Tips When Looking at Funds

In mutual fund investing there are no immutable laws to guide us, as we have in physics. But the collective experience of fund investors can be distilled into a few general rules. Some of it has empirical evidence pointing its way. Most is simply common sense that investors often set aside or forget in the heat of making an investment decision.

Top performance lists are dangerous. Probably the single most potentially dangerous action a mutual fund investor can take is to glance at these ubiquitous lists. Funds make the top of the lists not because they are like all the rest of the funds, but because they are decidedly different in some important way. Risk is usually the first important difference. For stock funds, holding stocks that are more volatile than the average stock, holding fewer stocks, or concentrating on only a few industries, raises risk and puts a fund in position to have a greater chance at making the top of the list.

As an example, take sector funds. You can't beat the market by holding it, which is why you can always find a sector fund of one kind or another at the top of most performance lists. Call it stock picking, or industry weighting, or both, but the net effect is increased risk, and less diversification than the overall stock market.

Picking the funds at the top of the performance lists assumes that either these same stocks or sectors will continue to do well, or that the managers can continue to deftly take high risk and move money around better than all the rest.

For domestic bond funds, making the top of the list is a result of the maturity structure of the fund's portfolio.

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