Beware of Mutual Fund Performance Claims

At the end of a football match, everyone wants to know the score. The score can mean the difference between becoming a champion and being knocked out of the competition. Just as professional sport is about winning, professional investing is about performance. Keeping track of how your investments are doing is much like following your favourite football team.

Unfortunately, measuring the performance of our assets over time is considerably more complicated than keeping score at a football match. This is especially true in the case of mutual funds whose performance can be measured in various ways, each having significantly different outcomes.

In assessing mutual fund returns, it is extremely important to consider how the performance figures are calculated and what assumptions have been made so that you can make accurate comparisons among similar funds.

Performance information in the local mutual fund industry is inadequately regulated. Until the SEC enforces standards for calculating mutual fund returns, investors should be wary of any performance figures published in fund literature, the press or on the internet, and always consult an independent advisor before investing.

The best way to illustrate this point is to examine how each method of measuring performance impacts a specific fund’s returns. Fig. 1 shows the quarterly returns and changes in Net Asset Value (NAV) for Roytrin’s TTD Income & Growth Fund. The lightest bar shows the Fund’s returns based on NAV changes.

A fund’s NAV represents the price of one share of the fund, obtained by dividing the value of the fund’s holdings by the number of outstanding shares. Because the NAV indicates the price per share of a fund, investors often use a fund’s NAV as a measure of performance, similar to the way a stock’s performance is tracked based on price-per-share.

A fund’s NAV will fluctuate with changes in the value of securities held by the fund. The difference in the net asset value of your shares, that is, the difference between what you paid for a fund and what it is worth today is your potential capital appreciation (or depreciation, if the NAV has declined). Remember that capital appreciation is only a potential that is not realised until you sell your shares.

Fund shares may be bought or sold through brokers/dealers who have contracts with the Principal Underwriters for the fund. If a brokerage firm or other sales representative charges an up-front sales commission (front-end load), the sales charge on purchases is calculated as a percentage of the NAV and added to the purchase price.

For example, the purchase price for a mutual fund with a NAV of $8 and a 6% sales charge is $8.00 divided by (100% - 6%) or $8.51. The difference between the purchase price of the unit (offer price) and the sale value of units (bid price) is know as the “bid-offer spread”. The standard bid-offer spread is roughly equivalent to the maximum sales charge (typically 5%) but this may vary.

Some mutual funds that charge front-end sales loads will charge lower commissions for larger investments. The investment levels required to obtain a reduced sales load are commonly referred to as breakpoints. Breakpoint discounts increase the potential earning power of your investments by allowing you to invest more of your money in the fund instead of paying it out in sales charges.

The size of the bid-offer spread can have a significant impact on mutual fund returns, especially in the short-term. Always check whether performance data quoted reflects the effect of any sales charges that might apply. If the changes in NAV are based on “offer-to-bid” prices, the returns include commissions, whereas “bid-to-bid” price returns do not.

The Roytrin TTD Income & growth Fund referred to in this article is an example of a “no-load” mutual fund, indicating the absence of any type of sales charge. Since there is no sales charge, the NAV, market price and offer prices are exactly the same so whether the changes in the Fund’s NAV are based on offer-to-bid or bid-to-bid prices is irrelevant. What is important, however, is that investors using the change in net asset value as the only measure of performance may underestimate the performance of a fund.

When you invest in a mutual fund, your earnings are derived from two potential sources: any appreciation in the value of your fund shares and any fund distributions. Returns indicated by NAV changes only capture the former and ignore the different ways that dividend and capital gains can contribute to an investor’s return from a fund.

Omitting these important elements of return can give investors an incomplete picture of the fund’s true performance, particularly with fixed income or balanced funds, where distributions tend to contribute more to a fund’s return than is typically the case with an equity fund.

There are two types of fund distributions: potential dividends and capital gains. Mutual funds invest in a variety of securities, including stocks, bonds, and/or money market instruments. When the securities pay interest or dividends, the fund is required to pass them along to its shareholders (less a portion of the costs of managing the fund).

Fund distributions also include capital gains realised by the fund when it sells portfolio holdings. The difference between what was paid for a security and what it sells for is a capital gain or loss. When cash is distributed to a fund’s shareholders, whether in the form of dividends or capital gains, those payments add to the investor’s total return which is why they must be considered when evaluating the performance of your investments.

A return calculated by simply tracking the change in the fund’s NAV over time would not only miss these payments but would also be affected by them. When the fund distributes income to shareholders (monthly, quarterly or annually, depending on the fund), the NAV declines but shareholders have not lost money.

Distributions may be received in cash or automatically reinvested in additional shares or partial shares of the fund. When distributions are reinvested, the total value of the fund investment remains the same even though the NAV declines by the distributed amount.

