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How to pick funds the way the wealthy pick money managers

Personal Finance

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Today, we take a lesson on choosing mutual funds from someone who helps high-net-worth individuals hook up with the right money manager.

Pay close attention to volatility and track record, says Peter Tanous, president of Washington, D.C.-based Lynx Investment Advisory LLP and author of several investing books. Then, mix your funds properly, with consideration given to both index funds and hedge funds.

It's no great revelation that a quality mutual fund will have an excellent track record. The question is, how long a history of good performance does a manager need to deserve your attention?

Mr. Tanous, who interviewed investing legends such as Peter Lynch for his book, *Investing Gurus: A Road Map to Wealth from the World's Best Money Managers*, says five years is the minimum for establishing a reliable history, but 10 works better.

"With a track record of three years or so, it's very hard to distinguish between luck and skill," he said by phone from Montreal, where he consults for Blue Bridge Wealth Management Consultants.

"A guy could have been lucky for three years," Mr. Tanous added. "At five years, you start to smell skill. At 10 years, you're sure it's there."

Once you've found a fund with good results, check the volatility.

There are technical measures of volatility such as beta and standard deviation, but Mr. Tanous said they're overly complicated for many investors.

Instead, he suggests you simply look at the fund's annual returns to see if there are wide swings, say an increase of 40 per cent one year and a decline of 20 per cent in another year. Alternatively, you can look at a graph of the fund's performance to look for high peaks and low valleys.

Eliminate funds with wide variations in returns, Mr. Tanous said.

The reason: To protect yourself from the possibility that you'll buy into the fund when it's peaking and about to hit a downswing.

Protecting yourself more generally against risk is a matter of effective diversification, Mr. Tanous said. Specifically, he suggests you diversify your funds according to the investing style they use and the size of stocks they invest in, as well as geography.

For example, he suggests pairing a value fund, which seeks undervalued stocks, with a growth fund, where the emphasis is on riding companies with fast-rising earnings.

He also suggests adding a small-capitalization equity fund to your mix to complement the large-cap stocks that tend to populate most broad-based equity funds.

Mr. Tanous said index funds work well for large-cap investing, but small-cap funds that are actively managed have some appeal.

"In the large-stock area, the market is extraordinarily efficient and it is very hard to beat," he said. "You're far more likely to find a talented manager who is going to add skill and performance in the small-cap area than you are in the large-cap area."

Hedge funds have some appeal in Mr. Tanous's estimation, largely because of his view on what the markets are likely to do in the years ahead.

Most stock market pros believe that equity market returns for the foreseeable future will be single digit, he said. As for bonds, a 20-year bull market in the fixed income market seems to be coming to an end.

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As always, the prime directive is investment diversity

WINNERS *from page C1*

The result is an environment where bonds won't be able to bail you out of a patchy, risky stock market.

This is where hedge funds come in, Mr. Tanous argues. Because they use such a wide variety of strategies, hedge funds have the potential to deliver performance that doesn't necessarily reflect what the major stock and or bond indices are doing.

That said, Mr. Tanous suggests investors take special care when choosing a hedge fund.

"The problem with hedge funds is that they're exotic. You don't know what the managers are doing — they can do things that are potentially very dangerous to your financial health, and some of them can lose 100 per cent of your money."

One way to cut hedge fund risk is to avoid buying just one fund, Mr. Tanous said. Fund-of-fund products, which invest directly in a series of underlying funds, are an easy alternative here.

"The rap on fund of fund [products], and it's absolutely true, is that these things are so fee-rich that it boggles the mind. You have layers of fees that you can't possibly imagine, and they get a percentage of the profits."

Still, he argues that if you can find a fund of funds that has the ability to deliver 8 to 10 per cent returns, it's worth a look.

Hedge funds are available mainly to high-net-worth people who, for example, can afford a minimum upfront investment of $150,000. There are a few hedge products available to small investors, but Mr. Tanous advises caution when looking at them because of the potential for stiff fees to be involved.

Whatever type of fund you're looking at, Mr. Tanous suggests you search for consistent returns and not buy on the basis of current success.

"The worst way to pick a fund is last year's great winners," he said. "They tend not to repeat."

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