

Mutual Fund & ETF Selection Criteria

The most important part of Mutual Fund Analysis process is to conduct thorough research. It starts from talking to the managers/ product specialists at the fund company to obtain information about their investment process, strategy and philosophy. The next step is to review the fund's annual reports, prospectuses, manager commentaries and reading through the company's websites for more information. Obtaining firsthand information whenever possible from the fund's specialists is very important. The below mentioned points are considered after ensuring that the fund's investment mandate suits the investment objective.

Have you or your advisor considered the following criteria when choosing investment funds?

(Please check the appropriate boxes and enter comments)

1. **Fund's Star Rating:** Star rating forms a good starting point to select funds. Morningstar assigns this rating based on the fund's risk adjusted returns compared to its peers. But this should not be the only criteria to choose funds. It's a historical reference only.

Yes No N/A Comments: _____

2. **Medal/Analyst Rating:** Though not a guarantee, it is an opinion by the Morningstar's analysts about the fund's future performance based on their research.

Yes No N/A Comments: _____

3. **Rank in The Category:** Funds with higher percentile ranking have been better performers as compared to its peers. This information is available on the fund's overview page under the heading 'performance'.

Yes No N/A Comments: _____

4. **Fund's Long Term Standard Deviation/Volatility (for equity funds):** Measure to gauge the fund's volatility. Compare the fund's Standard deviation with its benchmark to determine whether the fund is more/less volatile than the market. Also use this measure to determine whether the fund fits within your risk tolerance levels. Interpreting standard deviation with an example: If your 3 year standard deviation is 15 and your mean return for 3 years is 8%, then your returns will be between -7% and +23%, 67% of the time i.e, in about 2 years for every 3 years.

Yes No N/A Comments: _____

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5. **Average Duration (for bond funds):** Bonds with higher duration indicate higher sensitivity to interest rate changes. The funds with intermediate duration must generate higher yield than the short term bonds. The credit quality of the bonds largely determines the yield. Call the fund company to enquire about the hedging techniques they have in place to manage interest rate volatility.

Yes No N/A Comments: _____

6. **12 Month Yield:** Per Morningstar, it is a measure of the fund's income distribution as a percentage of the fund's price. Income distribution includes dividends from stocks, interest from bonds and realized gains from currency transactions.

Yes No N/A Comments: _____

7. **Bear Market Percentile Rank:** Indicates the fund's performance in bear market. The best performing fund is ranked 1. (Not reported for ETFs on Morning Star)

Yes No N/A Comments: _____

8. **Fund's Expense Ratio as Compared to its Peers:** This information is available on Morningstar. Funds with higher expenses will be a drag on the returns over the long run. Only exception is long term performance exceeding its peers. While ETFs are mostly cost effective, be wary of some ETFs with high fees. Closed end funds have higher management fees than the traditional ETFs.

Yes No N/A Comments: _____

9. **Number of Holdings in The Fund:** Determine if the fund is concentrated only in a few stocks/bonds. Look for funds with a greater number of holdings diversified across different sectors.

Yes No N/A Comments: _____

10. **No-Load Funds:** Look for No-Load funds. These funds do not have any sales charge or commission when purchasing or selling thereby improving the net returns. Avoid 12B-1 fees. Choose the share class with lowest expenses based on availability. (Not applicable to ETFs)

Yes No N/A Comments: _____

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11. **Long Term Performance Chart:** Consider 5 or 10 years performance history. Especially look for the fund's performance during market downturn as in 2008.

Yes No N/A Comments: _____

12. **Fund Total Returns:** Compare the fund's returns with its benchmark/category average. It is always important to consider the risk when evaluating returns to determine whether a fund is assuming more risk than the benchmark to generate excess returns.

Yes No N/A Comments: _____

13. **Average Bond Credit Quality:** Higher quality bonds indicate lower credit risk.

Yes No N/A Comments: _____

14. **Sharpe Ratio:** It is a measure of risk adjusted returns. Considers standard deviation as a measure of risk. Standard deviation is a measure of total risk (systematic and unsystematic) Higher the fund's Sharpe ratio, better it is. When comparing two funds, the fund with a higher Sharpe ratio has better returns for the risk it has assumed.

Yes No N/A Comments: _____

15. **Sortino Ratio:** A risk adjusted measure similar to Sharpe ratio except it considers downside deviation (volatility) as a risk measure. Useful in analyzing volatile funds. A stable fund may not have many data points for downside deviation making a Sortino Ratio less reliable. A high Sortino Ratio is better as it means low probability of incurring a loss.

Yes No N/A Comments: _____

16. **Treynor Ratio:** Similar to Sharpe ratio but uses beta as the risk measure. Beta is a measure of systematic risk. Treynor ratio makes more sense when analyzing a balanced fund/diversified fund as most of the unsystematic risk is reduced due to diversification and the fund is mostly exposed to market risk. For undiversified funds like sector funds, Sharpe ratio must be used as the fund is exposed to both systematic and unsystematic risk. Higher the ratio, better it is.

