Morningstar® Guide to Mutual Funds

5-Star Strategies for Success

Christine Benz
Peter Di Teresa
Russel Kinnel

John Wiley & Sons, Inc.

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Foreword

We all know that if you invest wisely, you can increase your wealth, but it's easy to overlook the lessons that investing can teach us about ourselves. Money is a difficult subject to discuss. Emotions run deep when it comes to our finances, causing most of us to shy away from deep thoughts on how we save or invest. Sure, we might boast to our friends about a particular stock purchase that went through the roof, or tell tales of an IPO opportunity that got away, but we seldom speak honestly or openly about our overall financial experiences, even with those closest to us. That's unfortunate. Ultimately, to know oneself as an investor goes a long way toward knowing oneself as a person.

I know that's been true for me. I started investing in mutual funds as a teenager. My father bought me 100 shares of the Templeton Growth Fund when I was in my early teens. He showed me the fund's prospectus and annual report and explained that I was now an owner of a little piece of each of the companies listed in the report. It was a wonderful introduction—not only to mutual funds, but also to the world of adult activities. I'm not saying I stopped reading *Boy's Life* the next day and switched to the *Wall Street Journal,* but an introduction had been made. Over time, I read more about investing and particularly about mutual funds. I paid special attention to Sir

John Templeton's advice, reading his annual reports and watching him on his visits to *Wall $treet Week* with Louis Rukeyser. In short, I had started down the path to becoming an investor.

Over time, I've realized that the real lesson from those first few shares of Templeton Growth wasn't how a mutual fund works, but how a responsible adult acts. In effect, my Dad was showing me that investing was something he did to help provide for our family. He wasn't jumping in and out of hot stocks. He was systematically setting a little bit aside each month to build for a better future, and he wanted me to know that I could do the same. He taught me that investing, by its very nature, is a responsible act. It's deferring the instant gratification of consuming today in hopes of providing a more secure future for yourself and for your loved ones. How different that message was from the messages on television (save those of Rukeyser's show) that portrayed investing as something only for the snobbish elite. The same shows that disparaged investing were supported by countless commercials touting the immediate satisfaction to be derived from spending!

Fortunately, our collective attitude toward investing has improved since the days when J. R. Ewing was the only one on television you saw making investments—and doing so to hurt people, I might add! The rise of personal financial journalism, led by *Money* magazine, has opened up investing to a much wider audience. There's never been a time when an individual investor had as many resources at his or her disposal as today. If anything, the challenge has shifted from finding information to making sense of an overload of information!

The 1990s, in particular, saw a surge of interest in the investment markets. Unfortunately, it wasn't always a mature or well-grounded interest. To a large extent, big market returns drove people to trade the instant gratification of consumption for the seemingly instant gratification of investment riches. I had an advantage many investors didn't have in that market: over 20 years of investing experience, albeit almost all of it with very small sums at stake. Nevertheless, I'd seen my shares both rise and fall; I'd weathered a number of down markets and had learned that staying the course paid off in the end. I especially knew from my readings on John Templeton that investing was never as easy as it appeared to be in the heady days of the Internet-led bull market. While Templeton has enjoyed enormous success as an investor, he always stresses the importance of humility, recognizing that even with thorough research there is still a significant chance that your stocks will lose money. He has warned repeatedly that even your best-researched stock pick may well decline in value by 30%, 50%, even 70% or more. Pointedly, he also notes that investors who get rich quickly are usually the same ones who get poor quickly. How truly his words played out after the technology bubble of the late 1990s.

Still, even with the sharp losses of recent years, our generation is making progress as investors. We're learning important lessons not only about investments, but also about how we respond personally to both gains and setbacks. In so doing, we lay the foundation for better results ahead. Bear markets shouldn't cause you to lose faith in the markets. Rather, they should be seen as a part of the inexorable cycle of the market. Sure, they can damage investor portfolios, but they also bring opportunities. The test is whether you have the fortitude to withstand the inevitable downturns and unearth the values they create. How odd it is that many of the same investors who bemoaned being late to the game in the 1990s, but plunged in anyway, later turned their backs on stocks at much more attractive prices. Clearly, the path to investment success requires a discipline that's easier to grasp than to master.

