

★ **CAPITAL JOURNAL** ★ **POLITICS IN PERSPECTIVE** **READ NOW >**
 THE WALL STREET JOURNAL. *Dynamic coverage of politics, national security and policy.*



Chuck Jaffe

July 21, 2014, 7:31 a.m. EDT



The right way to pick a new mutual fund
A 7-step guide to adding mutual funds and ETFs to a portfolio

By Chuck Jaffe, MarketWatch

New Constructs named as one of the top fund rating firms by top expert.

Twenty years ago this month, I began writing a weekly column on mutual fund investing for the Boston Globe; one of my first pieces was on how I pick funds for my own portfolio.

Asked recently by a colleague if I remembered my first columns, I went back for a look-see.

My process has remained the same over the last two decades, but the fund industry has changed dramatically, so I've refined my methods along the way.

Because long-term happiness with a fund is often traced back to what the buyer was thinking at the time of purchase, it's imperative for investors to have a personal selection system. With that in mind, I'm sharing my updated process, in the hope that it helps you develop your own, making you more comfortable with what's in your portfolio.

Here is how my system works today.

Step 1: Determine why I want or need a new fund.

Investing isn't my hobby, it's a means to a better future; thus, I avoid impulse buys, superhot funds and moves that don't fit a bigger strategy. I want a small, manageable fund portfolio, filled with high-conviction choices; I'm not adding investments just for the sake of saying I own something new.

Fund selection starts with deciding what I want the purchase to accomplish, whether it's diversification, growth, stability, income or something else. Focusing on the reason for a new fund lets me properly set expectations.

Step 2: Find the funds or ETFs that meet my needs.

After finding the right asset class, look for issues that meet your key criteria.

I want below-average costs—or a darned good reason to pay more—and prefer managers with a track record of at least a decade. I avoid sales charges, not because load funds are bad but because they're not for someone like who does significant personal research and doesn't pay an adviser for help.

How to consolidate mutual-fund holdings

Do you own too many mutual funds? Here are some tips on how to slim down your portfolio.

I don't waste time with funds that have a minimum account size beyond my means (unless they waive it for regular deposits), or with ETFs with less than \$50 million in assets (too big a chance they will fold).

Step 3: Learn the story of the fund.

I want the basis for trust and confidence, whether it's the manager's expertise or the common-sense simplicity of indexing.

In searching for compelling reasons to buy a fund, examine a fund's newsletters and reports. You learn a lot about managers by reading what they tell shareholders and prospective investors.

This is also where I factor the firm into play if a company has earned investor trust. If there's something scary in the past—an oversize implosion during the 2008 financial crisis, for example, or a history of playing outside the rules of its prospectus—move on.

By the end of this step, you should know a fund well enough to justify its place in the portfolio. If you can't support your selection now—if you couldn't explain it to your spouse or kids and have it sound like savvy thinking—you won't be able to stick by it when the market gets tricky.

Step 4: Compare the fund to its peers, then check returns.

People who make returns their first criteria wind up chasing hot numbers, leading to unbalanced portfolios filled with yesterday's winners. But picking a fund more for asset class than raw performance makes comparison-shopping within the category essential.

My initial cut has always been for funds in the top 25% of their peer group over the last five years, but right now I'd extend that to a decade because the shorter time frame excludes any big downturns. I'm looking for consistency, and I'll sacrifice some upside potential for the promise of a smoother ride.

Step 5: Choose the finalists, read the prospectuses, check with the analysts.

I'm looking for holdings that are consistent with a manager's discipline; examine what a fund is allowed to invest in, which is key to how the portfolio could change over time.

If a fund's ratings from firms like Morningstar, Lipper, **New Constructs** or others make me question my analysis, I'm moving on. I don't let ratings determine which funds I consider, but I want confirmation of my gut feelings and I'm careful when betting against those experts.

Step 6: Check under the hood.

This is where the shortlist gets weeded to my pick. Lower costs, better tax efficiency (unless the fund is in an IRA), and less overlap with my current holdings tend to be my key tiebreakers.

Step 7: Pick my winner, jot down my thinking and make the purchase.

My file on any new fund starts with a detailed list of factors that led to my decision, making it easier years from now to answer the question "Would I buy it again today?"

If I'm not nervously excited by the potential of my pick, something is wrong. Without that rush, I'd refine the search, start over and keep looking until I find something I believe in.

Copyright © 2014 MarketWatch, Inc. All rights reserved.
By using this site, you agree to the [Terms of Service](#), [Privacy Policy](#), and [Cookie Policy](#).

Intraday Data provided by SIX Financial Information and subject to [terms of use](#). Historical and current end-of-day data provided by SIX Financial Information. Intraday data delayed per exchange requirements. S&P/Dow Jones Indices (SM) from Dow Jones & Company, Inc. All quotes are in local exchange time. Real time last sale data provided by NASDAQ. More information on [NASDAQ traded symbols](#) and their current financial status. Intraday data delayed 15 minutes for Nasdaq, and 20 minutes for other exchanges. S&P/Dow Jones Indices (SM) from Dow Jones & Company, Inc. SEHK intraday data is provided by SIX Financial Information and is at least 60-minutes delayed. All quotes are in local exchange time.