too large a proportion of their assets as non-working cash, both of which can alter that fund's returns as well as its justification for inclusion in your portfolio.

Remember, a qualified retirement plan should never purchase shares with front- or back-end loads or commissions.



Top 10 Holdings as A Percentage of Total Assets

Most funds provide their Top 10 holdings – use them. We recommend that you examine the exposure of the fund to: 1) its Top 10 holdings by total weight, and 2) each holding by individual weight, in relation to the fund's total assets. A portfolio with a total Top 10 weighting of less than 20%, or a maximum exposure of 2% per holding, generally indicates a broadly diversified strategy. On the other hand, a fund with a total Top Ten weighting of 30%, or exposures to individual holdings of approximately 5%, denotes a more concentrated strategy. Either can be appropriate for your portfolio, but you must be aware of weightings to ensure they fit your manager's strategy.

Portfolio Sector Attribution

Analyze how the fund portfolio is diversified by market sector. This is critical in understanding how the manager's strategy compares to the appropriate benchmark. It sheds light on both sector diversification and stock-picking prowess. Unfortunately, because these data come from thorough analysis of portfolio holdings, they aren't always readily available. They are obtainable, however, if the plan fiduciaries have access to sophisticated analytical tools or are using an independent advisor.

Modern Portfolio Theory Statistics

These statistics generally are measures of portfolio risk, correlation and value added. They're based on the results of regression techniques, which are then compared to a market benchmark. A plan fiduciary should focus on these metrics: Beta, R2, Alpha, Sharpe or Sortino, and Standard Deviation.

We also suggest
using a broad market
benchmark that's
indicative of asset class.

Conclusion

To understand the quality and ability of an investment manager, along with the mutual fund they represent, the plan fiduciary must unravel its historical performance from various points of view. It takes more than simply looking at past returns, as they provide only a one-dimensional picture, and may more accurately reflect luck than skill – whether good or bad. Objectively evaluating an investment manager or fund requires a deep, thorough investigation into both their/its qualitative and quantitative characteristics. And once an investment has been selected, the work doesn't end. Rather, evaluation should be continued to ensure that the investment firm, strategy and style persist in meeting asset class expectations, within the overall context of your asset class offering.

If you would like to speak to an unbiased, completely independent financial consultant about your bid process, the principals at Bidart & Ross would appreciate hearing from you. You can learn more at www.Bidart-Ross.com, or by calling (775) 826-6400.