MORNINGSTAR®

FundSpy

Morningstar's Inside Secrets to Selecting Mutual Funds That Outperform

RUSSEL KINNEL

Director of Mutual Fund Research, Morningstar

Foreword by Don Phillips,

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For Elisabeth

Foreword

MANY MUTUAL FUND GUIDES, quite frankly, are tired rehashings of stale academic papers. The run you through the history and evolution of the fund industry and discuss the efficient frontier, th importance of diversification, and the necessity of a long-term perspective, but they always pull bac when it gets to the good stuff, the stuff that really matters—whom you can trust and why. That certainly not the case with *Fund Spy*, a book built entirely around original research, as well as pull-n punches opinions on how you should invest and to whom you can entrust your savings. This book the real deal, an insider's guide to what the fund industry is like—the good, the bad, and the funny.

Mutual fund analysis is at the very core of Morningstar's identity, and while there are many tean of great people at the company, there's no group more passionate in their mission than Morningstar fund analysts. I ought to know. I was the company's first analyst, and it has been a delight to see th team evolve over the past two decades. Crucial to the team's growth has been the immen contribution of Russ Kinnel. As you'll see in the pages that follow, Russ brings keen insights, wicked wit, and a genuine concern for the small investor to his work. He's a wonderful writer and ha led many ground-breaking research efforts, several of which are detailed here. Moreover, he's a bla to work with. No one sends a sharper, funnier e-mail than Russ.

Fund Spy gives a great picture of what it's like to be a fund analyst at Morningstar. Trading cost managers investing (or not) in their own funds, variations on an investment style—these are the kin of things we discuss daily and work to teach our new analysts about. Russ has condensed 20 years our collective learning into a tidy primer that would be a great asset for any fund investor. He doesn kowtow to fund industry interests; he simply does what we ask all our analysts to do: Tell the story a fairly and accurately as possible, and do it from the investor's perspective. When you can do all th and combine it with Russ's wit, you've got a winning combination.

In the pages that follow, you'll get the inside dope on how to assess a fund manager's commitmen why costs matter so much to your results, and how to avoid common pitfalls in fund selection ar portfolio construction. But like any great storyteller, Russ saves the best for last. His rundown on th top fund shops—both load and no-load—and his take on the best, time-tested funds are both dead o the mark. I wouldn't change a word. Having Russ at your side when navigating the world of mutu funds is like having Quentin Tarantino helping you fill your Netflix list, or having Lester Bangs your side as you sort through stacks of classic rock and roll records. Even if you know the territor you're sure to learn something new and discover some hidden gems.

Enjoy!

DON PHILLIPS
Managing Director
Morningstar

Preface

I STARTED AT Morningstar in 1994. That year, interest rates were spiking, and the Mexican equit bubble inspired by NAFTA turned into a panic. Soon after that, California's Orange County defaulte on a slew of debt brought on by unwise mortgage investments. Over the ensuing years, we saw Russian default mess, an Asian meltdown, the bailout of Long-Term Capital Management, th bursting of the Internet bubble, the attacks of September 11, wars in Iraq and Afghanistan, th corporate meltdowns of Enron and WorldCom, and, most recently, the subprime housing bubbl bursting and shaking financial institutions to their knees.

Yet somehow, we got the largest bull market in there somewhere, and nearly all the top mone managers and investment firms are still standing with strong long-term results to show for it. Ye buy-and-hold investing still works, while trendier strategies have their moments and then collaps With the markets at depressed levels (as of fourth quarter 2008), this is a great time to invest wi good managers, provided you're in it for the long term.

I started writing Morningstar's Fund Spy column back in 1997, and over the years I've shared lo of ideas, observations, and laughs at the fund world's occasionally out-of-control marketin departments. I'll share the results of years of research and a lot of experience from talking wi managers and seeing the difference between words and deeds.

My aim is to make investing much easier for you by showing you the key data points and sharin my years of research on the best managers. You don't need a ton of data or sophisticated programs– just focus and patience. I'll show you the handful of quantitative and qualitative factors you need pick winning funds. In fact, I've built it all into an easy-to-use tool www.morningstar.com/goto/Fundspy. Just plug in a fund ticker or name and you're good to go.

