

PART ONE

How to Pick Mutual Funds

Know What Your Fund Owns

MOST OF US wouldn't buy a new home just because it looked good from the outside. We would do a thorough walk-through first. We'd examine the furnace, check for a leaky roof, and look for cracks in the foundation.

Mutual fund investing requires the same careful investigation. You need to give a fund more than a surface-level once-over before investing in it. Knowing that the fund has been a good performer in the past isn't enough to warrant risking your money. You need to understand what's inside its portfolio—or how it invests. You must find out what a fund owns to know if it's right for you.

The stocks and bonds in a fund's portfolio are so important that Morningstar analysts spend a lot of their time on the subject; news about what high-profile fund managers are buying is a constant source of e-mail chatter in the office. Our analysts examine fund portfolios of stocks or bonds, talk with the managers about their strategies in picking those holdings, and check on recent changes to the portfolio. Knowing what a fund owns helps you understand its past behavior, set realistic expectations for what it might do in the future, and figure out how it will work with the other investments you might own.

At the most basic level, a fund can own stocks, bonds, cash (usually money market securities), or a combination of the three. (Funds might also own other securities, including other funds and stock/bond hybrid securities, but let's stick with the basics for now.) If it invests in stocks, it could focus on U.S. companies or venture abroad. If the fund owns U.S. companies, it might invest in giants such as General Electric or Microsoft or seek out tiny companies that most of us have never heard of. If a fund invests in bonds, it could focus only on those issued by companies with rock-solid finances and a high probability that they'll make good on their debts or it could venture into higher-yielding bonds issued by firms with shaky future prospects. How a manager chooses to invest your money has a big impact on performance. For example, if your manager devotes much of the portfolio to a single volatile area such as technology stocks, your fund may generate high returns at times, but there's also a greater likelihood that you'll lose money at other times. Stocks have historically generated higher returns than cash or bonds. Because you take the least risk when you invest in cash, those securities also tend to generate lower returns than you'd get with stocks or bonds.

A fund's name doesn't always reveal what a fund owns because funds often have generic handles. Take the intriguingly named Janus Olympus and American Century Veedot funds. If you were to skim over only their names, you would be hard-pressed to glean that the former focuses on mid- and large-sized companies that are growing quickly (think Yahoo! and eBay), whereas the latter is a fund that uses computer models to help direct investments to whatever type of stocks look like they could be strong performers in the future.

Nor will a fund's prospectus—a legal document filed with the Securities and Exchange Commission (SEC) that lays out the basics of an investment—necessarily be of much help in determining what a given fund is up to. While fund prospectuses do include information about who's running a fund and its basic investment parameters, prospectuses are typically written in very broad terms to give managers the latitude to invest as they see fit.

In their prospectuses, funds are also required to state their objectives—a one- or two-word description of their basic goals, such as "Growth," "Equity-Income," "Growth & Income," and so on. You'd think these so-called prospectus objectives might help you sort out who's doing what, but in reality funds with the same prospectus objectives can be pursuing radically dif-

ferent investment approaches and end up with very different returns. For example, both Aegis Value Fund and AllianceBernstein Large Cap Growth have prospectus objectives of “Growth.” But the former focuses on tiny, budget-priced stocks, whereas the Alliance fund focuses on fast-growing stocks of large companies. When the bear market struck between 2000 and 2002, the Aegis fund returned 18% annually, whereas the Alliance fund lost 26% over that stretch.

Understanding The Morningstar® Style Box™

A desire to help investors choose funds based on what they really own—instead of on what funds call themselves, how they classify themselves, or how they’ve performed recently—was precisely what inspired Morningstar to develop its investment style box in the early 1990s. The style box provides a quick visual summary of a given fund’s portfolio, showing you, using a nine-box investment-style grid, where most of your fund’s portfolio is invested. (To check out a fund’s current style box, go to Morningstar’s Web site, www.morningstar.com, and type in a fund’s name or ticker.) While investors needn’t own a fund from each and every square of the style box, the tool can help you know whether your portfolio is diversified. If all of your funds are huddled in a single corner of the style box, that’s a tip-off that you’ll probably want to spread your bets around more. The style box also helps investors keep track of whether a fund has changed its approach, because we update each fund’s style-box placement every time we receive a new portfolio. If a fund that you bought to bring your portfolio exposure to the fast-moving technology and telecom industries is suddenly delving into the securities of small manufacturing firms, you’ll see that change reflected in your fund’s style-box placement.

