

Analysts:

Ian S. Filderman, MBA
Jennifer Gilbert

How We Analyze Mutual Funds

INTRODUCTION

One of the most often asked questions we get is how do we decide between the hundreds of different funds available to come up with our recommendations. This is a quick summary to give you some background on our philosophy, framework and methodology in selecting mutual funds for our Recommended List.

PHILOSOPHY

There are two key underpinnings to our philosophy on selecting mutual funds. When recommending a mutual fund we take the viewpoint that we are hiring a money manager to do a specific job within a diversified portfolio, for the long term. By long term we mean at least a full market cycle. Short-term performance variations are not usually a key consideration.

Experience and empirical research has shown us that past performance, while useful and interesting in analyzing mutual funds and their managers, is not generally, by itself, a reliable indicator of future performance. While we thoroughly analyze funds statistically, we believe that we need to know a great deal more in order to give those numbers any context or meaning. As a result, we attempt to gain a thorough understanding of the portfolio management process, style and discipline, the mandate of the fund (the manager's job description), and the risks inherent to implementation of that strategy and style of management.

FRAMEWORK

Our *Mutual Fund Recommended List* currently covers mutual funds in thirteen core asset classes. We make recommendations on Canadian equity funds (mid to large cap and small cap), Canadian balanced funds (strategic and asset allocation), Canadian dividend income funds, U.S. equity funds (mid to large cap and small cap), global equity funds (large cap and small cap), global balanced funds (strategic and asset allocation), international equity funds, as well as funds in the European, technology and health care sectors. The global equity category includes funds whose mandates allow them to invest in stocks anywhere in the world, while the international equity category includes funds whose mandates allow them to invest anywhere in the world except for Canada and the U.S.

The *Recommended List* is annually updated in January. Recommended funds typically have three years of performance history, which makes much of the quantitative analysis described below possible. Funds with less than a three-year history, but with whom we are comfortable from a qualitative perspective and review of previous experience (wherever possible), will be shown as "funds to watch."

METHODOLOGY

Quantitative Review

We extensively review the historical record of a fund from a risk, reward and style perspective. This includes a review of numerous statistical measures from traditional performance numbers to risk adjusted returns among others. We look at a multiple holding period analysis of funds relative to appropriate benchmarks and peer funds to gain a realistic understanding of return characteristics and variability over time without the bias inherent to only looking at the most recent period. When reviewing risk, we use traditional risk measures such as standard deviation and beta (market related risk), as well as others such as the fund's maximum loss, which give us a better sense of historical and potential future downside exposure. Finally, from a style perspective, we review the fund using what is called returns based style analysis. We statistically regress the performance history of the fund against various style benchmarks to determine the extent to which the funds performance can be explained by the performance of various investment styles and asset classes. This is a process that can provide a reasonable confirmation or create cause for discussion of the manager's stated investment style.

Qualitative Review

As noted earlier, while we thoroughly analyze funds quantitatively to help understand various attributes, we do not simply employ statistical ranking systems for our fund selections. Instead, we have found that many of the explanatory variables for fund performance (both past and future) can be uncovered by a thorough qualitative review of the fund's portfolio manager and how they go about the process of managing that fund. This involves meetings by phone or in person whenever possible, with dozens of different portfolio managers and their teams to gain a detailed understanding of what they do, how and why.

Issues which we typically explore include the research process employed (use of in-house analysts versus street research, use of company visits and quantitative models, etc.), buy and sell criteria for securities, team versus individual management, resources and support systems, portfolio construction parameters and risk control, and many others. We want to thoroughly understand the investment philosophy of the fund manager or managers so that we can give proper context to past, current and future security selections and portfolio strategies in addition to the eventual outcome - performance.

By bringing this all together, we hope to form a clear picture of the manager, their strategy, the resources they bring, and the risks involved in the funds we look at. From this, we select what we feel are the best managers within each asset class or mandate and with varying degrees of risk, to place on our Recommended List for the purpose of long-term portfolio construction.