Screening mutual funds on-line with Morningstar.com (Part 2 of 2)

Category : On-line Screening of ETFs and Mutual Funds

Published by The Skilled Investor on Feb/7/2007

Screening mutual funds on-line with Morningstar.com (Part 2 of 2)

Summary: In this two-part article, The Skilled Investor discusses how to screen mutual funds on-line using our seven scientifically based mutual fund screening criteria. This article focuses on using the free mutual fund screener and database available at Morningstar.com. **6) MORNINGSTAR STAR RATING: Choose "2, 3, 4, and 5" star funds. Do not check the "1 star" box and do not check the "New, unrated funds" box. This setting should implement two of our screening criteria: #5) avoidance of immature funds and #7) "the exclusion only of funds with very poor historical performance records." Star rated funds must have at least a three-year performance record to receive a star rating. Therefore, choosing star rated funds will cut out immature funds. Concerning historical performance, if your investment instinct is to select only 4 and 5 star funds, you should rethink this selection rule and you should read this article now: Evaluate historical investment performance, but only after using other investment screening criteria.**

You might also choose to exclude 2 star funds, but the scientific investment literature indicates that 3 star funds should be retained. Note that if you exclude 1 star funds, you are excluding about 10% of the fund population. If you exclude 1 and 2 star funds, you are excluding about 32.5% of the fund population.7) MORNINGSTAR RISK BETTER THAN OR EQUAL TO: Choose "Any."

Risk should be managed via the asset allocation of your portfolio. Risk-adjusted investing is an involved topic, which is beyond the scope of this article. However, to get some understanding of this, see Chapter 3, "The Interior Decorator Fallacy," in Peter Bernstein's Capital Ideas: The Improbable Origins of Modern Wall Street.8) 1-YEAR, 3-YEAR, 5-YEAR, and 10-YEAR RETURN GREATER THAN OR EQUAL TO: Set all four of these screeners to "Any." The subject of performance is already handled by selecting 2, 3, 4, and 5 star funds in item six above. Using these performance selection parameters is both redundant and probably counterproductive.9) (FOR STOCK-FUNDS) TURNOVER LESS THAN OR EQUAL TO: Choose less than "25%." This setting should implement our screening criteria #2) "minimum turnover." You should find many funds with turnover under 25% annually. The next selectable breakpoint is 75%, which puts you far into actively managed fund territory, where high costs tend to drain your net returns. 10) (FOR STOCK-FUNDS) TOTAL ASSETS LESS THAN OR EQUAL TO: Choose "$5B" or "$1B" to start. You can always lower this screener, but using this screener is necessary to implement our screening criteria #4) "avoidance of very large funds with higher trading costs."11) (FOR STOCK-FUNDS) AVERAGE MARKET CAP ($mil): Choose "Any." This selector is possibly useful, if you are selecting by fund category (see item 2 above).12) (FOR BOND FUNDS) AVERAGE CREDIT QUALITY: Choose the minimum average credit quality you are willing to hold.13) (FOR BOND FUNDS) DURATION: Choose the average length of bond maturity that you want.

Bond investing is very complex, but the scientific literature provides relatively simple fund

selection rules. Invest through funds, unless you really know what you are doing, and you have a very substantial asset portfolio. You probably would need to have at least hundreds of thousands of dollars for the bond portion of your portfolio, if you want to self-construct a sufficiently diversified bond portfolio. Most people do not have this much in assets, and the investment costs, time commitment, and potential for mistakes are excessive, when buying individual bonds. Pick the bond credit quality and duration that you want in a bond fund, and then look for low fund management costs. See: [Is it worth paying higher bond mutual fund management fees?]() Again, low costs tend to lead to higher bond fund performance. Of course, you also should vet the fund family and apply other selection criteria such as a minimum economical fund operating size. Note that high or low turnover for bond funds is tied to the average duration or maturity characteristics of the bonds held, and therefore, turnover is less useful as a proxy indicator of trading costs. STEP TWO: EVALUATING THE SCREENED LIST TO CHOOSE INDIVIDUAL FUNDS FOR YOU INVESTMENTSThe automated screening in STEP ONE allowed us to screen automatically for six of our seven scientific screening criteria listed at the start of this article. Only screening criteria #6) "a minimally sufficient asset base over which to spread required fund expenses" was not covered. Your resulting screened fund list will probably average some dozens of funds depending on your criteria. Once you have a reduced list of that size, then you can manually screen out any fund with perhaps under $100 million to $200 million in assets. Once you have your smaller, screened list of funds, you can investigate remaining funds in greater depth. If you have too few / too many funds, revise your criteria to be less/more restrictive. With your screened "Results" list you can begin to use the different "Views" that Morningstar provides to look at additional characteristics about your screened list of funds. Choose from one of the four "Views" (Snapshot, Performance, Portfolio, Nuts & Bolts) and click on the column headers to rank order the screened funds. When you find funds that are interesting, then click on the fund name to learn more about them. Morningstar.com will provide additional fund and fund family information that you may or may not find useful. If you want to go to the website of the fund itself, after you click on the fund name in the screener and the webpage changes, click on "Purchase Info" to the left and you will find a URL (not a link) that you can copy and paste into your browser's address bar. Alternatively, copy the fund name into Google and follow the search results.Once you are satisfied with one or several funds that meet your investment criteria, then you can invest directly with the fund(s) you like. The only cost to you of buying mutual funds directly is your personal time and effort. However, the savings value can be huge over your lifetime, if you buy funds directly and cut out very costly sales agents in the middle.

Note: If you want to understand how much you personally could waste by paying excessive fund investment costs over your lifetime, [see this article about VeriPlan's automated lifecycle investment cost analyzer](). Across your lifecycle, VeriPlan automatically projects the full value of the personal assets you could lose to the five main types of investment costs. VeriPlan develops projections that assume you will continue to invest at the same level of cost-efficiency or cost-inefficiency associated with your current financial asset portfolio. Alternatively, VeriPlan's automated Cost-Effectiveness Tool lets you compare investment costs that you believe are more reasonable to pay versus the investment costs of your current portfolio. ____

SCROLL DOWN FOR LINKS TO OTHER ARTICLES IN THIS CATEGORY