Selecting Mutual Funds

Mutual funds are the most popular investment vehicle in the United States, with more than 90 million individuals owning one or more funds as of mid-2014.[1] And of those 90 million, 68% held more than half their financial assets in mutual funds.[2] But with more than 9,000 funds available,[3] choosing among them can seem overwhelming. Screening tools can help, but they often require users to identify evaluation criteria upfront, and some variables may not be fully addressed by screening tools. Here, then, are some things to consider when selecting mutual funds.

Key points:

- With more than 9,000 mutual funds available to investors today, selecting the right ones can be overwhelming.
- Fund selection considerations include the fund's role in a portfolio, expenses, and taxes.
- Schwab offers tools and packaged solutions to simplify fund comparison and selection.

The Right Time?

First things first: Investors often wonder if there's a "right" time to buy a fund. Although some market participants can be credited with insightful calls of market highs or lows, few can do it with any regularity. The reason? Successful, repeatable market timing is virtually impossible. While cautious investors wait for the "optimal" time to invest, they may unwittingly fall victim to another risk: missing out on large one-day market moves by staying on the sidelines for too long. For the average person, investing early and consistently over a long time horizon has a better potential for success in the long run than trying to time the market. The time you first start thinking about your next mutual fund purchase is the time to act.

Understand the Role of Your Fund

What are you looking for in a fund? Total return? Income? Do you want to simply match the returns of the overall market or a specific area of the market, or are you willing to take some risk in exchange for the potential of higher returns? Will the prospect of a decline in the value of your portfolio cause you to lose sleep at night? The answers to these questions will determine the kinds of funds you consider.

If you simply want to match market performance, index funds may meet your needs; if you seek to outperform the broader market, you will likely be looking at actively managed funds. For actively managed funds, look at the benchmark against which a fund compares its performance and be sure that you understand the fund's investment objective and strategy. Also keep in mind that index funds, although reliably reflecting market performance, may leave investors vulnerable in times of market downturns as compared to actively managed funds, which provide managers the ability to react to market shifts.

Another variable when considering actively managed funds is quantitative vs. fundamental analysis—this refers to the method of portfolio analysis employed by the fund's manager. Funds that take a quantitative approach screen and select holdings based on a mathematical algorithm, often with additional factors overlaid by the manager; funds with a fundamental approach require more hands-on research and analysis by the manager, which generally translates to higher costs. "Quant" funds, however, may have more turnover, resulting in higher trading costs than a fundamental fund.

Consider Expenses

All else being equal, consider mutual funds with lower expenses. Fund expenses add up over time and can significantly impact an investor's long-term returns.

All mutual funds have ongoing operating expenses. Some also charge 12b-1 fees to cover marketing, distribution, and shareholder services. Index funds generally offer the lowest fees. However, sometimes a fund with a higher operating expense ratio ("OER") is warranted if the manager is able to deliver superior returns.

Also understand that there are mutual funds with loads and mutual funds with no loads—a sales charge or commission that compensates an intermediary for his or her time and expertise. Loads come in different forms: The most common are front-end loads, which are charged at the time of purchase and immediately reduce the value of an investment, and back-end loads, which are charged when a fund is sold. Although in some cases loads can be warranted as a means for paying for advice, investors should be aware of such charges.

While a percentage point here and there doesn't sound like much, it can add up. For example, a $25,000 investment in a mutual fund with a 5% front-end load, an expense ratio of 2%, and a hypothetical annualized return of 7% would grow to about $61,000 after 20 years. The same investment in a fund with no load and a 1% annual expense ratio, assuming the same annualized return, would grow to roughly $79,000 over the same period—a difference of $18,000.

Don't Chase Performance

The caveat "past performance is not indicative of future results" is ubiquitous in the mutual fund industry. But it is extraordinarily difficult not to look to the past when making a decision about the future—after all, in many other circumstances, the past does provide us valuable insight. And while in some cases, historical performance could be useful in helping to identify superior managers who may be most likely to beat the averages over time, investors should be cautious. Strong short-term performance can be a function of a temporarily hot industry, or even manager luck, as much as the skill of the portfolio management team.

When evaluating performance, also consider the following:

- How long has the fund existed? Those with a longer life span allow you to judge their performance over both up and down market cycles and across different market environments.
- How long has the current manager or management team been in place? Long-term results cannot be reliably applied to managers with short tenures.
- Have the returns been achieved moderately or have they been volatile, with extreme rises and plunges? Has the fund's size been consistent, or has it grown so large as to become less wieldy than when it was posting strong returns?
- Has the investment strategy been consistent over the life of the fund?

Keep Taxes in Mind

There's a key difference between taxation of mutual funds vs. stocks that's imperative for investors who hold mutual funds outside of retirement accounts to understand: For stocks, investors aren't liable for taxes on gains until those stocks are sold; but mutual funds are required to distribute capital gains annually, which means that shareholders may be subject to taxable distributions even if they continue to hold the fund.

A mutual fund's turnover ratio generally provides a good indicator of its tax efficiency. Turnover measures how long a fund holds the stocks it buys. The longer the holding period, the lower the turnover. Conversely, the more buying and selling, the higher the turnover and, consequently, the greater the potential tax liability. Index funds, because of their limited buying and selling activity, are generally more tax-efficient than actively managed funds (although some actively managed funds are specifically managed to minimize taxes). Another measure that might paint an even clearer picture is a fund's "tax cost ratio," a metric by mutual fund research firm Morningstar, Inc. that indicates how much a fund's annualized return is reduced by the taxes investors pay on dividends.

Simplifying Fund Selection

Schwab offers several tools and products to help investors select mutual funds. Schwab's Mutual Fund OneSource Select List® can help investors narrow down their fund choices: Each quarter, the list highlights rigorously screened actively managed funds with no loads or transaction fees, and organized by asset class. Investors can compare funds by performance over various periods, assets, expenses, and upside and downside market capture—a measure of how much a fund moves in comparison to the broad market when the market goes up or down. Also included in the Select List are target-date funds, which generally take a "fund-of-fund" approach, holding a variety of underlying funds and further simplifying an investor's fund selection.

Schwab also offers several all-in-one mutual fund portfolio solutions. The Schwab Mutual Fund Portfolio Builder™ provides investors the ability to allocate an initial lump sum across a diversified model portfolio comprising mutual funds selected based on which of the five portfolios best match the investor's risk tolerance. Investors can choose from two variations: a blend of Schwab and third-party funds, or all third-party funds (chosen from the Schwab Mutual Fund OneSource® Select List).

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[1] Investment Company Institute, 2015 Investment Company Fact Book.

[2] Ibid.

[3] Ibid, as of April 2015. Includes funds that invest primarily in other funds; excludes ETFs.

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