Fortunately, you don't have to go it alone. I learned much about patience and the benefits of weathering bad markets through the lessons of owning the Templeton fund. I've learned even more by working at Morningstar® with a group of people who genuinely like investing and want to learn more. Having smart people to share ideas with is a great benefit during tough markets. Sadly, many investors have no choice but to go it alone, having few friends or colleagues with whom they feel comfortable discussing their finances. That was certainly the case for me prior to joining Morningstar. I didn't find a lot of fellow investors in high school or even in college. I remember long nights in graduate school poring over personal finance magazines trying to make sense of the bewildering world of mutual funds to begin to put together a financial plan for my family. What a joy to join a community of fellow investors.

Now that opportunity is open to everyone. *The Morningstar Guide to Mutual Funds* is an invitation for you to join a community of investors who want to better understand what makes funds tick and what separates the top managers from the rest of the pack. You'll learn from three fine teachers—Christine

Benz, Peter Di Teresa, and Russ Kinnel—each of whom not only offers great insights on funds, but also has a real talent for making investing accessible and fun. You'll learn the lessons we've found most valuable over the years—everything from how to read fund documents to assembling a well-balanced portfolio. In short, you'll get the "on-ramp" introduction you need to get moving along the road to better investment results.

Even if you're a seasoned investor, I think there's much in these pages that will help you hone your skills as an investor. I hope that you'll also become a part of an investing discussion that continues each month in *Morningstar FundInvestor* and daily on Morningstar.com. Among our editors and readers, you'll find a group of independent thinkers who trade ideas in a shared quest to help people make better investment decisions. It's a lively and rewarding discussion, one that's evolving as its participants, both in print and on the Web, have grown. I value what I learn from our writers and readers about investment opportunities, but even more so I admire the spirit and spark they bring to the endeavor. They help me keep my feet on the ground during good markets and my head up during bad ones.

Please join us on this journey toward better investment results and greater financial independence. I think you'll learn a lot about investments and possibly a little about yourself along the way. Maybe you'll even use this book to introduce a young person in your life to the world of investing and set them on their own journey. In any case, I wish you well.

DON PHILLIPS

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Many people played important roles in creating this book. Amy Arnott and Erica Moor shepherded this book from start to finish, putting in long hours as they coordinated and edited the work of all of the contributors and kept the process on track. Award-winning Morningstar designer Jason Ackley created the graphics and layout.

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Morningstar fosters collaborative efforts, and it's fair to say that the hundreds of people who work here deserve a share of the credit for this book. Most important, founder Joe Mansueto set the spirit for Morningstar and for this book by promoting independent, objective analysis that puts investors first.

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PART ONE

How to Pick Mutual Funds

I

Know What Your Fund Owns

Most of us wouldn't buy a new home just because it looked good from the outside. We would do a thorough walk-through first. We'd examine the furnace, check for a leaky roof, and look for cracks in the foundation.

Mutual fund investing requires the same careful investigation. You need to give a fund more than a surface-level once-over before investing in it. Knowing that the fund has been a good performer in the past isn't enough to warrant risking your money. You need to understand what's inside its portfolio—or how it invests. You must find out what a fund owns to know if it's right for you.

The stocks and bonds in a fund's portfolio are so important that Morningstar analysts spend a lot of their time on the subject; news about what high-profile fund managers are buying is a constant source of e-mail chatter in the office. Our analysts examine fund portfolios of holdings, talk with the managers about their strategies in picking those holdings, and check on recent changes to the lineup. Knowing what a fund owns helps you understand its past behavior, set realistic expectations for what it might do in the future, and figure out how it will work with the other funds you own.

