Investments: Qualitative Considerations When Picking a Mutual Fund

Considerations Other Than Return When Picking a Mutual Fund

By: Joe the Investor

Everyone hears about the returns of a mutual fund or investment portfolio. Is there anything else to consider when investing your money? It turns out there is, and many of the intangible, immeasurable or “qualitative” characteristics are important in deciding which money managers should be taken seriously or not. Some of these criteria can apply to index funds, but typically they are used for “active management”, where someone is deciding what securities to buy, and trying to do a better job than their competitors.

Intangible or Qualitative Aspects

Besides return and risk calculations, the other considerations center around trust and reputation. The questions underlying these considerations are: How do I know this person or company is not going to take my money and run? How do I know if these results are useful for me?

It should be kept in mind that you will never really know with 100% certainty whether you can trust a set of results or an institution. Why? Things change constantly, and even people with a stellar record can change their intentions and become corrupted and greedy. These factors are an attempt to minimize the risk of a poor reputation, and avoid obvious land mines of the “if it is too good to be true, it probably is” variety.

Time as an Indicator

One of the key factors in determining reputation and trust is time. As examples, good questions to ask are: How long has this company existed? How many years has this product existed? How long has this manager been running this particular mutual fund or investment portfolio that I want to put money into? Most financial companies have been around a long time, so for most companies, time would not be an issue. If you are investing in a new company such as a hedge fund, time would be important to see if the personnel can consistently provide results, and it can be seen how they are doing it. Some scams take a long time to get figured out, but at least if you have a history of results, you have better odds of seeing through something if it is fishy.

As a rule of thumb, 5 years is a minimum number when looking at a return history or how long someone has been running a portfolio. The trade-off is that most people change jobs frequently, and products change frequently, so many product histories and track records of individuals don't reach this period of time. Ten years would be an even more solid indicator of consistency, but this is harder to find. If you find someone running the same product, and doing it well for 10 years, this product would be preferred over the others. If you find the same situation for 5 years, I would have this product on a secondary list.

What if Someone Leaves the Company?

A related consideration is the fact that some well-known portfolio managers may leave from one company and join another, and take their track records with them. This can be a double edged sword. On the one hand, if they are managing exactly the same product for a new institution, you can look at the results from the investment manager's old employer and then the new employer and see if the results are solid over the whole period. On the other hand, when changing employers, money managers may have to change their style or may have their decisions limited, and this will change their future return history. This means that stringing together returns from the same person running a similar portfolio in two places can be misleading. A very big indicator in how well your money is being managed is by looking at the individual who is making the investment decisions – who is typically the portfolio manager.

Furthermore, there is a situation when companies start mixing responsibilities of portfolio managers with analysts, and taking a "team approach" in investment decisions, which may mean that you are not sure who is making the decisions for your fund. If one person on this team leaves, you are not sure what this means to you because you cannot tell what influence this person had on the fund performance. That leads to this question which is good to ask: How long has the investment team been together? This is an alternative to focusing on an individual, but due to team fluidity, this question will be harder to use for accountability than a single person making the investment decisions.

In terms of avoiding land mines, one approach is to use the cockroach concept. If there is one cockroach, there are bound to be others. In this case, if there is one regulatory infraction, scandal, defection, illegality, questionable activity, shady practice or uncertainty in one instance, the odds of the same thing repeating are increased. Another way to think of this is once someone lies to you the first time, they are likely to lie to you again. The counterargument to this thinking is that once something is discovered, the offenders are usually let go. This unfortunately can be scapegoating, and the conditions that precipitated the questionable activity tend to persist long after the person has left. This is why the cockroach theory works. The safest route to pursue if something questionable were to happen in a fund where you have money invested is to sell it. If the questionable conditions are everywhere, then it is better not to sell immediately, but to lower your threshold of trust and ask more questions.

The Cost of Running the Portfolio

The cost of running the portfolio is another factor than be used to decide which fund to invest in. The cost in this case translates as fees. This includes all fees: management expense ratios, referral fees, advisor fees or sales charges. If you have two fairly equal products, and one is cheaper, that product would be ranked higher on the list. Since many of the variables are uncertain, and fees are pretty certain to stay where they are, fees should be a large indicator when deciding what fund to invest in. If fee differences are less than 0.5% between two products, it may not matter which fund to buy. Once differences exceed 1%, you need to ask if one product is noticeably better than the other.

Many of these factors boil down to the reputation of the company and of the individuals working there. The key to this process is: Do the people running the investment portfolio have skill over and above the average portfolio manager? This question is not easy to answer, as this skill is not measurable and not always recognized. The best way to know this is with consistent results, which ironically are witnessed through the returns, especially when comparative funds are not cutting it.

These intangible aspects are useful in narrowing down the list of potential products to invest in. Combining these factors with returns and risk indicators will increase your odds of finding a better product to invest in.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what these options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**