

First, a Priority Check

"Investors First" is one of our five core values and it is of utmost importance to our team. This is reflected in the priorities we bring to our fund analysis. We are independent thinkers and put individual investors' interests first. In addition, we strive to be opinionated, letting investors know whether a particular fund is worth owning and why. We base that opinion on rigorous analysis, not just past performance. We do our best to keep investors up to date on changes affecting their fund investments. And, we keep a long-term time horizon.

Our research combines qualitative and quantitative factors. In other words, we do not screen funds and base our recommendations solely on easy-to-measure backward-looking figures. To really get at the heart of what makes a fund a good or bad investment, our research process incorporates a wide variety of information including comprehensive reviews of a fund's strategy, fees, portfolio positioning, and risk profile. We also look at a fund's record, but in detail, evaluating how it performed in various market conditions and considering if it had different managers or strategies in different periods. That's a lot, but it can all be grouped in the following five questions:

How good are the fund's managers and analysts?

When purchasing a mutual fund, you are hiring a management team to pick securities for you. That's why we pay extra close attention to the people contributing to the research process. We place a great deal of emphasis on the manager who is making the calls in the portfolio, but our research doesn't end there. We also key in on everyone integral to the process --from the research staff to the firm's chief executive and chief investment officers. That background helps us spot potential weaknesses and determine whether a manager's departure is a dealbreaker for shareholders.

While we value experience, (I've been learning this business for over 37 years) we also are always on the prowl for promising managers who may not have reached investing-legend status. Usually, these managers are running far smaller sums and are thus more flexible than today's stars, so there's a lot of room for upside if they can be discovered early on. We like to see managers with a solid investment philosophy and an investing temperament that resembles the great investors'. We also look for managers practicing a consistent, repeatable process. We, at **FAS**, call on the experts at Morningstar, Investor's Daily, Barons, The Wall Street Journal, Smart Investor, Mutual Fund Magazine and many other quality sources to provide us with the unbiased information needed for this analysis. They do semi-annual visits with the Managers and their staff and track closely the consistency of their strategy.

What is the strategy and how well is it executed?

Very rarely do we come across a strategy that sounds downright awful. There are too many smart consultants and marketers out there for that to happen. Yet, there's a big difference between having an investment strategy that could add value and one that actually does.

Investing is a competitive sport. In order for a fund to do well over a long time horizon, we firmly believe that some combination of its strategy, process, execution, people and fees have to give it a lasting edge over rivals.

We compare the actions we see in the portfolio with the strategy they claim to follow. We're looking for managers who can stick with their approach and have conviction in their research, rather than those who abandon their strategy when the market disagrees or those who show a lack of confidence in their process. Things such as Style-Drift are reviewed on every Mutual Fund.

Understanding the strategy also helps put performance into context and set investors' expectations regarding the risks associated with it. Is it a deep-value fund or an aggressive-growth fund? Does it specialize in a small market niche or cover a broad swath of the universe? Does the fund focus more on relative returns versus a benchmark, or does it value absolute returns and capital preservation? The answers to those questions help us gauge how a fund might fare in different environments and how it might be used in a portfolio.

Is the fund a good value proposition?

A number of studies on expenses have been performed and although we do not always opt for the lowest costing fund there is a point when a higher fee is not adding value. It is all about value and we keep a sharp eye out for excessive costs within funds. So, Morningstar analysts for example, focus on them and have a hard time pounding the table for funds that charge prices too far above their average peer. We take a holistic approach and look at a fund's costs and factors that can affect fees, such as asset size. But in general, we think there's a lot of fat in mutual fund expense ratios and there are many funds of all sizes with low fees.

The expense ratio isn't the only cost to keep an eye on, though. Transaction costs, including brokerage commissions and the market impact of large or illiquid trades can also chip away at a fund's returns. And, investors in taxable accounts need to be wary of the tax costs of owning a mutual fund. Some managers' strategies and trading methods are very tax-aware, while others ignore that factor altogether. Where there are hidden costs, Morningstar points them out and incorporate them into their overall opinion of a fund.

The expense ratio, transaction costs, and tax consequences make up the overall hurdle that fund managers must clear before any gains are passed on to investors. If the overall hurdle rate is high, we're likely to have less confidence in the fund's ability to overcome those impediments and deliver a good end result for shareholders.

Have the fund and its advisor been shareholder-friendly?

When investing hard-earned money, trust is paramount, and we've found the interests of fund companies are not always in line with the interests of fund investors. High fees and more assets can be good for the fund company, but they're not good for fund shareholders, for example. To get behind the question of trust and ascertain how well the fund treats its shareholders, we review Morningstar's [Stewardship Grades to roughly 1,000 funds](#). A fund's Stewardship Grade is based on the fund analysts' evaluation of five main components: corporate culture, fund board independence, fund manager incentives, fees, and regulatory history. We don't suggest that investors choose their investments solely on the Stewardship Grades, but we've found that strong stewardship and investment merit often go hand in hand.

Why has the fund performed the way it has?

We all know that past performance isn't predictive of future results, but it's still tempting to focus on a fund's recent past. We pay attention to performance, but we analyze the drivers of long-term performance and put a fund's record in context. For example, we look at results during discrete stretches of market stress to add some clarity about the fund's downside risks. In addition, some funds harbor sector-specific or market-cap biases that can cause them to perform differently from peers at times.

Rather than rely exclusively on the standard three- and five-year measures of performance, we also consider performance over more meaningful time periods, such as a manager's tenure on the fund, extreme swings in market returns, or a full market cycle. In addition, we value consistency. Strong trailing returns, even over the past three or five years, could stem from a short stretch of hot performance. More consistent performance tends to lead to better long-term results that are easier for investors to handle.

We look for portfolio risks that could, but haven't yet, materialized. Sometimes that will lead us to favor a fund that is more conservative over a fund that has higher returns but may be headed for a big fall. We think this is important because we've found that investors haven't owned volatile funds very successfully. Investors often buy bumpy funds when they're high and sell when they're low. In addition, it's hard for investors to recover from losses. Funds that are prone to large, extended losses have to gain that much more to get back to even. You have all heard me talk about Standard Deviation of returns and it for just this reason that we review that element in every Mutual Fund.

Keeping our Own Discipline

Just as we require strong investment philosophies and consistency from mutual fund managers, we demand the same level of discipline from ourselves. Our goal is to help guide investors toward the industry's best funds. Doing so sometimes means standing behind an underperforming manager when we believe in his or her talent, strategy, and process. It also helps us avoid the latest hot trend that looks great today, but could have devastating consequences for investors down the road. Our calls are sometimes unpopular, but we stand behind our approach because we firmly believe it helps investors over the long haul.