

Understanding funds can help you find right mix

There is an endless debate about the merits of investing in index mutual funds or actively managed mutual funds. When viewed collectively, professional mutual fund managers don't always justify their expense by delivering better returns than their appropriate index benchmark.

But there are many actively managed mutual funds whose managers have demonstrated ability to consistently outperform. So, how does an investment advisor identify the actively managed funds that are more likely to provide a satisfying experience to investors over time?



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One factor that carries a lot of weight in my evaluations is capture ratio.

Capture ratio identifies how good the mutual fund manager has been at adding value in both rising and declining markets.

Index funds capture 100 percent of the up and 100 percent of the down. The ideal actively managed fund outperforms the passive index whichever way the market is moving. If markets rise, it rises more. If markets decline, it loses less.

If the market gains 10 percent and your investment rises 11 percent over the same period, it has a 110 percent up-market capture ratio. If the market is in a down cycle and loses 10 percent but your investment loses only 8 percent, that's an 80 percent down-market capture ratio. Ideally, you want a healthy spread between these two numbers.

FINDING THE RIGHT MIX

A mix of index funds and actively managed mutual funds can provide the best of both worlds. The index funds deliver broad market diversification at the lowest cost, are more tax efficient and at times will outperform actively managed mutual funds. The actively managed mutual funds have the potential to boost returns beyond indexes and avoid the full extent of market dips.

Active mutual funds gain more attention when they are significantly outperforming their benchmark in rising markets. However, they demonstrate perhaps even more value when they protect against down-market risk by avoiding some of the decline. Many investors are happy with funds that don't fully capture all the return of a rising market if the tradeoff is experiencing much less of a down market.

Participating less in market declines can ultimately make a big difference over time. It may be a hollow victory to lose less but this is a critical component to achieving longer term returns that you can build a financial plan or a retirement income strategy around.

PERSISTENCE IS THE KEY

It's important to understand how a mutual fund performs over multiple time periods. Some find a sweet spot for a short period of time as their particular approach aligns in favor with the market but their promising capture ratio fades over time.

Another circumstance that limits a fund manager's ability to outperform the index is asset bloat. Some of the biggest, well-known funds available have drawn attention with good past performance. This has led to exceptional cash flow into the fund forcing the manager to buy more and more positions that are further down on his preferred list. This makes the holdings of the fund more index like and the fund's ability to demonstrate bigger capture ratio differences is reduced.

This is one reason why it can be beneficial to invest in active funds where the manager has the flexibility to concentrate investments in their best ideas, increasing the likelihood of an attractive capture ratio.

BEWARE OF HIGH FLYERS

Some funds post impressive up-market capture ratios of 140 percent or more. It may sound great to advance well ahead of the market overall, but the risk they take to build an edge often works the same on the way down and they may lose even more than the index. This is more often characteristic of aggressive funds or those in volatile market segments like emerging markets, commodities or technology.

To review capture ratios for funds you are interested in, visit Morningstar.com or ask your adviser.

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