If recent markets have you jaded and you think all mutual funds are the same, take another look. Chapter 1, I'll reveal the huge gap between the returns of above-average and below-average func You'll see that it will be a lot easier to reach your long-term goals if most of your funds outperform.

We've long known that low costs and dedication to clients were the keys to successful funds, b now we have some new tools to do a better job of finding funds that meet those criteria. We now hav data on how much fund managers are investing in their funds so that we can more accurately judg their commitment to shareholders. In Chapter 2, I'll look at how to separate the good managers fro the indifferent.

In Chapter 3, I'll shine a light on a crucial piece of information that has been hidden all these year trading costs. Trading costs are as big and important as expense ratios, but until we came out with o data on trading costs, individual investors had no way of knowing what they were. I'll show you ho we calculate trading costs, what they mean, and how they will help you to improve your fu selection.

The other half of the cost equation is expense ratios. If you're skeptical about the importance expenses, allow me to show you that they're more important than you think. In Chapter 4, I'll sho you that fund companies hide a lot of their high-cost losers in a way that obscures the awful tru

about fund costs. More importantly, I’ll show you just how much you can improve your chances o
success with low-cost funds.

But what about performance? I’m glad you asked, because I’ll show you how to avoid th
performance trap of betting the ranch on tempting recent results. There’s a better way to use return
I’ll walk you through it in Chapter 5.

The importance of quantitative factors in choosing the right funds is huge, but so is the qualitativ
side. For starters you need to understand fund strategies and the risk they entail in order to build
sound portfolio and to use funds wisely. I’ll make it easy for you in Chapter 6. We see lots of goo
funds that investors end up using poorly because they didn’t contemplate the downside inherent in
fund’s strategy. This bit isn’t part of the formula, but it should be part of your process because yo
have to know what you own.

You are essentially hiring a manager or managers to handle your life savings, so you need to kno
how to pick good managers and avoid the ones that let conflicts of interest get the better of them.
Chapter 7, I’ll help you to spot the good ones and introduce you to our stewardship grades. A
Morningstar, we have years of experience interviewing managers and evaluating funds, and we als
sift through all the SEC filings and do on-site visits to find out which firms really care abo
shareholders. We boil all that down to a letter grade.

In Chapters 8 and 9, I’ll provide you a nice and easy cheat sheet to make the most of different fun
companies. Even if you had access to the managers and analysts, you probably don’t have the time
meet with them, make follow-up phone calls, and do all the work that is necessary to fully understan
a fund company. That’s why I share my insight from 14 years of research, as well as all the visits an
calls our outstanding fund analyst staff has done. Where should you go for index funds or momentu
funds, for example? I’ll tell you. Chapter 8 is for do-it-yourself investors in no-load funds and Chapt
9 is for those who buy through a full-service broker.

Finally, in Chapter 10, I’ll share 20 funds that aced all the tests laid out in the book. I’ll even te
you what each fund’s competitive edge is and which red flags to watch out for so you’ll know when
sell.

Acknowledgments

GREGG WOLPER, KAREN DOLAN, KAREN WALLACE, AND HAYWOOD KELLY edited thi book and were a tremendous help to me. Maureen Dahlen’s work as business and project manager w invaluable.

The groundwork for much of Morningstar’s research over the years including this book was laid b CEO Joe Mansueto; president of Individual Investor Business Unit Catherine Gillis Odelbo; managi director Don Phillips; vice president of research John Rekenthaler; and director of research Pa Kaplan in our central research group.

Many of the studies appearing here or influencing work here were run by Annette Larson and Ma Komissorauk. In addition, Bridget Bulger and Kailin Liu helped with all manner of research tasks.

Kunal Kapoor and Christopher Traulsen developed our stewardship grade methodology, and Lau Pavlenko Lutton refined it.

Our trading cost work built on a paper by Roger Edelen, Greg Kadlec, and Richard Evans.

