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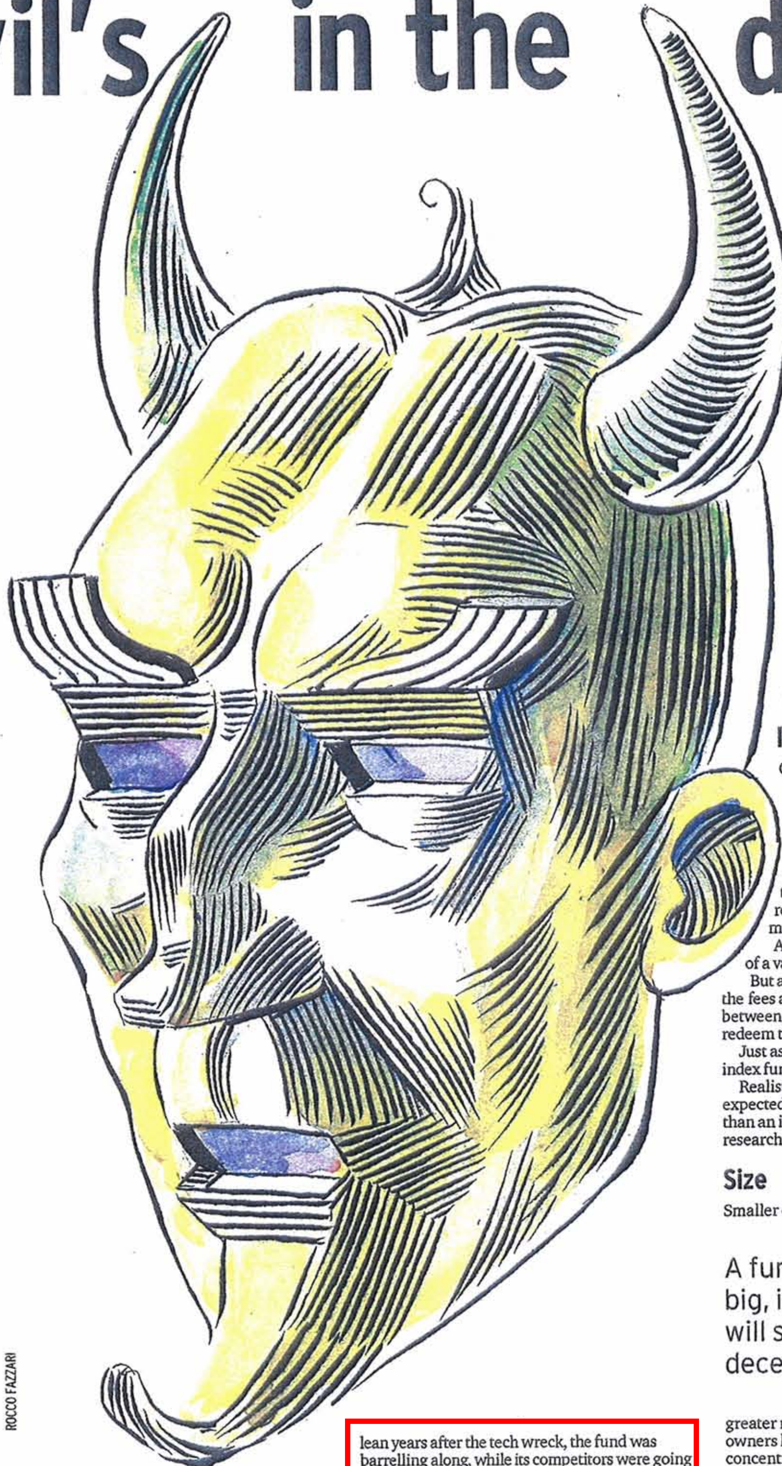
When picking the right fund, the devil's in the detail

With booming shares perhaps due for correction, the key is a decent fund, **David Potts** writes.



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THE WAY the sharemarket is going, finding a half decent managed fund should be easy enough.

Anything in Australian shares should be returning about 12 per cent, including dividends, so far this year, a sensational run considering the 30 per cent last year. And 25 per cent before that.

Because we're one of the best performing markets, it also solves the problem of where you should be investing.

Neat all round, I'd say.

There's got to be a catch, and I've found it.

You could be lulled into making your biggest boo-boo, and not because the sharemarket is toppy, although that doesn't help.

After all, the higher the market goes, the riskier it becomes, strange as it sounds. Just think of it as having further to fall if something goes wrong.

Still, if you were worried about that you'd never invest in the sharemarket and you'd be all the poorer for the experience, or in this case lack of it.

No, the market is at what analysts call fair value. So while it's not exactly a bargain, there's room for higher dividends and capital gains over time as the economy grows.

And nobody thinks it's forming a bubble like the one before the tech wreck.

Rather, the risk is grabbing the best performing managed fund on the seemingly not unreasonable ground that it must be doing something right.

