HOW DO YOU EVALUATE THE BEST MANAGED FUND FOR YOU WHEN THERE IS SO MUCH INFORMATION?

FROM MOUNTAINS BACK TO MOLEHILLS

▸ Managed Funds

Selecting a managed fund can be akin to finding a needle in a haystack, but the rewards are worth it

If you've ever decided to invest in a managed fund, you were probably like most other prospective investors and faltered at the first hurdle.

The problem is that what should be a relatively easy task becomes exponentially complicated as you look at the wealth of options available.

You might just want to invest in some good Australian shares – but how do you know what's best?

"What should be a relatively easy task becomes exponentially complicated"

WHERE AND WHAT?

The first decision you need to make is what you'd like to invest in.

Managed funds cover an array of options, including Australian shares, international shares, property, bonds and even different forms of cash.

Two things usually determine the number and type of managed funds you will invest in: your age and your risk tolerance.

Typically, younger investors might be focused on high-growth assets such as shares, while older investors, especially those that are retired, are typically looking for income-generating investments such as bonds or cash.

For most investors, they usually first dip their toes in the water with exposure to Australian shares. This is for two reasons.

First of all, Australian shares are broadly in line with the kinds of investments first-timers are interested in and, second, local shares are an asset class that most market newbies are familiar with.

ACTIVE OR PASSIVE?

There are two main forms of managed funds.

In the first instance, there are passive funds. Passive funds charge clients lower fees because they don't try to beat the market. Instead, passive funds identify a benchmark, such as the S&P/ASX 200, and just try to replicate the performance of the overall benchmark. In Australian equites funds, these charges can be between 0.5% to 1.0% per annum.

The other form is actively managed funds. These funds try to beat the benchmark index by only holding the stocks or securities that they believe have the best prospects for growth. By doing this, they hope to achieve a performance that is better than the average rate.

Of course, these funds charge a premium for this service and investors can expect to pay between 1.0% and 2.5% per annum.

Yong Quek, co-founder and executive director of Prime Value, a Melbourne-based boutique investment manager, says investors should have a clear understanding of their view of the market when deciding whether to use an active or passive manager.

"If you believe in the efficient market, that is, that the market processes all information efficiently and there is no opportunity for outperformance, then you should look for a passively managed fund," Quek said.

"Be wary of performance from one or two stocks"

CAN YOU USE PERFORMANCE?

The question of whether to use past performance as part of your selection criteria is a tricky one.

"Performance alone isn't enough to judge a fund on, but to some extent, it's all we have," Quek said.

If you really want to drill down, most managed funds provide marketing brochures that detail where the fund's performance has come from.

Quek cautioned to be wary of funds that have produced their performance from just one or two stocks or as a result of exposure to just one sector.

"Potential return is always closely tied to how risky the fund is"

When looking at performance, it is important that investors remember that the potential return from a managed fund is always closely tied to how risky the fund is.

In the managed funds industry, different funds are measured by what is known as "tracking error".

Tracking error indicates how much the fund deviates from the benchmark, so a fund with a tracking error of 1% is much more likely to provide a return that is close to the benchmark than a fund with a tracking error of 5%.

So, the greater the tracking error, the more likely you will receive a return – either higher or lower – than the benchmark.

Generally, more conservative investors might look to hold funds that have a lower tracking error, while more aggressive investors would look to own funds with higher tracking errors.

CORE-SATELLITE MODEL

One of the more popular ways of using managed funds is to hold more than one managed fund in the same asset classes.

This is known as the "core-satellite" model and involves holding the majority of your investment in a more conservative fund and having one or two (or even more) funds than take on greater risk in order to try and generate greater returns.

WHAT'S IMPORTANT?

Quek said that investors can get caught up focusing on a fund's past performance and fee structure, while what's really important is the management and philosophy of the organisation.

This is because past performance is no guarantee for the future, while depending on one brilliant investor to lead the management team – a common practise in fund marketing – is also problematic.

"The most important factor is that the people behind the organisation have integrity and believe in the concept of 'stewardship'. This means they believe in managing money for others as an important philosophical responsibility. You need to be careful that they just aren't in it for the money," Quek said. **W**

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