In addition, all of my work has been informed by our Director of Personal Finance Christine Be and our outstanding fund analyst staff headed by Karen Dolan. The senior analysts are Michael Bree Dan Culloton, Arijit Dutta, Andrew Gogerty, Bridget Hughes, Eric Jacobson, Lawrence Jones, Lau Pavlenko Lutton, William Samuel Rocco, and Gregg Wolper. I’m also indebted to all the former fun analysts at Morningstar who have contributed so much to our knowledge of funds as well as t thousands of mutual fund managers who have taken the time to talk with us over the years, and t subscribers to our publications who have engaged us in an enlightening dialogue and provid remarkable support through bear markets and bull markets alike.

1

The Remarkable Gap Between Winners and Losers

THIS BOOK IS ALL ABOUT picking winning funds, so let's take a look at what you'll win if yo select good funds.

Too often, people assume that one fund is as good as the next. Or they put in the effort to pick the stock funds but buy their bond funds from whichever fund company is most convenient. But that leaving a lot of money on the table.

As the immortal Spinal Tap lead singer David St. Hubbins said, "It's such a fine line betwee stupid, and clever." Put a little time into your fund selection, and you'll be on the right side of the S Hubbins line.

It's amazing to me how people will spend way more time researching fun expenditures, like ca and plasma TVs, than they will on developing an investment plan and selecting their investmen Sure, it isn't as fun, but it's your retirement, your house, and your kids' college education!

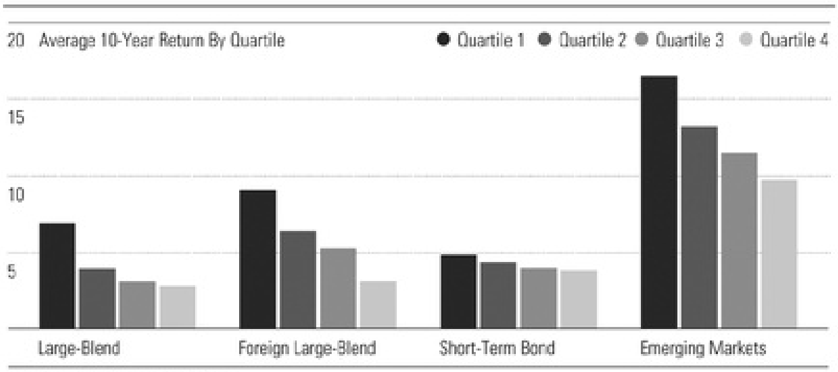
Let's look at why it's worth a little effort. It's not too hard to pick funds that will do a little bette than average, and it takes only a little more work to upgrade from there so that you've meaningful improved your chances of returns that are well above average while reducing your chances of lous performance. Of course, there's no foolproof method of predicting the top-performing fund over th next 10 years, but there are dependable methods to select funds that should earn strong returns whi limiting cellar-dwellers.

The Forest for the Trees

Sometimes short-term returns, such as those for a six-month period, can be all bunched together. Fro that perspective, funds in a particular category might all look alike. If you step back and look at th effects of long-term compounding, however, the differences get dramatic. You can see the gaps i Figure 1.1, where even among low-returning bond funds the gap is quite wide.

Figure 1.1 The Enormous Gap Between Winning and Losing Funds

Source: Morningstar



Data through end of April, 2008.

You don't have to pick the best fund. Just pick a good one and you'll make thousands more than you would have in a weak performer.

Let's consider the returns of large-blend funds returns over the past 10 years. The large-blen category, which is home to a passel of S&P 500 Index funds, might seem like a bunch of blan benchmark-huggers. But consider the differences in average 10-year annualized returns for eac quartile through April 2008: Funds in the top quartile gained 7.02 percent per year over the 10-ye period; funds in the second quartile rose 4.06 percent per year; the third, 3.23 percent; and the fourt 2.9 percent. That's a huge gap from the top quartile to the second and down to the fourth. In honor St. Hubbins, let's call the gap between the top and bottom quartiles the *stupid penalty*. In the case large-blend funds, it's more than 400 basis points. Put in dollar terms, $100,000 invested 10 years ag in the typical top-quartile large-blend fund grew to $197,000 today, versus $149,000 for the secon quartile and $133,000 for the worst—making a stupid penalty of $64,000!