For stock funds, the style box isolates two key factors that drive its performance: the size of the stocks the fund invests in and the type of companies it buys—rapidly growing companies for which investors are willing to pay a pretty penny, slower growers that trade at lower prices, or a combination of the two (see Figure 1.1). Those two factors—company size and investment style—form the two axes of the stock, or equity, style box. For bond funds, the style box focuses on the two key determinants of bond-fund behavior: a fund’s sensitivity to changes in interest rates and the credit quality of the bonds in which it invests. Those two factors form the axes of the bond-fund

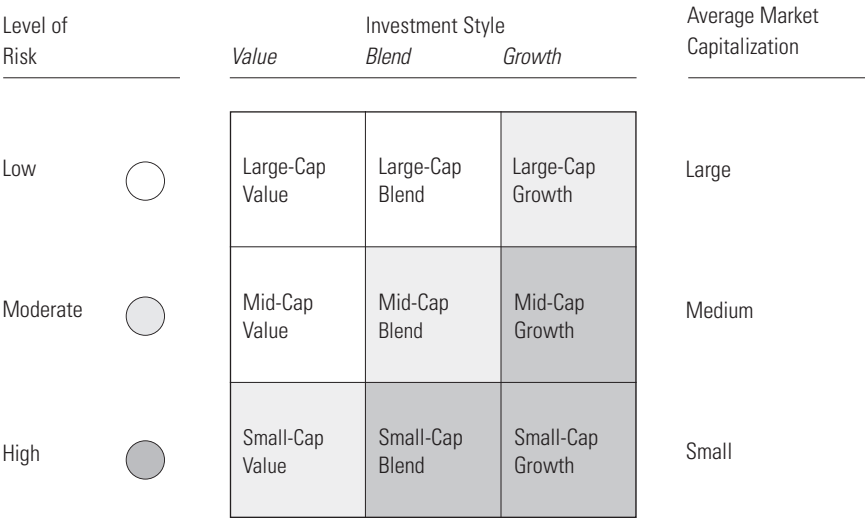


Figure 1.1 The Morningstar stock style box is a nine-square grid that provides a quick and clear picture of a stock fund's investment style.

style box (see Figure 1.2). Once we have determined the size and investment-style coordinates for a stock fund and the interest-rate sensitivity and credit-quality coordinates for a bond fund, we can use our nine-square style box grid to show investors—visually—where their fund lands.

Using the Stock-Fund Style Box

To figure out which square of our stock style box a fund portfolio lands in, we first analyze each and every stock in that portfolio. We begin by grouping each stock in a portfolio into one of seven regions: the United States, Latin America, Canada, Europe, Japan, Asia ex-Japan, and Australia/New Zealand.

Once we've placed a stock within one of our regional zones, we then go on to evaluate how it stacks up relative to other firms within that same zone. We start that process by determining whether a security is small, medium, or large within its region. In investing parlance, stock size is often called market capitalization, or market cap. Market cap sounds like a technical term, but it's not particularly hard to understand—essentially, it's the current dollar value of all of a given company's stock shares. So if a stock is selling for \$30 and there are