At the most basic level, a fund can own stocks, bonds, cash, or a combination of the three. If it invests in stocks, it could focus on U.S. companies or venture abroad. If the fund owns U.S. companies, it might invest in giants such as General Electric or Microsoft or seek out tiny companies that most of us have never heard of. A manager may focus on fast-growing companies that command high prices or on slow-growth (or no-growth) firms trading at bargain-basement prices. Finally, managers can own anywhere from 20 to hundreds of stocks. How a manager chooses to invest your money has a big impact on performance. For example, if your manager devotes much of the portfolio to a single volatile area such as technology stocks, your fund may generate high returns at times but will also be very risky.

A fund's name doesn't always reveal what a fund owns because funds often have generic handles. Take the intriguingly named State Street Research Aurora and American Century Veedot funds. If you were to skim over only their names, you would be hard-pressed to glean that the former focuses on small companies that are trading cheaply, whereas the latter is a go-anywhere fund that uses computer models to help direct investments. Nor do the objectives that the firm identifies in its prospectus always give you clues about its portfolio. Aegis Value Fund focuses on tiny, budget-priced stocks, whereas Alliance Premier Growth focuses on fast-growing stocks of large companies. The Aegis fund returned 43% in 2001, whereas the Alliance fund lost 25% that year. Yet both funds are classified as "Growth" funds in their prospectuses. To discern their differences, you'd need to dig beneath the funds' stated objectives.

Using the Morningstar® Style Box™

A desire to help investors choose funds based on what they really own—instead of on what funds call themselves or how they've performed recently—was precisely what inspired Morningstar to develop its investment style box in the early 1990s. The style box provides a summary of a given fund's portfolio—it does not tell you about every security the fund owns, but the box gives a quick and clear picture of the portfolio as a whole. (To check out a fund's current style box, go to Morningstar's Web site, www.morningstar.com, and type in a fund's name or ticker.) The style box isolates two key factors that drive a stock fund's performance: the size of the stocks the fund invests in, and the type of companies it invests in—rapidly growing companies, slow growers, or a combination (see Figure 1.1).

To figure out which square of our stock style box a whole fund portfolio lands in, we first analyze each and every stock in that portfolio. We look at a stock's market capitalization (the number of shares outstanding multiplied by the stock's price), categorizing each holding as small, medium, or large. We then figure out the portfolio's overall capitalization. The calculation resembles a simple average, except that it takes outliers into account (e.g., large-company stocks in a mostly small-cap portfolio) without letting them completely distort the results. A portfolio's capitalization—whether the fund invests mainly in small, medium-size, or large companies—forms the vertical axis of the style box.

Once we've pinpointed what size stocks a fund invests in, we plot its investment style on the horizontal axis of the box. We classify stocks as value (think stodgy dividend payers like Philip Morris), core (steady but not scintillating growers, e.g., Procter & Gamble), or growth (highfliers like eBay or biotech firm Amgen). We score each stock in several ways ranging from value

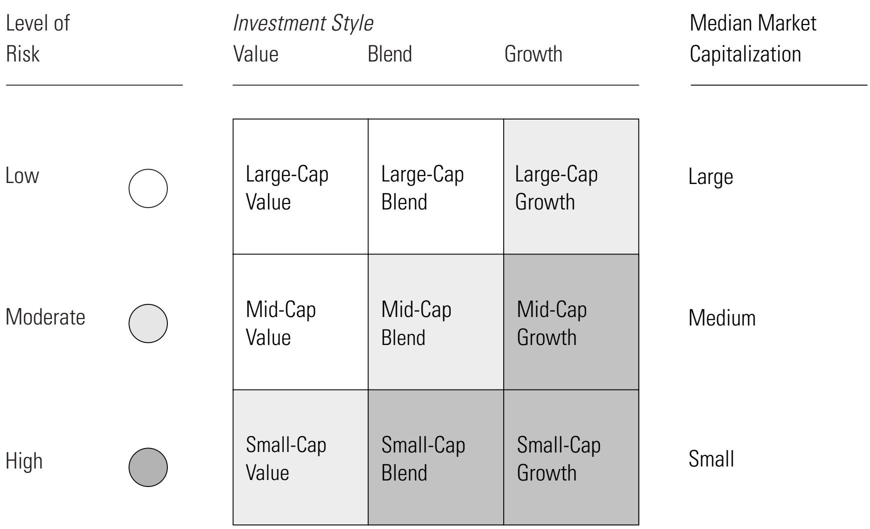

Figure 1.1 The Morningstar style box is a nine-square grid that provides a quick and clear picture of a fund's investment style.