Top 10 Best Things About Mutual Funds

1. Diversification is better than you get on your own.
2. There is greater transparency than any other managed account.
3. They bring great management to individual investors.
4. Low-cost funds are the best deal in investing.
5. They enable you to invest outside your area of expertise.
6. They are easy to compare.
7. Audited portfolios make theft nearly impossible.
8. You can get in or out every day at net asset value.
9. Some have track records that are decades long.
10. You can invest automatically without paying commissions.

The gap remains dramatic in other categories. For the foreign-large-blend group, the top quarti returned 9.16 percent, compared with 6.49 percent, 5.38 percent, and 3.24 percent for the three oth quartiles, respectively. For the intermediate-bond fund category, returns were 6.02 percent, 5.2 percent, 4.85 percent, and 4.07 percent. That's a big gap for high-quality bond funds. Then, I checke two categories at the extreme ends of the risk spectrum and found not much changed in the gaps. F short-term bond funds, the breakdown was 4.93 percent, 4.47 percent, 4.10 percent, and 3.91 percen It's amazing to think that you can do 100 basis points better per year in a category where yields an returns are so tightly bunched. For the diversified-emerging-markets-stock category, returns we 16.62 percent, 13.31 percent, 11.58 percent, and 9.84 percent.

One of the most striking aspects of the study is that it even works across categories. Except for th ~~emerging-markets-stock fund category, you could take the top quartile of one of the four oth~~ categories and beat the bottom quartile of other groups. For example, you'd have been better off in top-quartile short-term-bond fund than a bottom-quartile or even second-best-quartile large-blen fund. The top quartile of intermediate-bond funds beat the bottom-half returns for the foreign-larg blend group.

Improve Your Chances of Success

In short, you'll make it much easier to beat your investment goals if you can select outperformer This book will show you how to do that. No, you won't bat 1.000, but you should be able to be on th right side of the St. Hubbins line most of the time.

Don't settle for high-cost, poorly run funds simply because they fell into your portfolio or someon is touting them. Take the time to research and buy funds that will work for the long haul. Thre months or even a year from now, you may not see a difference, but you will see a dramatic differenc in 10 and 20 years, when the power of compounding has grown your portfolio.

The returns we just reviewed include only funds that were good enough to survive in the first plac It's tough to take into account those funds that were around for only part of the time period. Suffice to say that if we could factor those in, the gap would be even greater. The crummiest funds are th ones generally killed off, so the bottom-quartile figures would be even worse if extinct funds could b included.

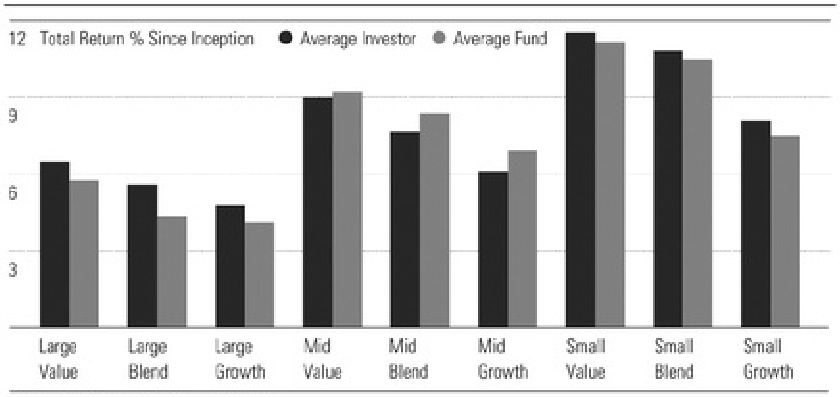
Welcome to Lake Wobegon

Lest you think that finding better funds is a daunting task, consider this: The average fund invest actually does better than the average fund, despite making key errors. Yes, that sounds like Lak Wobegon where everyone is above average, but it's just a matter of two different averages. It doe seem hard to believe, considering that many fund investors are lousy timers. They buy hot secto after they have gone up a lot, and they panic and sell poor-performing sectors just before they rall Yet they actually compensate for their bad timing by picking above-average funds.

In 2006, I used asset-weighting to find out how the typical investor did. That means I weighted fun returns based on asset size at the end of each month. When you do that, you see that investo typically fare worse than the actual stated returns for a fund because of lousy timing of purchases an sales. In fact, I first wrote about this in a *Morningstar FundInvestor* commentary titled "Mind th Gap" published in 2005. Financial pundits ate this up with a spoon because it made fund compani and fund investors look bad, and justifiably so.

