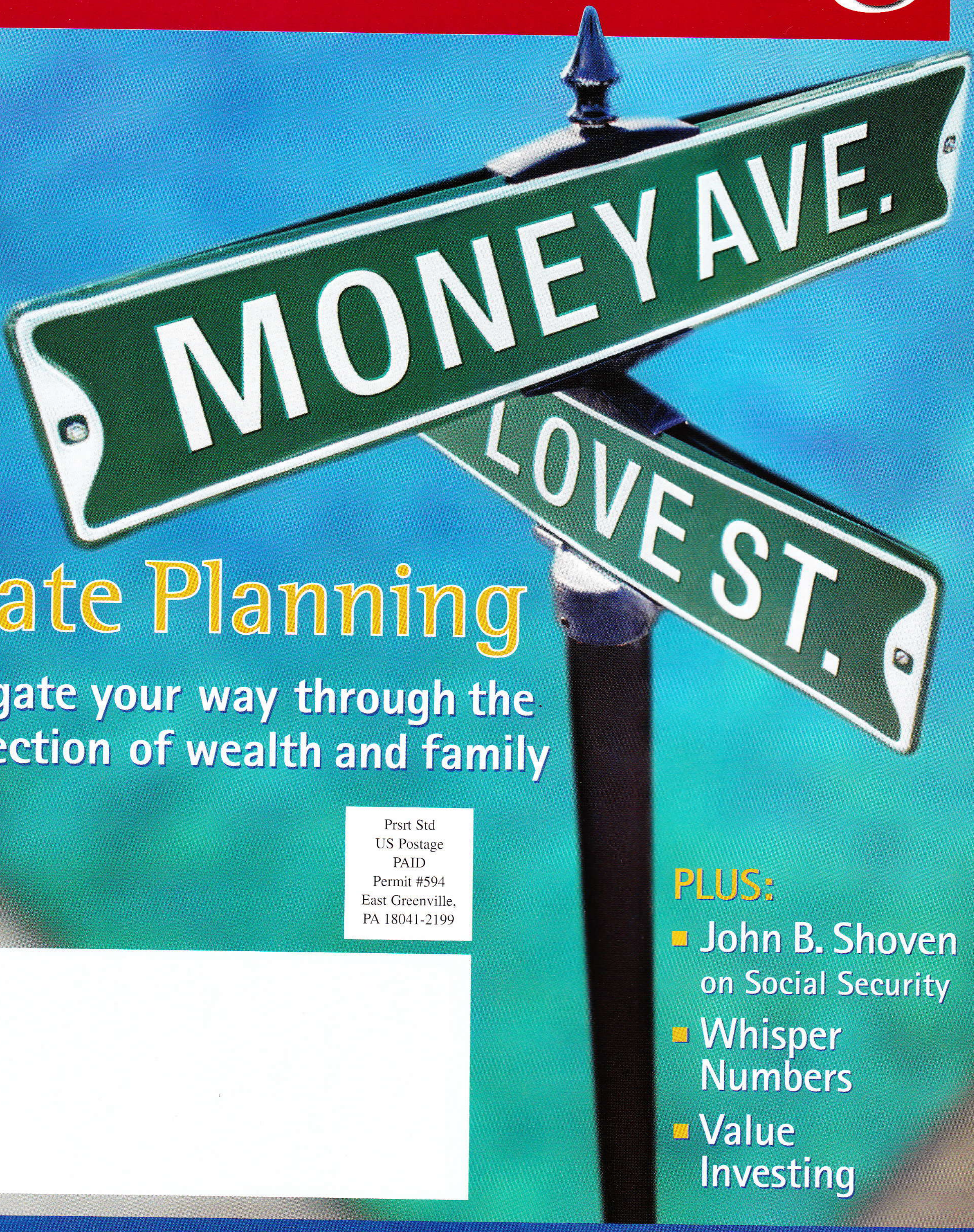
FALL 2000

On Investing

A BLOOMBERG PERSONAL FINANCE MAGAZINE FOR SCHWAB SIGNATURE SERVICES CLIENTS



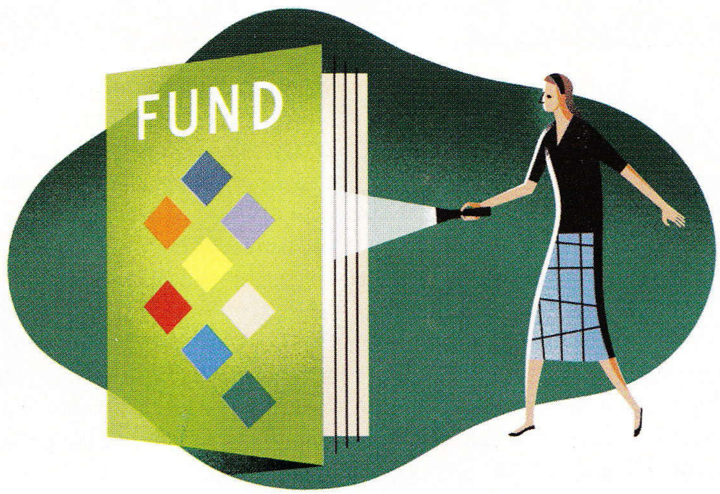
Estate Planning

Navigate your way through the intersection of wealth and family

PLUS:

- John B. Shoven on Social Security
- Whisper Numbers
- Value Investing

CHARLES SCHWAB ON: FUND TAX EFFICIENCY ▪ ELECTION OVERVIEW ▪ WEB MORTGAGES ▪ CHARITABLE GIVING ▪ SCHWAB MUTUAL FUND SELECT LIST™ PAGE 33



Mutual Fund **Reports**

Knowing what to look for can help you discern your comfort quotient, says DIANA ASCHER

WHETHER YOU are considering investing in a mutual fund or doing your annual evaluation of one you already own, the mutual fund report is a critical document. While the Securities and Exchange Commission requires mutual fund companies to file annual and semiannual shareholder reports, it can't require you to read them. For a responsible investor, though, it's a good idea. A comparison of a fund's prospectus and its annual report may shed some light on issues that affect your investment decisions.

Investment Objective

A mutual fund's prospectus usually begins with the fund's investment objective. The annual report of the fund should indicate whether the fund's investments have remained in line with the objective stated in the prospectus. Many annual reports begin with a letter from the chairman, president, or portfolio manager of the fund. Check this letter for significant changes in investment strategy, including industry and geographic concentration, and maturity ranges. If you notice a style drift, you have to decide if this change is in line with your investment objectives.

Investment Strategy and Performance

