

EVALUATING OPEN END MUTUAL FUNDS

Recently open-end mutual funds have become a popular investment option. The number of funds in Slovakia is growing and people are faced with an ever more difficult task in selecting which one to invest in. The Slovak Rating Agency, as an independent institution in the market (which does not have any capital connection to any of the funds) together with the analysis department of ING Bank have therefore come up with a new product, which could be a useful addition for people choosing open-end mutual funds. This product is termed fund scoring, something which is not peculiar to Slovakia, but a common standard on world financial markets. It is a relative evaluation of open-end mutual funds on the basis of information about their past performance. Funds are divided into groups: equity, mixed, bond, money market funds, funds of funds, etc. The classification is made on the basis of criteria set by the Association of Asset Management Companies. Each category is evaluated separately, where some categories are subdivided into groups, with regard to their differing aims and risk profiles.

An evaluation of funds is undertaken on the basis of four basic indicators:

1. Yield – in the case of this criterion the yields of different funds over a given period are compared, creating the basis for a ranking of the funds, from the fund with the highest yield (in percent) for the given period through to the fund with the lowest yield. The spread of yield rates is then subsequently divided into five parts: funds with a yield in the top 10 percent get five stars, into the next 22.5 percent four stars, in the further 35 percent three stars, in the following 22.5 percent two stars and the rest of the funds are assigned one star.

2. Fluctuation of yield rates – investors are concerned not only with yield, but also with the stability of these yields (i.e. risk), which is calculated on the basis of the volatility of weekly yields for a given period. In this point funds with the lowest risk are assigned the greatest number of stars. The assignation of stars is undertaken on the basis of identical intervals as those in the previous criterion.

3. Market share – evaluates the fund's market share in connection to the four criteria: share of net sales in Slovakia, share of net sales for the past 52 weeks, share of the inflow and outflow of money invested for the past 52 weeks and the relative share of the fund manager in the market on the basis of cumulative net sales in the Slovak Republic.

4. Company Rating – the preceding three criteria concerned the funds themselves. However, investors are often interested also in the company managing the respective fund. They want answers to questions regarding the transparency and seriousness of the company. Some investors prefer to put their money into large international institutions rather than into small, recently established firms. On the other hand, there are also those who prefer smaller, more flexible companies.

Around the world it is usual that the result of fund scoring is a certain number of stars (usually from one to five). This means that companies performing fund scoring attach to the basic evaluation criteria (in our case yield, fluctuation, market share and rating) certain importance and then calculate the results as a weighted average. In this case however, they ignore the diversity of the approach of individual investors to risk. Some are interested only in yield, others wish to be conservative to the maximum possible extent, others seek a balance between risk and yield. The Slovak Rating Agency and the analysis department of ING Bank therefore decided to publish the numbers of stars for each of the basic parameters so as to help more in guiding the users of fund scoring. They did however still retain the one resulting indicator, which is a weighted average of the four basic indicators.

A key factor in fund scoring is the need to correctly interpret the results, which are not directly an investment recommendation as they merely track the past and therefore serve only as a simple guide between funds and need not be a guarantee of future performance. Moreover, the short history of some funds can in certain cases distort the results (especially in the case of equity funds). If a fund achieves a five star rating, this does not have to necessarily mean that it is excellent, but merely that it is better than other funds in the given group for the given time period. It is therefore recommended to work with stars as a support instrument, which may guide the potential investor in the collective investment market (for example, in narrowing down the number of possible candidates on the basis of the investor's own risk profile). It does not, however, replace the need for consultation with an investment adviser.

*Fund scoring is available on the website
www.fundscoring.sk*

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