Yes No N/A Comments: _____

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17. **R-Squared:** It is used to determine the percentage of the fund's movement that can be explained by market movements. It ranges from 0 to 100. R-squared of 100 means that the fund is moving in lockstep with the benchmark. According to Morningstar R-squared value above 85 has a close correlation with the benchmark.

Yes No N/A Comments: _____

18. **Capture Ratio:** Measures manager's performance during up and down markets relative to the market (benchmark) Calculated as Upside Capture ratio/Downside Capture ratio. Higher the ratio better it is. A ratio of 1 indicates that the manager has moved in sync with the market. A ratio less than 1 indicates a manger mostly capturing the downside more than the upside.

Yes No N/A Comments: _____

19. **Alpha:** In simple terms, alpha measures the excess returns generated by the portfolio manager as compared to the fund's benchmark. Alpha is valid as long as the beta is meaningful. (Beta measurement is meaningful for funds with high R-squared)

Yes No N/A Comments: _____

20. **Number of Managers:** Funds managed by more than one manager is preferable as the fund would be better positioned to function in case any manager departs.

Yes No N/A Comments: _____

21. **Manager Tenure:** Longer the manager tenure, better it is as the long term performance of the fund can be attributed to the manager managing investments. If the manager is new, fund's past performance will not be of much value.

Yes No N/A Comments: _____

22. **Information Ratio:** It is used to determine the consistency of the portfolio managers. Higher the ratio, better it is. When comparing the information ratio of two managers of similar funds, the manager with a higher information ratio is considered to be more consistent in generating excess returns.

Yes No N/A Comments: _____

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23. **Turnover Ratio:** Compare the turnover ratio of a fund with other funds of similar category. A high turnover ratio indicates high trading costs and high tax costs due to capital gains distribution. Generally T/O ratio of 20 or 30 is considered low indicating buy and hold strategy while T/O ratio above 100 is considered high. But bond funds and small cap funds will naturally have a high turnover ratio (close to 100). Therefore, it is important to compare the ratio within a similar category of funds.

Yes No N/A Comments: _____

24. **Potential Capital Gains Exposure:** This indicates the capital gains embedded in the fund. It is good idea to call the company to determine the likelihood of the fund making capital gains distribution during the year. Also the turnover ratio can give some idea about the fund's capital gains distribution. Capital gains distributions have tax consequences for the investor. TIP: Avoid buying high capital gains exposure funds in taxable accounts at the end of the year.

Yes No N/A Comments: _____

25. **Third Party Research:** Research reports from companies such as Morningstar includes analysis on performance, process, people, price and parent company. They also provide stewardship grades which includes ratings provided for corporate culture, manager incentives, fees, regulatory history and board quality grade.

Yes No N/A Comments: _____

26. **GIPS Compliant:** (GIPS stands for Global Investment Performance Standards) While it is not mandatory for investment firms to comply with GIPS, the ones that choose to do so demonstrate their commitment towards ethical practices and discipline in their performance presentation.

Yes No N/A Comments: _____

27. **Leveraged Funds:** These funds attempt to increase returns by using leverage in the portfolio. While these funds enhance returns, they also magnify losses. Leveraged funds are risky and not suitable for all types of investors. Look for names such as 'Ultra', 'Bull', '2X', '3X' to identify these funds.

Yes No N/A Comments: _____

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28. **Premium/Discounts:** As ETFs trade like stocks, their actual price can be above or below their NAV. Buy ETFs that are selling at a discount or at lower premiums to their NAV. Do not over pay to buy an ETF. The premium/discount information is available on Morningstar.

Yes No N/A Comments: _____

29. **Bid/Ask Spread:** This is a measure of liquidity. Always choose funds with lower bid/ask spread. The funds that have wide bid/ask spreads are thinly traded.

Yes No N/A Comments: _____

30. **Tracking error:** Measures how closely a fund tracks its benchmark. A fund with a lower tracking error deviates less from its benchmark.

Yes No N/A Comments: _____

31. **Benchmark:** We recommend investing in a fund that has a broad, widely followed underlying index. These funds are less volatile than those based on a narrowly followed index.

Yes No N/A Comments: _____

32. **ETF Asset Base:** An ETF with smaller asset base will have larger spreads due to liquidity problems. Look for funds with a minimum asset base of at least \$100M.

Yes No N/A Comments: _____

33. **Commissions:** Consider the cost of commissions when buying and selling an ETF. Paying an \$8 commission to invest just \$100 may not be a worthy investment. Hence dollar-cost-averaging may not be a suitable strategy for ETFs unless purchases are free.

Yes No N/A Comments: _____

34. **Semi-Standard Deviation:** Per Morningstar, it is the standard deviation of returns for those months where the returns are BELOW average returns. Reported for ETFs.

Yes No N/A Comments: _____