criteria such as dividend yields and price/earnings ratios to growth factors such as earnings and sales growth. This helps us decide whether to classify a stock as growth, value, or core. Once we have classified each stock's investment style, we then classify the entire portfolio, based on which square of our style box most of its stocks land in.

Understanding the difference between a growth stock and a value stock is critical to understanding what makes a fund tick. Growth stocks typically enjoy strong growth in earnings that is often related to a hot new product or service. Because the market expects good things from these fast growers, and earnings growth usually drives a higher share price, investors are willing to pay more for the shares than they will pay for slower growers.

Value stocks, on the other hand, look like growth stocks' less successful cousins. These companies' earnings are usually growing slowly, if at all, and they often operate in industries that are prone to boom-and-bust cycles. So why does anyone bother with these underachievers? The answer is, because they're cheap. Managers who focus on value stocks are willing to put up with unattractive historical earnings growth because they think the market is being overly pessimistic about the company's future. Should things turn out better than the market thinks, the bargain-hunting fund manager stands to profit.

As you might expect, different-style funds tend to behave differently in various market and economic environments, which is why the style box can be so handy. Quickly eyeballing a fund's style box can give you some indication of how it might perform in good markets and in bad. As a rule of thumb, the large-cap value square of Morningstar's style box is considered the safest because large-cap companies typically are more stable than small ones (the high-profile blowups of giants like Worldcom and Enron notwithstanding). And in down markets, when investors are concerned that stock prices could be too high across the board, value funds' budget-priced stocks don't have very far to fall.

Funds that hit the small-growth square of the style box are usually the riskiest. The success of a single product can make or break a small company, and because small-growth stocks often trade at lofty prices, they can take a disastrous tumble if one of the company's products or services fails to take off as the market expects. These funds can deliver glittering riches in upmarkets, though: In 1999, the average small-growth fund returned 58% (for more on the correlation between investment style and risk, see Chapter 3).

Using the Morningstar Categories

Despite the usefulness of the Morningstar style box, it's just a snapshot of the fund's most recent portfolio. When you are selecting a fund to play a particular role, such as adding large-cap value stocks to your portfolio, you want to be confident that it actually has played that role over time. That's what we have in mind when we plug funds into Morningstar categories. We assign funds to categories based on the past three years' worth of style boxes. A single portfolio could reflect a temporary aberration—maybe the fund's holdings have been doing really well, so they have grown from small- to mid-cap as stock prices have gone up. But because a fund's category assignment is based on three years' worth of portfolios, it gives you a better handle on how the fund typically invests.

Our categories are based on the style box with style-specific categories ranging from large value in the upper left corner to small growth in the lower right corner. We also carve out some categories for specialized funds. To name a few, there are categories for high-yield bond funds, Japan funds, and health care funds. Morningstar slots funds into about 50 categories (see Figure 1.2).

As with the style box, Morningstar categories pick up where fund names and prospectus objectives leave off. They help you figure out how a fund actually invests, which in turn lets you know how to use it in your portfolio. If you're looking for a good core stock fund, you might begin your search within the large-blend category. Funds that land there usually invest in the biggest, best established U.S. companies and buy stocks with a mix of growth and value characteristics. Thus, large-blend funds tend to be a decent bet in varied market and economic conditions. Although they may not lead the pack too often, neither are they apt to be left completely behind. (This subject is discussed in detail in Part Two.)