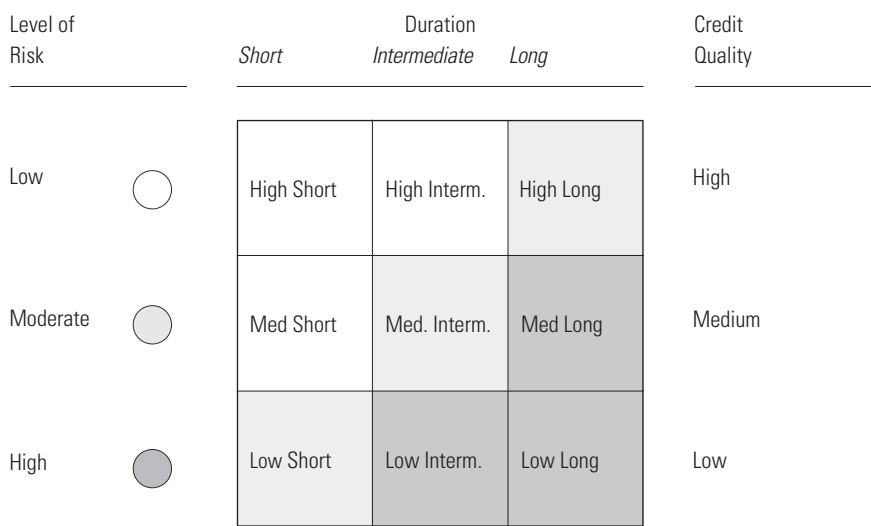


Figure 1.2 The Morningstar bond style box is a nine-square grid that provides a quick and clear picture of a bond fund’s investment style.

a million shares of it floating around in the market, the company has a market cap of \$30 million. We consider companies whose market caps land within the largest 70% of their region to be large cap; the next 20% are midcap; and the smallest 10% are small caps. Although small-cap stocks only account for 10% of each region’s market, there are actually many more of them than there are large-cap companies.

Having determined a security’s regional and size classification, we turn our attention to its investment style. Investing aficionados typically group stocks into one of two major buckets—growth stocks or value stocks—and often identify themselves as growth investors or value investors. Understanding the difference between the two styles is critical to understanding what makes a fund tick.

Growth stocks typically enjoy strong growth in earnings or revenues because they’ve got a hot new product or service. Because the market expects good things from these fast growers, and earnings growth usually drives a higher share price, investors are willing to pay more for the shares than they will pay for slower growers.

Value stocks, conversely, look like growth stocks' less successful cousins. These companies' earnings are usually growing slowly, if at all, and they often operate in industries that are prone to boom-and-bust cycles. So why does anyone bother with these underachievers? The answer is, because they're cheap. Fund managers who focus on value stocks are willing to put up with lackluster earnings growth because they think the market is being overly pessimistic about the company's future. Should things turn out better than the market thinks, the bargain-hunting fund stands to profit.

Some companies display a mixture of both growth and value characteristics—we call these *core stocks*. Many pharmaceuticals stocks currently fit the core designation. Historically, these firms have been terrific growers, as new drug launches and stepped-up demand from aging baby boomers have driven high profits and, in turn, high stock prices. But lately, problems with a few high-profile drugs as well as chatter about lackluster new products and drug-price controls have depressed the prices for drug stocks.

To help classify a stock as growth, value, or core, we look at 10 separate factors, including dividend yields, price/earnings ratios (a company's current share price divided by its earnings), and historical and projected earnings growth.

Once we have classified each stock's investment style, we then classify the entire portfolio, based on which square of our style box most of its stocks land in. Securities that the manager has weighted the most heavily will play a bigger role in determining a fund's investment style than will smaller positions. For example, a stock that takes up 10% of a portfolio will be a much bigger determinant of a fund's style-box positioning than will a stock that takes up 2%.

Funds that devote most of their assets to stocks with strong growth characteristics will land in the growth column of our style box, while those with a higher concentration of value stocks will land in our value column. Funds that hold both growth and value stocks, or those that focus mainly on so-called core stocks, will land in the blend column of our style box.

Using the Bond-Fund Style Box

The bond-fund style box, like the stock style box, is also a nine-square grid. Whereas the stock style box has a growth/value axis and a small/large axis, however, the two axes of the bond style box are interest-rate sensitivity (or du-

ration, which we define in the following discussion) and credit quality. Unlike the equity style box, we arrive at a bond portfolio's style box not by drilling into each and every security, but instead by measuring the average weighted characteristics of the portfolio. (Average weighted means that our calculation gives greater weight to a portfolio's big positions than its small ones.)