But in a 2006 study, I took the extra step of asset-weighting those investor returns so that I cou see how the average investor did overall. It turns out that collectively, fund investors actually d better than the average category performance because they chose better-than-average funds (se Figure 1.2)~~. Interestingly, none of the pundits picked up this follow-up story. In fact, the earlier~~ stud is still cited far more than the latter because financial writers like the elitist sound of it. Fun companies and fund investors are idiots—end of story. The follow-up study shows that the averag investor isn't quite that much of a dolt, but that won't sell newspapers or really high-priced hedg funds.

Figure 1.2 The Average Investor versus the Average Fund



Return data through February 28, 2006.

The average investor often beats the average fund because most of investors' money is in large funds with below average costs.

Why does the average investor beat the average fund? The main reason is costs. Big funds general have lower costs because the funds pass along some economies of scale to fundholders. (Don't wor —they keep plenty for themselves.) In fact, the difference between the average fund investor performance and the average fund's performance is almost exactly the same as the difference betwee the asset-weighted expense ratio and the average expense ratio.

Fund investors and their advisors find their way to bigger, lower-cost funds for a wide range o reasons. Some seek out lower costs; others like to consolidate their accounts, and the big fun companies (which tend to have cheaper funds) make that easy. Others go through brokerages, whic favor certain big fund companies, and some just buy them because they're in their 401(k). In additio there's a self-reinforcing aspect to this, as lower-cost funds tend to outperform, thereby attractin assets, and that, in turn, lowers the expense ratio further.

FAQs

Q. When you say better than average, what group are you averaging?

A. I'm referring to the average return of a fund category. Categories are our way of classifying fund Comparing returns within a category enables you to assess a fund's performance. The categories a also helpful in building a diversified portfolio. We base the categories on three years' worth o portfolio data. For example, we group domestic stock funds by our Style Box with categories such small value and mid-growth.

Q. What is the Morningstar Style Box™?

A. The Style Box is a nine-box grid we use to analyze funds; the categories are based on them. We'v found that funds with similar market cap, value, and growth characteristics tend to behave in simil fashion and invest in similar holdings. It's divided by market cap vertically (small, mid, and larg and value/growth horizontally (value, blend, and growth). We use five value characteristics and fiv growth characteristics to determine where a fund plots on the *y* axis.

Conclusion

So, if the typical investor can easily find his way to an above-average fund, imagine what you can do when you intelligently target the key factors that drive fund performance. Only a few investors are using all of the tools I'm going to share with you in this book. Some are brand new, and others are tried and true.

Armed with the right strategy, you can do better than the average fund *and* the average investor. With better information, you can avoid the timing mistakes that so many investors make, and you'll be well on your way to reaching your goals.

2

Does Your Manager Eat His Own Cooking?

IF I ASKED you if the managers of your mutual funds invested in their funds, your first reactio might be, “Of course they do.” It turns out that most don’t.

Some managers really do mean it when they say they consider fundholders partners, while othe don’t. Until recently, everyone could talk big, but then the SEC started requiring managers to actual disclose their investments.

The good news is that hundreds of managers have more than $1 million of their own money in th funds. The bad news is that thousands don’t have a dime in their funds. Apparently, those fund ads ar slick brokers’ pitches didn’t even convince the folks running the fund to invest.

Let’s take a look at the gory details.

How Ownership Is Disclosed

The disclosure rules say that managers must disclose ownership in the following ranges:

- $0
- $1-$10,000
- $10,001-$50,000
- $50,001-$100,000
- $100,001-$500,000
- $500,001-$1 million
- Over $1 million

Each manager on a fund must disclose his or her investment.

The ownership figures are disclosed in the Statement of Additional Information (SAI), which is companion document to the prospectus. Not many people read their funds’ prospectuses, let alone g to the trouble of asking the fund company to send the SAI, too. You can go the fund company’s We site or the SEC’s Edgar site (www.sec.gov/edgar.shtml) to try and track the SAI down and then searc the SAI on the manager’s name to see if you can find the ownership information.