By targeting funds in different categories, you are much more likely to pull together a diversified portfolio than if you rely on funds' prospectus objectives to show you the way. An investor focusing exclusively on prospectus objectives might think he or she had a diversified mix in a portfolio that consisted of Dreyfus Premier Value (with a prospectus objective of Growth),

Domestic Stock	Large Value Large Blend Large Growth Mid-Cap Value	Mid-Cap Blend Mid-Cap Growth Small Value Small Blend
International Stock	Europe Stock Latin America Stock Diversified Emerging Markets Pacific Stock	Pacific Stock ex-Japan Japan Stock Foreign Stock World Stock
Specialty Stock	Communications Financial Health Natural Resources	Precious Metals Real Estate Technology Utilities
Hybrid	Conservative Allocation Moderate Allocation	Bear
Specialty Bond	High-Yield Bond Multisector Bond International Bond	Emerging Markets Bond Bank Loan
General Bond	Long-Term Bond Intermediate-Term Bond	Short-Term Bond Ultrashort Bond
Government Bond	Long-Term Government Intermediate-Term Gov't	Short-Term Government
Municipal Bond	Muni National Long Muni National Intermediate Muni NY Long Muni NY Intermediate Muni CA Long Muni CA Intermediate Muni Florida Muni Pennsylvania Muni New Jersey	Muni Ohio Muni Minnesota Muni Maryland Muni Single State Long Muni Single State Intermediate Muni Short-Term Muni High-Yield

Figure 1.2 Morningstar's category breakdown for the fund universe.

Hancock Sovereign Investors (Growth and Income), and Armada Large Cap Value (Equity-Income). Diversified? Not so fast. According to their Morningstar categories, which take their underlying holdings into account, all three funds are actually large-cap value offerings.

Examining Sector Weightings

Checking a fund's category and style box can go a long way toward helping you know what a fund is all about, but it may not tell the whole story. Not all funds that land in the same style box or even the same category will behave the same way. Both Fidelity OTC and Marsico Growth land in the large-cap growth category. Yet they have tended to own very different kinds of large-growth stocks. In the late 1990s, Fidelity OTC often dedicated more than half of its assets to technology-related stocks—as much as 75% at one point. Marsico Growth also staked a sizable amount on tech, but its position topped out at 40% of the portfolio.

What a difference those two approaches made! A heavy weighting in the tech sector was a boon in 1999, when investors adored technology stocks. Fidelity OTC soared an amazing 73% that year, whereas Marsico Growth gained 53%. A 53% gain is an impressive return in its own right, but if you had put $10,000 in each fund at the start of the year, your Fidelity OTC investment would have been worth $2,000 more than Marsico Growth at the end of 1999. But anything that produces such strong returns can also prove an Achilles' heel, and that's exactly what happened to Fidelity OTC; when tech collapsed in 2000, it lost 26%, whereas Marsico Growth lost 16%. The moral of the story isn't that a technology-heavy fund like Fidelity OTC is automatically a bad idea, but, that people who own it, should limit their investment in it and make sure to diversify with other funds.

Morningstar calculates a fund's sector exposure based on the percentage of its portfolio that is committed to stocks in each of 12 industry groupings. We also cluster those sectors into one of three "supersectors": information, services, and manufacturing (see Figure 1.3). We developed the broader classification system because the sectors within our supersector groupings tend to behave in a similar way in various stock market environments. In the recent market downturn of 2000 through 2002, every sector in our information supersector—hardware, software, telecommunications, and media—incurred

Information Economy	Service Economy	Manufacturing Economy
Software	Health Care	Consumer Goods
Hardware	Consumer Services	Industrial Materials
Telecommunications	Business Services	Energy
Media	Financial Services	Utilities

Figure 1.3 Morningstar's sector breakdown. Twelve sectors are divided into three supersectors representing broader economies.

terrible losses. If all the funds in your portfolio heavily concentrate their holdings in a certain supersector, it can be a strong indication that your portfolio needs exposure to other parts of the economy. Similarly, if you have a job in a technology-related field, you will want your portfolio to have plenty of exposure outside the information supersector because much of your economic well-being (through your job) is already tied to that area.