Knowing a bond fund's interest-rate sensitivity helps you determine how much it will react when interest rates go up or down. When interest rates go up, that typically depresses the price of already-existing bonds, particularly those with longer maturities, because investors would rather buy a newer bond with a higher interest payment, or yield, than get locked into a long-term bond that happens to have a lower yield. The reverse happens when interest rates go down. Investors would rather buy an existing bond with a higher yield than they would opt for a new, lower-yielding bond. That demand drives up the price of existing bonds.

To help measure a bond fund's interest-rate sensitivity, we rely on a figure called *duration*. Duration is a pretty knotty concept; it's defined as the average time it takes a bondholder to receive the interest and the principal payments from a bond. Because it's a measure of time, duration is expressed in years. As a general rule of thumb, every one-percentage-point change in interest rates will cause a fund to gain or lose the amount of its duration. For example, a bond fund with a duration of 8 years is apt to lose 8% of its value if interest rates go up by one percentage point. For the purpose of our fixed-income style box, we classify bond funds with average durations of less than 3.5 years as short term, those with durations between 3.5 and 6 years as intermediate term, and those with durations of 6 years or more as long term. (We use a slightly different framework for classifying municipal-bond funds' interest-rate sensitivity. Municipal bond funds with durations of less than 4.5 years are short; those with durations between 4.5 and 7 years are intermediate term; and those with durations of 7 years or more are long.)

A bond portfolio's average duration helps us plot a fund on the horizontal axis of the style box. To determine its placement on the vertical axis, we examine the average credit quality of the bonds in the portfolio. Third parties such as Moody's and Standard & Poor's assign credit qualities to bonds. By looking at a bond's credit quality, you can get a sense of how likely it is that a bond's issuer will be able to continue making its interest payments to bondholders—an

important consideration if you're looking for regular income, as many bond investors are. Morningstar considers bond funds with average credit qualities of AAA or AA to be high quality, those with credit qualities that are lower than AA but greater than or equal to BBB to be of medium quality, and those with average credit qualities below BBB to be low quality.

Armed with both a portfolio's interest-rate sensitivity and its average credit quality, we can plot that fund in our style box.

Using Morningstar's Category System

Despite the usefulness of the Morningstar style box, it's just a snapshot of the fund's most recent portfolio. When you are selecting a fund to play a particular role, such as adding a high-quality bond fund because you want stability and regular income, you want to be confident that it actually has played that role over time. That's what we have in mind when we plug funds into Morningstar categories. We assign funds to categories based on the past three years' worth of style boxes. (Fund firms are required to provide shareholders with a list of their funds' portfolio holdings every quarter, but some fund shops make their portfolios available even more frequently than that.) A single portfolio could reflect a temporary aberration—maybe the fund's holdings have been doing really well, so they have grown from small- to mid-cap as stock prices have gone up. But because a fund's category assignment is based on three years' worth of portfolios, it gives you a better handle on how the fund typically invests.

You'll see that our category system for U.S. and foreign-stock funds is closely related to our style box. On the U.S. stock side, we have categories corresponding with each of the nine squares of the style box, ranging from large value in the upper left corner to small growth in the lower right corner. Similarly, we have five style-based categories for diversified foreign-stock funds (i.e., those that don't focus on a single region), ranging from foreign large-value to foreign small/mid-growth. (Because there aren't quite as many foreign-stock funds in the U.S. as there are domestically focused funds, we don't have separate foreign-stock categories corresponding with all nine squares of the style box.) We also carve out some categories for specialized stock funds. To name a few, there are categories for health-care offerings, Japan funds, and energy funds. Morningstar slots funds into about 50 categories (see Figure 1.3).

