Scientific mutual fund and ETF screening criteria -- a summary

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Summary: The Skilled Investor Blog published a series of articles on scientifically based selection criteria for mutual funds and exchange traded funds (ETFs). Scientifically based selection criteria are rational fund screening rules. They help you to winnow down the thousands of available investment funds to a more manageable group for your more careful evaluation prior to investing. This article summarizes these selection criteria.People simply want to invest in mutual funds and exchange traded funds (ETFs) that have higher chances of doing better in the future on both a sustained and risk-adjusted performance basis. With real lives to lead, people who are not professional investors just want an efficient, but effective fund identification process. They want to pick the funds that will make their investment assets work for them rather than having to work for their assets by spending large amounts of time monitoring and repeatedly changing funds. Millions of individual investors run futile hamster wheel races pursuing the illusion that the superior past performance of funds and individual securities will lead to superior future performance. *The Skilled Investor Blog* wrote these articles for those who know that they need to stop chasing their tails and get on with their real lives. However, it is difficult for anyone to stop running in a personal hamster wheel and get off, unless he or she is convinced of a better alternative that can be self-implemented with relative ease.   The good news is that the scientific finance literature has shown that there really are better approaches to buying and owning funds. You do not need to frantically chase fund performance. Better performance tends to come to those who calm down and more carefully evaluate what tends to work before buying into investment funds. The following summarizes fund selection articles published in *The Skilled Investor Blog*. They can help to break the cycle of frequent fund buying and selling.   -> Rational selection of bond and equity mutual funds and ETFs -- overview This overview introduced the idea of only using selection criteria that have a scientific basis that has been established in the financial research literature.->Choose mutual funds and ETFs with lower investment management expenses Lower investment management fees are usually better. Lowest is best, and lowest means passively managed index mutual funds and ETFs. Since there are numerous funds with annual expense ratios below .25%, look there first. The higher the annual fund expense ratio the more you should question why you should pay such high expenses. Paying more tends to lead to inferior rather than superior net performance.->Avoid mutual funds and ETFs with higher investment portfolio turnover Lower portfolio turnover is better. Higher turnover increases hidden fund transactions costs, which tend not to be recouped through better performance. Look for single-digit and very low double-digit annual portfolio turnover rates in the funds you purchase. ->Avoid mutual funds and ETFs with sales commissions and 12b-1 fees The great majority of investors buy funds through advisors and pay a very, very high price over their lives for doing so. You simply do not need to pay hefty sales commissions (loads and higher annual expense ratios) to advisors who will only offer to you those funds that will pay them these hefty sales commissions. When you pay the sales commission of someone who will only sell you something that is too expensive, you shoot yourself in both feet. All mutual fund sales commissions and marketing fees can be avoided entirely by buying from the many mutual fund families that will sell fund shares directly to the public without such fees. ETFs will inevitably involve brokerage commissions, so use discount brokers and a long-term buy-and-hold strategy to amortize these trading costs. Zero is the maximum amount of front-end and back-end fees you should to pay. Zero is the maximum marketing or 12b-1 fee you should pay.-> Avoid very large actively managed mutual funds and ETFs Very large actively managed funds tend to affect securities market prices negatively, when they trade their overly large portfolio positions. This can only drag down net fund performance. High turnover by large funds is a big red flag. When there are hundreds of actively managed funds under $5 billion and under $1 billion, you do not have to look at bigger funds. If you avoid actively managed funds altogether, then your concerns about excessive fund size can be greatly reduced, but these concerns are not eliminated entirely.   -> Choose sufficiently mature mutual funds and ETFs The fund industry throws a lot of new fund spaghetti on the wall to see what will stick. When you invest in very new funds and they fail to grow, these funds tend to get merged into larger funds with noticeably inferior historical performance. To avoid participating in this frenetic new fund infanticide process, only pick funds that have been in business for at least a few years. Three years is probably enough.->Choose mutual funds and ETFs with a minimum economical portfolio size Small funds cannot operate efficiently. They need a minimum critical mass of assets to fund required management expenses. Simply avoid very small funds. One or two hundred million dollars is probably the minimum for actively managed funds. Since index funds have lower costs but also lower expense ratios they probably require a similar minimum. ->Evaluate the historical investment performance of mutual funds and ETFs, but only AFTER using other screening criteria   Superior or average past fund performance tells you ABSOLUTELY NOTHING about how a fund will perform in the future. Pay attention to the fine print in the prospectus that says that past performance does not indicate future performance, because this has been shown to be true. Ignore all the fund industry's selective marketing of only their past winners. Individuals need to move beyond their naive and flawed notions about historical investment performance. Modern, highly competitive, and real-time securities markets are auction price setting mechanisms that force the mass of smart and not-so-smart professional and amateur investors to accept largely average returns over time. Only very poor past performance tends to indicate potentially sub-par performance in the future, and that is probably due to higher costs. Therefore, eliminate only the worst of historical performance during fund screening and choose from the remainder -- despite whether a fund had superior, average, or somewhat below average performance in the past. Four and five star funds are no better than three star funds and probably even two star funds. Eliminate the bottom one-tenth to one-third of funds on a historical performance basis and choose from the remaining nine-tenths to two-thirds.