

## Disclaimer and Caution

This Mutual Fund Report Card System is the creation of Active Fund Strategies (AFS) president Jeff McTague. It was created and published in 1998. The data source for the research and findings of the system and its reports is Thomson Reuters *InvestmentView* mutual fund software system. While the system was painstakingly researched, AFS offers no warranty of its accuracy. The system's reports represent a good faith judgment of the issue and the findings of the research. It is intended for the educational purposes of licensed investment professionals. If you are viewing this report as an investor, AFS cautions you to seek the advice of an investment professional for proper interpretation of the report, and asks you to note that, with all investments, past performance is no guarantee of future performance and that investment risk is real, to include a possible loss of original capital.

February 2011

## Mutual Fund Report Cards — Selecting Funds the Right Way by Promoting Structure Over Outcome

AFS is not in the business of selling financial self-help magazine subscriptions nor is it trying to sell air time for a highly acclaimed television financial news program. Therefore, we do not feel a need to represent the sizzle or the hype. *AFS does not receive compensation or funding from any mutual fund manufacturer or distributor*, so our Mutual Fund Report Card System (MFRCS) does not suffer that bias. Additionally, to both capture and control client expectations, we believe investment professionals would do well to promote an investment portfolio's structure over the usual promotion of expected outcome. From a compliance and arbitration standpoint, a provable portfolio structure has it all over a portfolio built on outcome.

Our **Mutual Fund Report Card System** serves as the centerpiece of an investment portfolio's structure. It is a simple yet highly successful process that was first created in 1998 by AFS president Jeff McTague. The 2011 edition represents the 14<sup>th</sup> annual printing. The system employs an investment philosophy and process that works in good times and in bad.

***“Jeff’s approach incorporated into my business puts me head shoulders above my competitors and provides me a verifiable process and result!”***

**— Scot Morris, Financial Consultant - RBC Dain Rauscher, Richmond VA**

### ***The Philosophy***

The Mutual Fund Report Card System :

- ❑ does not claim to be able to predict next year's winners.
- ❑ does not try to predict the beginning or end of market cycles, neither up nor down.
- ❑ claims that every mutual fund that the system reviews will face periods of declining value. It is not a matter of “*if*” but rather a matter of “*when*.”
- ❑ recognizes that investment advisors are cautioned to claim that past performance is no guarantee of future performance. The MFRCS takes that concept further. It believes past performance has absolutely nothing to do with future performance, and has conducted exhaustive research to prove it.
- ❑ does not consider a mutual fund unless the manager making the investment decisions has been doing so for at least the previous three consecutive years. Does this also mean it will miss some top performing newcomers? Yes, but it still believes it is wise to restrict consideration to those managers with a longer tenure.

- ❑ believes that the “Five-Ten” mutual fund regulation forces larger funds into owning so many different issues that they provide, at best, average returns. Our many studies support that notion; therefore, the system penalizes funds for becoming too large.
- ❑ penalizes funds that have significantly higher turnover than that of their peer group. Higher turnover creates higher expenses and larger taxes for investors.
- ❑ penalizes funds that have significantly higher expenses than those of their peer group. Higher expenses too often mean less total return for the investor.
- ❑ penalizes funds whose performance is achieved with portfolio decisions significantly outside the norm for the category. To accomplish this, the MFRCS monitors a fund’s standard deviation and beta.
- ❑ Since the Bull giveth and the Bear taketh away, the system penalizes funds that perform admirably in one environment and dismally in the other.
- ❑ penalizes funds whose managers’ performance is unimpressive when risk-related. To accomplish this, it monitors a fund’s alpha.
- ❑ removes a fund from the list if the manager responsible for its recent performance departs the fund. History suggests that, too often, fund performance suffers from the departure of its decision maker.
- ❑ does not replace a fund because it performed poorly against its peer group in any given year. However, two consecutive years of performing in the lower half of its peer group demands attention. Should the fund underperform its designated investment category average through the second quarter of a third consecutive year, the system replaces the fund with another fund from the same investment category.
- ❑ The Mutual Fund Report Card selection criteria will not necessarily help find next year’s top-performing mutual funds nor the next five or ten year’s top funds. What it will do is help investment professionals meet the structure of their promise and the long-term investment goals of their valued clients.

## The Process

- **Ranking of fund data** — After eliminating redundant share class funds, all funds are assessed for their relative category performance in 11 key statistical areas, using a 4-point quartile grading system, with “1” being best and “4” being worst. There are times when the process awards a statistical category score of “5.” This occurs when a fund’s category performance is significantly worse than even the lowest quartile.

1. **Manager Tenure** —When you board a commercial airliner and pass the cockpit, you are comforted by the amount of gray hair on the pilot’s head, especially when the aircraft encounters turbulence. The fund selection process responds in similar fashion. While our research suggests that manager tenure is of little importance while flying in clear skies, it proves critical to fund performance when the skies turn turbulent. Therefore, our system rewards fund management that has been consistently at the helm through the good times as well as the bad times.