Examining Number of Holdings

To understand what a particular fund is up to, knowing the number of stocks it owns can be just as important as any of the other factors we have discussed. For obvious reasons, whether your fund holds 20 stocks or hundreds of them will make a big difference in its behavior. (Because Securities and Exchange Commission regulations limit the percentage of its assets that a fund can commit to each holding, fund portfolios rarely have fewer than 20 stocks.) Janus Twenty, which divides its portfolio among a small number of stocks, is likely to see a lot more gyrations in its performance—for better and for worse—than one that spreads its money wide like Fidelity Contrafund (it owns more than 400 stocks), even though both are large-growth funds.

Checking Up on the Frequency of Portfolio Changes

In addition to checking categories, style boxes, sectors, and number of holdings (phew!), a fund's turnover rate is another important factor when you're judging a fund's style. Turnover measures how much the portfolio has changed during the past year and shows approximately how long a manager typically holds a stock. For example, a fund with a turnover rate of 100% has a typical holding period of one year; a fund with 25% turnover holds a stock for four years on average.

Turnover is a pretty simple calculation: To figure it out, fund accountants just divide a fund's total investment sales or purchases (whichever is less) by its average monthly assets for the year.

A fund's turnover rate can give you important insights into a manager's style. It can tell you whether a manager tends to buy and hold, picking stocks and sticking with them for the long haul instead of frequently trading in and out of them. To give you a basis for comparison, stock funds on average have turnover rates of 114%. We consider a fund's turnover rate to be notably modest when it's 30% or lower.

Insights about turnover are useful because managers who keep turnover low tend to practice low-risk strategies, whereas high-turnover funds tend to be aggressive and much riskier. That gets back to investment style: As a rule of thumb, the more value-conscious your manager is, the more patient he or she will tend to be with the holdings in the portfolio. Meanwhile, growth-oriented fund managers often employ high-turnover strategies, and as we mentioned, higher-priced stocks often equal more risk.

High turnover can also spell tax consequences for investors. A manager who sells stocks at a profit incurs a taxable gain, which the fund is required to distribute to investors. If you own the fund in a taxable account instead of in a 401(k) or Individual Retirement Account, you'll have to pay taxes on that distribution. If the fund has a high turnover rate, the tax consequences could cut into returns you would otherwise pocket.

As if that weren't enough, high-turnover funds can incur higher trading costs than low-turnover offerings. When we say *trading costs* we're not just referring to the dollars that the fund pays its brokers to execute the trade (though those charges can cut into your returns, too). Rather, we're also referring to the fact that big funds can "move the market" when buying and selling their shares. Say a big fund like Fidelity Contrafund wants to get out of one of its largest positions in a hurry. Because Contrafund is flooding the market with shares, it may have to accept lower and lower prices for those shares as it unloads its position. The more the fund engages in such trading, the less attractive its average purchase and sale prices will be, and the less its shareholders will profit. (We probably shouldn't pick on Contrafund in

Fund Name	Category	Turnover %
Dreyfus Appreciation	Large Blend	5
Mairs & Power Growth	Large Blend	8
Dodge & Cox Stock	Large Value	10
Vanguard Health Care	Health	13
Gabelli Asset	Mid Blend	15
Third Avenue Value	Mid Blend	16
T. Rowe Price Equity-Income	Large Value	17
Longleaf Partners	Mid Value	18
Liberty Acorn	Small Growth	20
Selected American	Large Blend	20

Figure 1.4 Ten great low-turnover funds.

particular—it has been a strong performer, despite its huge asset base and high-turnover approach. But in general, a fund that combines a high-turnover strategy with a big asset base is fighting an uphill battle.)

For all these reasons, we think you greatly improve your portfolio's odds of good long-term performance if you put the bulk of your assets in low-turnover funds. Figure 1.4 provides a list of some of our favorites.