Diversified Domestic Stock	Large Value	Mid-Cap Growth
	Large Blend	Small Value
	Large Growth	Small Blend
	Mid-Cap Value	Small Growth
	Mid-Cap Blend	
International Stock	Europe Stock	Foreign Large Blend
	Latin America Stock	Foreign Large Growth
	Diversified Emerging Markets	Foreign Large Value
	Diversified Pacific Stock	Foreign Small/Mid Growth
	Pacific Stock ex-Japan	Foreign Small/Mid Value
	Japan Stock	World Stock
Specialty Stock	Communications	Precious Metals
	Financial	Real Estate
	Health	Technology
	Natural Resources	Utilities
Hybrid	Conservative Allocation	Bear Market
	Moderate Allocation	Convertibles
Specialty Bond	High-Yield Bond	Emerging Markets Bond
	Multisector Bond	Bank Loan
	International Bond	
General Bond	Long-Term Bond	Short-Term Bond
	Intermediate-Term Bond	Ultrashort Bond
Government Bond	Long-Term Government	Short-Term Government
	Intermediate-Term Gov't.	
Municipal Bond	Muni National Long	Muni CA Intermediate/Short
	Muni National Intermediate	Muni NY Long
	Muni National Short	Muni NY Intermediate/Short
	Muni High-Yield	Muni Florida
	Muni Single-State Long	Muni Massachusetts
	Muni Single-State	Muni Minnesota
	Intermediate	Muni New Jersey
	Muni Single-State Short	Muni Ohio
	Muni CA Long	Muni Pennsylvania

Figure 1.3 Morningstar's fund-category system.

On the bond side, our categories also relate back to the style-box system. For example, the high-yield bond category—home to so-called junk-bond funds—captures most of the funds that land in the low-credit-quality row of the style box. Meanwhile, our long-term government category includes all of the funds that buy U.S. Treasury and agency bonds with long durations.

As with the style box, Morningstar categories pick up where fund names and prospectus objectives leave off. They help you figure out how a fund actually invests, which in turn lets you know how to use it in your portfolio. If you're looking for a good core stock fund, you might begin your search within the large-blend category. Funds that land there usually invest in the biggest, best-established U.S. companies and buy stocks with a mix of growth and value characteristics. Thus, large-blend funds tend to be a decent bet in varied market and economic conditions. Although they may not lead the pack too often, neither are they apt to be left completely behind. (We discuss this subject in detail in Part Two.)

By targeting funds in different categories, you are much more likely to pull together a diversified portfolio than if you rely on funds' prospectus objectives to show you the way. An investor focusing exclusively on prospectus objectives might think he or she had a diversified mix in a portfolio that consisted of Dreyfus Premier Value (with a prospectus objective of growth), American Funds Investment Company of America (growth and income), and USAA Income Stock (equity-income). Diversified? Not so fast. According to their Morningstar categories, which take their underlying holdings into account, all three funds are actually large-cap value offerings.

As you might expect, different-style funds tend to behave differently in various market and economic environments, which is why the style-box and category system can be so handy. Knowing a fund's category can give you some indication of how it might perform in good markets and in bad. As a rule of thumb, the large-cap value group is considered the safest category because large-cap companies typically are more stable than small ones (the high-profile blowups of giants like Worldcom and Enron notwithstanding). And in down markets, when investors are concerned that stock prices could be too high across the board, large-value funds' budget-priced stocks don't have very far to fall.

Funds that land in the small-growth category, however, are usually the riskiest. The success of a single product or service can make or break a small

company, and because small-growth stocks often trade at lofty prices, they can take a disastrous tumble if one of the company's products or services fails to take off as the market expects. These funds can deliver glittering riches in up markets, though: In 2004, the average small-growth fund returned 45%. (For more on the correlation between investment style and risk, see Chapter 3.)