Hire Date		Qtr
1923 —	1999	1
2000 —	2002	2
2003 —	2005	3
2006 —	2007	4
2008 —	2011	5

2. **Net Assets** — AFS has conducted many studies that convinced us, while bond funds benefited from asset size, equity fund performance suffers as funds grow larger. In his book *The Roaring 2000’s Investor*, noted economist and author Harry Dent quotes an unidentified fund manager as saying:

“When my fund was small, I bought stocks that I loved.  
 When my fund grew larger, I purchased stocks I liked,  
 When my fund got even larger, I tried to buy stocks that I didn’t hate!”

Equity Mutual Funds		
Net Assets		Qtr
\$0 —	\$500 million	1
\$500 million —	\$1 billion	2
\$1 billion —	\$5 billion	3
\$5 billion —	\$85 billion	4

Fixed Income Mutual Funds		
Net Assets		Qtr
\$5 billion —	\$85 billion	1
\$1 billion —	\$5 billion	2
\$500 million —	\$1 billion	3
\$0 —	\$500 million	4

- 3. Management Style** — Surveys we have conducted of all funds over the last 25 years indicate a clear returns advantage based on a fund’s management style. Additionally, we feel that managerial changes are more easily monitored in the star system.

Fund Management	Qtr
Star	1
Committee	2
Team	3

- 4. Fund Turnover** — AFS has conducted studies that convince us that fund turnover negatively impacts fund returns. In fact, the highest turnover funds consistently deliver the lowest returns in almost every investment category. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoints* — here is a typical breakdown:

Turnover Ratio		Qtr
0 —	25%	1
26% —	50%	2
51% —	99%	3
100% —	200%	4
201% —	+%	5

- 5. Expense Ratios** — All mutual funds, both load and no-load, have fund expense loads. Our studies suggest that the higher those expenses, the lower the fund returns. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoints* — here is a typical breakdown:

Expense Ratio		Qtr
0 —	0.99%	1
1.00% —	1.25%	2
1.26% —	1.50%	3
1.51% —	1.99%	4
2.00% —	+%	5

- 6. 3-Year Standard Deviation** — Standard Deviation reveals the volatility of a fund’s returns. How rocky was the ride on the way to satisfactory investment returns? The higher the standard deviation, the rockier the ride. All things being equal, obtaining performance with less volatility is emotionally preferred. AFS monitors the 3-year timeframe because Modern Portfolio Theory suggests it is the most accurate barometer of a fund’s statistical performance. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoints* — here is a typical breakdown:

Standard Deviation		Qtr
0 —	9.99%	1
10.00% —	19.99%	2
20.00% —	24.99%	3
25.00% —	39.00%	4
40.00% —	51.00%	5

***Very Important to Note:*** *During strong Bull Markets, funds with higher standard deviations have consistently outperformed funds with lower standard deviations; albeit, with a commensurate higher degree of risk.*

- 7. 3-Year Beta** — a fund’s beta establishes a ratio between the risks taken by the fund and the risks taken by the investment index that most closely approximates the fund’s investment objective. All things being equal, obtaining satisfactory returns while taking less risk than the investment category as a whole is preferred. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoint* — here is a typical breakdown:

Beta		Qtr
0 —	0.79%	1
0.80% —	0.99%	2
1.00% —	1.20%	3
1.21% —	1.99%	4
2.00% —	4.40%	5

- 8. 3-Year Alpha** — Alpha is the difference between the fund’s actual performance and the performance anticipated in light of the fund’s risk (beta) and the market’s behavior. A positive alpha indicates the manager outperformed the risks taken, while a negative alpha indicates the manager’s return performance was not worth the risk taken. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoints* — here is a typical breakdown:

Alpha		Qtr
53.00% —	5.00%	1
4.99% —	0.00%	2
-0.01% —	-4.99%	3
-5.00% —	-15.00%	4
-15.01% —	-70.00%	5

- 9. 3-Year R-Squared** — while beta and alpha tell a great deal about a fund’s risk history and investment success, they may be misleading. Both beta and alpha are derived from comparing the fund to a category benchmark. How closely the fund aligns with the benchmark is critical in determining the validity of the fund’s beta and alpha. R-Squared tells us how closely the fund invests in the securities that make up its benchmark. R-Squared is also a great tool for monitoring the accuracy of any portfolio allocation against its intended model. Although each investment category produces its own quartile ranking parameters — see *Report Breakpoints* — here is a typical breakdown:

R-Squared		Qtr
100 —	90	1
89 —	80	2
79 —	70	3
69 —	50	4
49 —	0	5

## 10. Return Last Bull . . . and

**11. . . . Return Last Bear** — How funds perform in bear markets is almost as important as how they perform in bull markets. Remember, the bull giveth and the bear taketh away. Adding the bull/bear criteria to the Report Card helps further identify funds that hold up well in one market, but trail their peers in the other. Although each investment category produces its own quartile ranking parameters — see *Report Card Breakpoints* — here is a typical breakdown:

Most Recent Bull Market	Qtr	Most Recent Bear Market	Qtr
34%+	1	-8%+	1
29% to 34%	2	-12% to -8%	2
24% to 29%	3	-16% to -12%	3
14% to 24%	4	-21% to -16%	4
	5		5

***Very Important to Note:*** *In all of our years of research, when it comes to bull market vs bear market performance, we have consistently observed that a fund's strong performance in a bull leads to weak performance in a bear . . . and visa versa. Few funds turn in outstanding performance in both. You can find a list of those "all weather" funds in a report of the same name.*

- **Final Score** — The SCORE is a compilation of the quartile rankings from each of the 11 pertinent statistical categories.
- After, the final score, additional information pertinent to each investment category is included in the report card. That information includes:
  - Annual Returns of the past ten years
  - Multi-Year Returns of 3-Yr, 5-Yr, 10-Yr, 15-Yr and 20-Yr
  - Median Market Cap
  - P/E Ratio
  - Bond Duration Average
  - Bond Percent-to-Par Value
  - Minimum Investment
  - Funds Closed to New Investors

- ***By the Numbers***

After eliminating money market funds and municipal bond funds, the mutual fund report card process for 2011 began with 18,742 mutual funds in 76 distinct equity, fixed income and combined categories. AFS then eliminated:

- 74% of all funds because they were redundant share class funds.
- The remaining 4,906 funds were then scored within their representative investment category. Some funds earned a score in more than one category.

Of the remaining funds, the following eliminations took place:

- 31% of the managers responsible for the funds' investment decisions have been on the job for less than 3 years.
- 64% generated a less-than-impressive score.
- 15% failed to outperform their category average in each of the preceding three years.
- *Best of the Best* status was earned by 224 funds or 4% of funds scored.
- Scores ranged from 14 to 46, with an overall average fund score of 25

## How to Read the Report Cards

- **Note** — In scoring the funds, performance that scores a “1” in any of the 11 fund data categories, indicating a top quartile ranking, is noted by the following symbol and color.

1

Performance that scores a “4” in any category, noting performance in the bottom quartile is noted by the following symbol and color.

4

Performance that scores a “5” in any category, noting performance significantly worse than the bottom 25% of the category is noted by the following symbol and color.

5

- **The Score** — Funds are sorted by their score.
- **Returns for 2001-2010** — Returns that exceed their investment category average are noted by the following symbol **Y**, while funds that underperformed their category for three consecutive years are noted as follows **N N N**
- **Multi-Year Returns** — Returns for the preceding 3-Year, 5-Year, 10-Year, 15-Year and 20-Year periods that are represent the top 10% are highlighted in green, while those returns in the bottom half of the peer group are highlighted in tan.
- **Median Market Cap** — the average size of the firms in the fund portfolio is noted with the following consideration:

category	size
Micro	\$50m – \$300m
Small	\$300m – \$2b
Mid	\$2b – \$10b
Large	\$10b – \$200b
Mega	Over \$200b

- **Price/Earnings Ratio** — P/Es of 23 or more are highlighted to draw attention to the fund’s collective price vs value.
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- **Bond Duration Average** — long bond durations can be debilitating to a fund in a rising interest rate environment, so portfolios with an average bond duration in excess of is highlighted. It also is considered heavily when searching for the Best-of-the-Best funds.

- **Percent to Par Value** — We created this statistic. For funds that present an average number for both coupon rate and yield to maturity, we create what we call *percent to par value*. It produces an approximate overall liquidation value of the fund's bond portfolio. A percent of 65% suggests the portfolio is underpriced and would sell for a 35% premium, while a percent of 145% indicates the portfolio is priced 45% over value.
  
- **Portfolio Breakdown Percentages** — A fund's portfolio makeup is divided among:
  - Equity
  - Fixed Income
  - Cash
  - North America
  - International
    - Europe
    - Latin America
    - Japan
    - Pacific Rim
    - Asia
    - Middle East
    - Africa
    - Emerging Markets

- **Closed** — Is the fund closed to new investors? If the answer is “Yes,” it is represented by the following symbol.

Y

### ***In Closing***

It is important for you to note that my Mutual Fund Report Card System is not a process that rates a fund; rather, it is a process that simply ranks the fund’s many attributes against its peers. It is my hope that after becoming familiar with this philosophy and process, you will agree that my Mutual Fund Report Card System is an outstanding tool that adds clarity and insight to both the mutual fund selection process and ongoing fund management.

Good luck!