New Fund... To Buy or Not To Buy …

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Do you ever notice how brand-new funds never miss the opportunity to advertise their outstanding returns? Usually you see them in the print media for a while. Then somehow they fade away.

Do new funds give you higher returns? Isn't it riskier to purchase a new fund?

Here is how I studied new funds:

- I included in my analysis only diversified Canadian equity funds. This enabled me to compare "apples" to "apples".
- I included funds that require less than $10,000 as the minimum investment amount. I wanted to analyze funds accessible to the average investor.
- I disregarded index funds because they reflect returns of the underlying index and do not try to outperform it.

My study included a total of ninety-three mutual funds that started between January 1985 and December 1994.

First, I calculated how much each fund would have returned in one year, if I invested $1000 *on the month* the fund opened.

Second, I calculated how much each fund would have returned in one year, if I invested $1000 *one year after* the fund opened.

Furthermore, I calculated how much each fund would have returned in one year, if I invested $1000 *three years after* the fund opened. I wanted to make sure that my findings in the first two steps were directionally correct.

For comparison, I also calculated the returns on the TSE300 index for each coinciding time period.

Here is the summary of my findings:

<u>Outperformers:</u>

- 43% of all new funds outperformed the TSE300 index in their first year. Compare this to all funds: Only 22% of all funds outperformed the index!
- 20% outperformed the TSE300 index in their first year *and* second year.
- 63% of new funds that outperformed the TSE300 index in their first and second year still outperformed the index by about 14% at the end of March 31st, 1999.

<u>Underperformers:</u>

- 57% of new funds under-performed the TSE300 index in their first year.
- 30% underperformed the TSE300 index in their first *and* second year.
- Funds that underperformed the TSE300 index in their first year still lagged the index by about 18% at the end of March 31st, 1999.
- Funds that underperformed the TSE300 index in their first and second years, continued to lag the index by about 21% at the end of March 31st 1999.
- Of the funds that under-performed the TSE300 index in their first year and second year, only 14% subsequently managed to outperform the index at the end of March 31st, 1999.

Are underperformers really that bad?

No, they are actually worse. When a fund does really bad, it may be dismantled, merged, or otherwise discontinued. I estimate that about 4% of new funds go to the chopping block. Fund databases only include funds that are still in the race. That is why the underperformers appear better here than they actually are.

If a new diversified Canadian equity fund underperforms the TSE300 index in its first year, the odds are that it will continue to stay there. After all, if a portfolio manager cannot outperform the index when s/he starts with a clean slate, how can s/he outperform the markets when his/her plate is full?

There are two main reasons why a new fund has a better chance of outperforming its older peers:

If you trade stocks, you probably know the first reason very well: the "buy" decision is a lot easier than the "sell" decision. Most mistakes are made not when buying, but when selling.

In a new fund, as the money rolls in, the job of the portfolio manager is mostly selecting and buying stocks. A reasonable degree of diligence on the "buy" side can give rise to the fund outperforming its peers. Little energy needs to be spent on the "sell" side. However, after a year or two, the fund manager has to spend increasingly more of his energy on the "sell" decisions. If they are not as effective as the "buy" decisions, the portfolio performance may start sagging. After a few years, the fund may just become an "average performer", or worse.

For example, in my DRIP (Dividend Reinvestment Plan) portfolio, I found the happy medium: I make the "buy" decisions, and my better half makes the "sell" decisions! -She likes to keep almost everything- This way, we minimize the "sell" mistakes! Perhaps fund companies should consider having two fund managers: one doing only

the buying, and the other doing only the selling, all within the frame of the fund style and objectives. That may improve their efficiency.

The second reason why new funds can outperform the index is their asset size. Asset size is generally not a consideration for international funds, but it does effect Canadian funds. In Canada, there are only so many good companies one can buy. After the portfolio manager reaches his/her natural asset size barrier, the fund becomes more and more inefficient. The natural asset size barrier depends on many factors such as fund style, large-cap or small-cap, the degree of available talent and resources, the speed of execution of portfolio decisions, and many other factors. When the natural asset size barrier is reached, the portfolio likely becomes an "average performer", or worse.

Conclusions:

When it comes to diversified Canadian equity funds, you have a better chance of outperforming the TSE300 index with a new fund in its first year.

However, be prepared to dump it after a year, if it underperforms the index: The longer it continues to underperform, the less are its chances of turning around.

If you want to avoid the "flash in the pan" situation, observe it until its second birthday. If it outperformed the TSE300 index both during its first *and* second year, and it outperformed the index by 15% or more during this time, then there is a good chance that this fund will continue outperforming the index. However, eventually almost all funds lose their efficiency, so keep in mind that "buy-and hold" does not mean "buy-and-forget".

Note that, in my study, I was unable take into account the effects of changes of portfolio managers. Manager history is not available in fund databases. If I had this information, then I'd restart the clock each time a new portfolio manager takes the helm.

Remember that all of these conclusions are based on diversified Canadian equity mutual funds. Do not apply these conclusions to any other fund category. The results for sector funds (such as precious metals, resources, energy), or foreign regional funds (such as Japan, Far East, Europe) are quite different and will be subject of a future article.

As usual, this study is based on historic data. The future performance and the conclusions based on that will be different.

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