Reinvestment of dividend distributions allows a shareholder to add to his or her investment through dollar cost averaging, which may lower the average cost of fund shares over time. Any future dividends will then be paid on the basis of the cumulative holdings of both full and fractional shares, thereby compounding the investment and yielding a slightly higher return (see Fig. 1).

Whether distributions are assumed to have been reinvested or taken as cash, mutual fund performance is more accurately measured using total returns, which factor in both dividend distributions and capital gains, than the change in NAV.

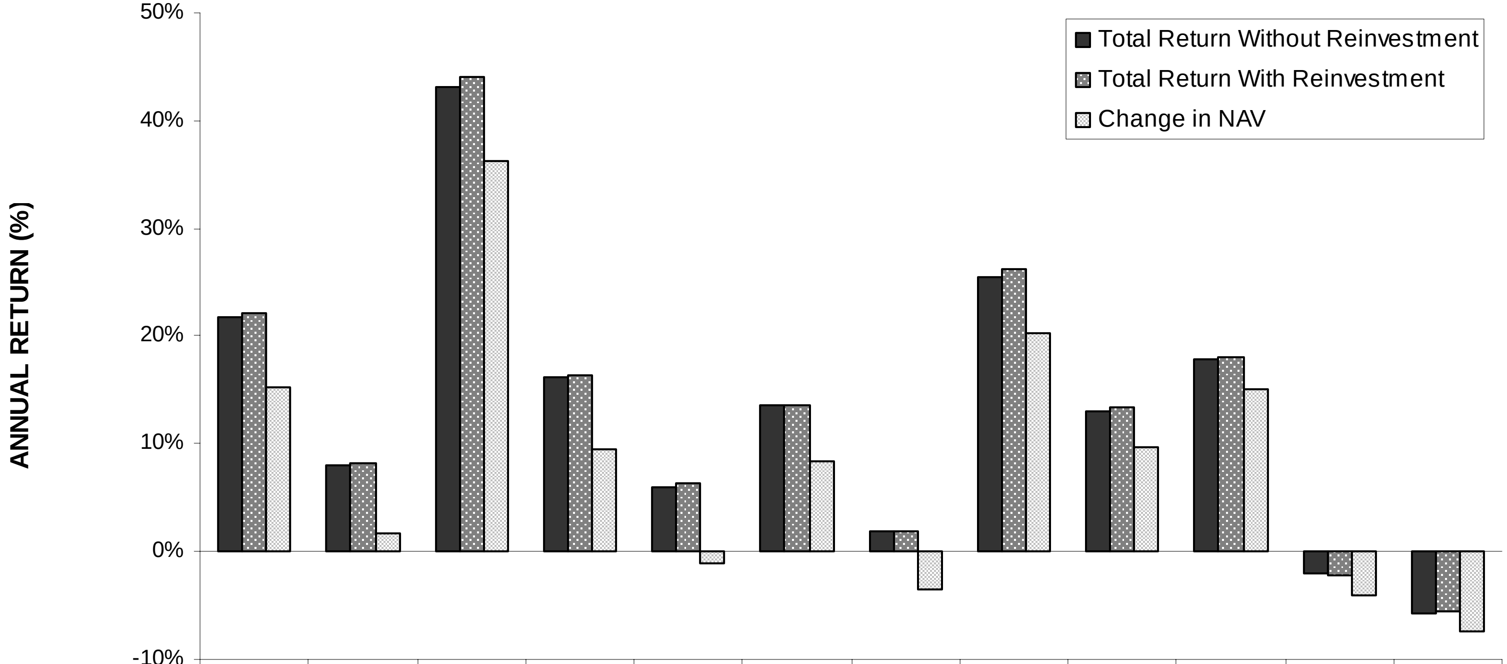
The NAV provides a quick summary and is readily available in newspapers and on the internet – but that summary can be misleading. The change in NAV reflects the increase or decrease in the value per share and does not accurately calculate the fund’s true total return as illustrated by the annual returns for Roytrin’s TTD Income & Growth Fund.

So don’t be fooled by the mutual fund marketing & distribution machine. More harm has probably been done by the misleading information in performance figures than any other statistical evil. When evaluating a mutual fund’s performance, always read the small print, find out how the data was derived and only make comparisons among similar funds if you are certain that the performance measures are accurate and consistent.

FIG 1. ROYTRIN TTD INCOME & GROWTH FUND

Annual returns, net of fees

Source: RBTT Trust Limited



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total Return Without Reinvestment	21.7%	8.1%	43.0%	16.2%	6.0%	13.6%	1.8%	25.5%	13.1%	17.9%	-2.0%	-5.7%
Total Return With Reinvestment	22.2%	8.3%	44.1%	16.4%	6.4%	13.6%	1.9%	26.3%	13.4%	18.0%	-2.1%	-5.6%
Change in NAV	15.2%	1.7%	36.3%	9.5%	-1.2%	8.4%	-3.5%	20.4%	9.6%	15.0%	-4.1%	-7.3%

YEAR