The Mechanics of the Fund Authority Score System for Stock ETFs and Mutual Funds - Part 2

Category : The Fund Authority Score System for Evaluating Mutual Funds and ETFs
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Fund Authority Scores for Stock ETFs and Mutual Funds - Historical investment performance Fund Authority Scores rate stock mutual funds and ETFs on the most important economic factors affecting long term diversified equity investment fund performance. This article explains how historical fund performance is calculated.
Go to Part 3 -->>Part 1 of this article discussed direct and hidden investment costs, the most heavily weighted factors used in the Fund Authority Score rating system for stock - equity funds. These first two factors are:
FACTOR 1: Annualized Investment Management Expenses and Sales Load Fees (-4 to +4 points)
FACTOR 2: Hidden Trading Costs using Fund Portfolio Turnover as a Proxy (-3 to +3 points)You can find a directory of Fund Authority Scores for mutual funds and ETFs here. FACTOR 3: Penalize very inferior historical performance and credit average and superior historical performance (-2 to +2 points)The scientific investment literature has demonstrated that previous superior or average fund performance simply does not predict similar superior or average fund performance in the future. However, there is good evidence that substantially inferior past fund performance is more likely to lead to continued inferior performance in the future. Much of this is sustained inferior performance is accounted for by the excessive costs of many funds with lousy past performance. Therefore, the Fund Authority Score rating system already has accounted for the influence of higher visible and hidden costs with Factor 1 (visible investment costs) and Factor 2 (hidden investment costs).Millions of individual investors run futile hamster wheel races pursuing the illusion that the superior past performance of mutual funds and ETFs will lead to superior future performance. Without considering the far more important cost factors first, superior or average past fund performance will tell you very little or nothing about how a fund will perform in the future. You should, instead, pay close attention to the fine print in the prospectus that tells you that past performance does not indicate future performance and superior performance is not guaranteed and may not be sustained. Simply ignore the investment fund industry's selective marketing of only their past winners, while they sweep their losers under the carpet. (See these articles: Evaluate historical investment performance, but only after using other investment screening criteria, The illusion of superior professional investment manager performance, and How to lie with statistics: Investment performance charts)The Fund Authority Score rating system gives a 20% weighting to historical stock mutual fund and ETF performance. Furthermore, this factor focuses on penalizing poor historical performance. The Fund Authority Score performance factor penalizes that relatively small minority of stock mutual funds and ETFS that either 1) are very unlucky, 2) are genuinely less competent, and/or 3) are suffering some other disadvantage within a fund promoter's portfolio of investment funds. In addition, Fund Authority Scores also credit average past performance and give some extra credit for even better past performance that could reflect some evidence of skill.To develop this measure, we combine the Morningstar and Lipper 3 year fund performance ratings. Both Morningstar and Lipper rate three year historical fund performance on a 1 to 5 scale. Combined, these ratings range from 2 to 10 points for any mutual fund or ETF. Ratings from both companies indicate a range of inferior to superior historical performance relative to an appropriate investment style and market capitalization benchmark. While there are modest differences in the methods used by Morningstar and Lipper to

assess historical performance, the combination of these two ratings provides a reasonable index of recent, relative fund portfolio performance. SCORING FOR THE HISTORICAL FUND PERFORMANCE FACTOR #3When the Morningstar and Lipper 3 year historical performance ratings for a fund are added together, the resulting "worse to better" scale ranges from +2 to +10.If the combined score for the Morningstar + Lipper three year ratings equals 2, then score -2 points
If the combined score for the Morningstar + Lipper three year ratings equals 3, then score -1 point
If the combined score for the Morningstar + Lipper three year ratings equals 4 or 5, then score 0 points
If the combined score for the Morningstar + Lipper three year ratings equals 6 or 7, then score +1 point
If the combined score for the Morningstar + Lipper three year ratings equals 8, 9, or 10, then score +2 points

Go to Part 3 -->>

These related articles may also be useful to you: Selecting Investment Funds: ->Rational selection of bond and equity mutual funds and ETFs -- overview ->Avoid mutual funds and ETFs with sales commissions and 12b-1 fees ->Avoid mutual funds and ETFs with higher investment portfolio turnover ->Avoid very large actively managed mutual funds and ETFs ->Evaluate historical investment performance, but only after using other investment screening criteria Controlling Investment Costs:
->Excessive investment costs are a huge problem for individual investors ->How much do hidden mutual fund trading expenses cost you? ->Beware of large and hidden mutual fund costs ->Invest in fixed income securities through bond mutual funds with low investment fees ->Is it worth paying higher bond mutual fund management fees? ->Passive individual investors are “free riders” who benefit from the higher costs of active traders ->The investment industry is not your investment partner