Performance

But a fund with the most out-there return will also slump the worst in bad times.

Usually there's one of two reasons for it being way out in front.

One is that it has a high level of gearing or borrowing. This bumps up the return, which is why it borrowed in the first place.

The more of other people's money it's using, the higher its own return must be because they're not sharing in the loot.

But when things go bad, it will have to wear the entire negative return, including the borrowed bit.

The other reason a fund will be way out in front is by specialising in one part of the market, such as smaller stocks, resources or whatever.

Because there's no diversification, when things go bad, it'll be hit proportionately harder.

A study by Morningstar, which compared the return from 1980 and 2002 between picking the previous year's winner and a diversified portfolio, found a 35 per cent difference between the two.

And it was in the diversified portfolio's favour, because while it missed some spectacular gains, it avoided huge losses.

Little wonder. Remember, any large loss has to be more than made up for just to get back to ground zero, even before it can start growing again.

"The asset classes with the greatest returns are the ones with the larger negative returns," says Morningstar's Phillip Gray.

Besides, past returns can be manipulated.

After a good year, for example, the performance for three or five years will also lift if a rolling average is used.

It's better to look at each year individually, which also tells you how volatile the returns might be.

Value

Mind you, considering you're paying fund managers good fees to do their job, it's a bit rich not to expect them to outclass the market.

Some do.

In the year to August, the Prime Value Growth Fund grew 41 per cent, including dividends. In the past three years, its annual growth rate has been a staggering 31 per cent. Nothing else comes within cooee.

But the real surprise is that this is a conservatively managed fund – nothing flighty here.

In fact, Han Lee kicks himself for being too conservative – a year ago he thought bank stocks were risky because they were overpriced – raising the interesting question of what the returns would be if he were more aggressive.

But then perhaps we have the answer, too. In the lean years after the tech wreck, the fund was barrelling along, while its competitors were going backwards.

Lee's is a classic value fund, or one that looks for shares on the cheap. The portfolio is tilted towards resources stocks and away from "domestic cyclicals" such as retailers or building suppliers.

"I'm not alone," says Lee. "Many are thinking along these lines. This translates into share prices so there's less opportunity."

No wonder cash represents a "high teens" percentage of his portfolio.

Growth

The other extreme is a growth fund, which looks for stocks that are likely to take off.

Each kind suits different times. A value fund will be consistent over time, while a growth fund will do well in a bull market.

One of the most successful growth fund managers is Colonial First State.

But remember the fund will have to see you through the bad times, too.

Navigator Research looked at funds over a five-year period to the end of March, which was a down month, and found six "value" managers featured in the top 10 performers.

The best was Investors Mutual's Australian Share Fund, which "has a perfect record of outperforming the index on every occasion when the market provided a negative return", says manager Stuart Fechner.

"This is a terrific track record."

Yet Investors Mutual, Sandhurst and Advance/Maple-Brown Abbott are at the bottom of Morningstar's list of performers because we're in a growth rather than value-style market. That's why only one value manager appears in the top 10.

Index funds

One way around the problem is to use an index fund offered by Vanguard or Macquarie. Index funds duplicate the main sharemarket index, without trying to beat it.

So an index fund is unlikely to beat a growth fund in a bull market, but over time carries the least risk because its returns don't depend on the skill of the manager.

As a result its fees are only about half those of a value, growth or specialist fund.

But as with all managed funds, remember the fees aren't the only cost. There's also the gap between what you pay for units and what you can redeem them for.

Just as the sharemarket can drop, so will an index fund. By exactly the same amount.

Realistically, a value or growth fund could be expected to return an average 2 per cent extra than an index fund, says Suzanne Tavill, head of research at van Eyk.

Size

Smaller or boutique funds tend to do better than the bigger ones, possibly because they're more fleet-footed, and no doubt prepared to take greater risks. But more likely it's because their owners have their own capital at risk, which concentrates the investment mind.

> A fund can be too big, in which case it will struggle to find decent investments

Certainly, a fund can be too big, in which case it will be struggling to find decent investments for the new inflows with the result that all the unit holders face reduced returns.

Most boutique funds come under the value label, and tend to have higher fees than the bigger, older funds.

Many have started in the bull market, so there's no record of how they go when the market is down.

But then, past performance is no guide to the future.

Not surprisingly, the smaller funds tend to be attracted to the smaller stocks.

While this has helped their returns, it also makes them a lot more volatile.

TOP 5 BLUE CHIP FUNDS

Fund	Started	Fees%	1 year%	3years%	Min invest
Prime	1998	1.44	41.01	31.44	$40,000
Merrill Lynch Growth	1983	1.44	39.88	18.89	$1000
ABN Amro Australian Equity	2000	0.83	38.89	19.36	$20,000
Fidelity Australian Equities	2003	0.85	37.99	na	$1000
AMP/ABN Amro Australian Equity	2004	2.25	2.25	na	$1500

Source: Morningstar