However, to make it a lot easier (much to the annoyance of managers who don’t invest in the funds), Morningstar’s data group has gathered the data on all mutual funds. You can find th information in our fund data pages on Morningstar.com, and you can also find it by plugging in th ticker of a fund on the special Web site for this book: www.morningstar.com/goto/fundspy.

Managers Hate Their Own Cooking

The figures that jump off the page are those where no manager invested a dime. In U.S.-stock fund 46 percent report no manager ownership. And it gets worse from there. Fully 59 percent of foreig stock funds have no ownership (though some had a reasonable excuse), 65 percent of taxable-bon funds have no ownership, 70 percent of balanced funds put up goose eggs, and 78 percent of mu funds lack ownership.

There are really only two legitimate reasons for not owning a fund you run. First, if you run single-state municipal-bond fund for a state other than the one you live in, it doesn't make sense own that fund, as you won't benefit from the tax breaks. Second, managers who are citizens of foreig countries have a good excuse if their country bars investment in U.S.-domiciled funds. Foreig citizens run a number of foreign-stock funds, and that may account for the ownership differen between U.S.stock funds and international-stock funds. For managers who run niche funds or run a l of funds, there's good reason for them to be at the lower end of the ranges, but not at zero.

The number of managers who don't eat their own cooking is staggering. With the two exceptions spelled out, I can't think of why anyone should invest in a fund that its own manager doesn't invest i True, higher investment levels aren't a guarantee of success or an ethical manager, but at least the show that managers believe in the funds and they are willing to pay the same costs and taxes that th rest of shareholders do.

So, for a core fund, demand manager investment in the top two levels ($500,000 or higher). F niche funds, any amount greater than $100,000 is okay.

Top 10 Worst Things About Mutual Funds

1. Capital gains are taxed as the fund realizes them rather than when you sell.
2. Assets can grow so large that they hurt performance.
3. There is too much manager turnover.
4. Too many funds have high portfolio turnover.
5. Fund supermarkets jack up fees.
6. Funds run meaningless ads.
7. Bad records can be hidden.
8. Huge fund complexes sometimes have more funds than good managers.
9. 12b-1 fees.
10. Inflows and outflows complicate a manager's job and hurt returns.

Looking at Investment Levels at Our Recommended Funds

To take another angle on it, let's examine how managers of funds on our recommended list and ou sell list stack up on manager investment.

It turns out that we're not the only ones who have more conviction in our Fund Analyst Picks tha our ~~Fund Analyst Pans. Assuming the midpoint of each range, we found an average investment~~ c $370,000 for our Fund Analyst Picks compared with $54,000 for our average pan.

That's a factor of nearly 7.

If we exclude areas where managers have reasonable excuses, such as target-date, single-state mun and index funds, the average pick's investment pops up to $503,000. That illustrates the conviction w look for, as well as the alignment of interests with shareholders'.

Is it an accident that managers are reluctant to invest in the pans, which suffer from son combination of high costs, poor strategy, shaky management, and disappointing stewardship? Th median pick has about $240,000 invested by each manager. Conversely, the median pan has $ invested.

Twenty-seven of our picks could claim that all of their managers have at least $1 million investe and 55 have at least one manager with more than $1 million.

How Do Fund Companies Shake Out?

So, how much do managers across different fund companies invest? It turns out that there's a hug difference among fund companies and that tells you a lot about the partners'/rubes' side of th equation. I broke out manager investment by asset class for the 30 largest fund companies.

As you can see in Table 2.1, the top boutique-type firms rate best, whereas some of the big broke sold companies are at the bottom. It's no accident that the firms with the highest manager investme have longer tenures, better performance, and lower fees than those at the bottom, where the firm ma consider a strong sales force more important than a strong management team.

FAQs

Q. If I'm looking for a single-state muni fund where the manager might have reason not to invest, there some way I can use manager investment levels to pick the right fund?

A. Yes, you can look at the manager's investment levels in other funds to see if the manager at lea buys into his or her process. In addition, some fund companies disclose managers' investmen throughout the fund company.

Q. How often is the information updated?

A. It's updated yearly, though some fund companies update it twice a year. That's worth keeping i mind regarding a new manager at a fund where the first filing might actually cover a period before l or she started at the fund.