Examining Sector Weightings

Checking a fund's style-box and category placement can go a long way toward helping you know what a fund is all about, but it may not tell the whole story. Not all funds that land in the same style box or even the same category will behave the same way. For example, both Marsico Growth and Fidelity OTC are popular funds that land in the large-cap growth category. Yet they have tended to own very different kinds of large-growth stocks. In the late 1990s, the Fidelity fund often dedicated more than half of its assets to technology-related stocks—as much as 75% at one point. Marsico Growth also staked a sizable amount in tech, but its position topped out at 40% of the portfolio.

What a difference those two approaches made! A heavy weighting in the tech sector was a boon in 1999, when investors adored technology stocks. Fidelity OTC soared an amazing 73% that year, whereas Marsico Growth gained 53%. A 53% gain is an impressive return in its own right, but if you had put \$10,000 in each fund at the start of the year, your Fidelity OTC investment would have been worth \$2,000 more than Marsico Growth at the end of 1999. But anything that produces such strong returns can also prove an Achilles' heel, and that's exactly what happened to Fidelity OTC. When tech collapsed in 2000, the Fidelity fund lost 26%, whereas Marsico Growth lost 16%. The moral of the story isn't that a technology-heavy fund like Fidelity OTC is automatically a bad idea, but that if your fund is inclined to make big bets on certain sectors, there's also a greater likelihood that your fund will suffer losses.

Morningstar calculates a fund's sector exposure based on the percentage of its portfolio that is committed to stocks in each of 12 industry groupings. We also cluster those 12 sectors into one of three supersectors: information, services, and manufacturing (see Figure 1.4). We developed the broader classification system because the sectors within our supersector groupings tend to behave in a similar way in various stock market environments. In the recent market downturn of 2000 through 2002, for example, every sector in our



Figure 1.4 Morningstar's sector breakdown. Twelve sectors are divided into three supersectors representing broader parts of the economy.

information supersector—hardware, software, telecommunications, and media—incurred terrible losses. If all the funds in your portfolio heavily concentrate their holdings in a certain supersector, it can be a strong indication that your portfolio needs exposure to other parts of the economy. Similarly, if you have a job in a technology-related field, you will want your portfolio to have plenty of exposure outside the information supersector because much of your economic well-being (through your job) is already tied to that area.

Examining Number of Holdings

To understand what a particular fund is up to, knowing the number of stocks it owns can be just as important as any of the other factors we have discussed. Whether your fund holds 20 stocks or hundreds of them will make a big difference in its behavior. (Because Securities and Exchange Commission regulations limit the percentage of its assets that a fund can commit to a single holding, fund portfolios rarely have fewer than 20 stocks.) For example, both Fidelity Contrafund and Janus Twenty land in our large-cap growth category. But the Janus fund, which typically holds fewer than 30 stocks, is likely to see a lot more gyrations in its performance—for better and for worse—than the Fidelity fund, which spreads its money across more than 500 stocks. If Janus Twenty's top holding, at 15% of assets, has a bad week or a bad year, the whole fund's performance is also apt to be poor. Meanwhile, trouble in Fidelity Contrafund's top stock, at 2.6% of assets, won't have as big an impact on the fund's total return.

The number of holdings in bond funds tends to have less of an impact on how they behave. All else being equal, however, a bond fund with more hold-

ings is likely to be less volatile than one that is more concentrated in bonds from a smaller number of issuers. A bond fund is apt to be particularly risky if it both delves into lower-quality bonds and concentrates in a short list of holdings. That stands to reason, because the fund's fortunes are dependent on a small group of risky securities.

Checking Up on Trading Behavior

In addition to checking style boxes, categories, sectors, and number of holdings (phew!), a fund's turnover rate is another important factor when you're judging a fund's style. Turnover rates, which funds are required to include in their reports to shareholders, measure how much the portfolio has changed during the past year and shows approximately how long a manager typically holds a stock. For example, a fund with a turnover rate of 100% has a typical holding period of one year; a fund with 25% turnover holds a stock for four years on average.

Turnover is a pretty simple calculation: To figure it out, fund accountants just divide a fund's total investment sales or purchases (whichever is less) by its average monthly assets for the year.

A fund's turnover rate can give you important insights into a manager's style. It can tell you whether a manager tends to buy and hold, picking stocks and sticking with them for the long haul instead of frequently trading in and out of them. To give you a basis for comparison, stock funds on average have turnover rates of about 100%. We consider a fund's turnover rate to be notably modest when it's 25% or lower.

Eyeballing a fund's turnover can provide insights into a fund's risk level. Managers who keep turnover low often practice low-risk strategies, whereas high-turnover funds can be aggressive and much riskier. That gets back to investment style: As a rule of thumb, the more value-conscious your manager is, the more patient he or she will tend to be with the holdings in the portfolio. Meanwhile, growth-oriented fund managers often employ high-turnover strategies.

In addition to potentially jacking up a fund's risk level, high turnover can also spell tax consequences for investors. A manager who sells a stock at a profit incurs a taxable gain, and funds are required to distribute any capital gains to their shareholders (provided the manager can't offset that gain by

realizing a loss from another holding in the portfolio). If you own the fund in a taxable account instead of a tax-sheltered vehicle like a 401(k) or Individual Retirement Account, you'll have to pay taxes on that capital-gain distribution. If the fund has a high turnover rate, the tax consequences could cut into returns you would otherwise pocket.

As if that weren't enough, high-turnover funds can incur higher trading costs than low-turnover offerings. When we say *trading costs* we're not just referring to the dollars that the fund pays its brokers to execute the trade (though those charges can cut into your returns, too). Rather, we're also referring to the fact that big funds can "move the market" when buying and selling their shares. Say a big fund like Fidelity Contrafund wants to get out of one of its largest positions in a hurry. Because Contrafund is flooding the market with shares, it may have to accept lower and lower prices for those shares as it unloads its position. The more the fund engages in such trading, the less attractive its average purchase and sale prices will be, and the less its shareholders will profit. (We probably shouldn't pick on Contrafund in particular—it has been a strong performer, despite its huge asset base and high-turnover approach. But in general, a fund that combines a high-turnover strategy with a big asset base is fighting an uphill battle.)

For all these reasons, we think you greatly improve your portfolio's odds of good long-term performance if you put the bulk of your assets in low-turnover funds. Figure 1.5 provides a list of some of our favorites. When shop-

Fund Name	Category	Turnover %
Selected American	Large Blend	3
Legg Mason Value	Large Blend	4
Tweedy, Browne Global Value	Foreign Small/Mid Value	8
Harbor International	Foreign Large Value	12
Oakmark Select	Large Blend	14
Clipper	Large Value	16
FPA Paramount	Small Value	16
Ariel Appreciation	Mid Blend	19
Fairholme	Mid Blend	23
American Funds EuroPacific Growth	Foreign Large Blend	25

Figure 1.5 Ten great low-turnover funds.

ping for stock funds, look for those funds whose turnover rates are lower than 50%, preferably much lower.

Generally speaking, turnover is a more significant factor for stock funds than it is for bond funds. In part that's because many bond funds employ short-term trading strategies that jack up their turnover rates but don't meaningfully affect their risk levels, tax efficiency, or trading costs.

Investor's Checklist: Know What Your Funds Own

- ▶ Use a fund's Morningstar style box as a visual guide to learn what the fund owns and how it's apt to behave in the future.
- ▶ When assembling a diversified portfolio, look for funds that land in a variety of Morningstar categories.
- ▶ Look in Morningstar's large-blend category for core funds that are unlikely to go too far out on a limb.
- ▶ Bond funds with limited interest-rate sensitivity and high credit quality are less risky than those that venture into longer-duration and/or lower-quality bonds.
- ▶ Check a fund's sector weightings relative to its category peers to see if the fund is betting heavily on a given area of the market.
- ▶ Funds that concentrate heavily in their top positions can generate big gains when their top picks pay off, but also stand to lose more if they don't.
- ▶ Put the bulk of your portfolio in low-turnover funds, which are generally less risky, more tax-efficient, and have lower trading costs.