"The most important things to look for in an annual report are fees and performance," says Douglas Fabian, president of Fabian Investment Resources and editor of a monthly newsletter, *Maverick Investor*. "Understand the price you're paying for the service you're receiving. Though the industry wants investors to passively accept their fund's performance, it is imperative that investors voice their displeasure for underperforming funds by selling and finding better value for their money."

One can find valuable information within the mutual fund annual report to help decide whether the fund's performance meets expectations. The prospectus outlines a fund's investment strategies, risks, fund fees, and expenses, and you can compare these factors with the mutual fund's performance presented in its annual report. Along with a descriptive evaluation of the performance is a line graph that compares the value of a $10,000 investment in the fund with a relevant benchmark, usually the Standard & Poor's 500 Index. If your investment goal is to perform along the lines of the S&P 500, this line graph can be a helpful tool in evaluating the fund's performance.

The factors affecting a fund's performance are discussed in the annual report's commentary from the manager or sponsor. This section should explain changes in the fund's holdings. You can compare the anticipated risks and the financial highlights table in the prospectus with the manager's analysis to see whether the investment strategy was effective and you are comfortable with the fund's performance and management. "I look for a well-articulated strategy and explanation of why the fund did what it did," says Russel Kinnel, director of fund analysis at Morningstar, Inc. "If they can't explain what they did or they offer a lot of excuses, you want to be a little wary."

Volatility and Risk

A fund's beta and r-squared are measures of volatility that can help you assess the risks associated with a fund (see sidebar).

Fund Holdings

The mutual fund's portfolio holdings are a key indicator of the fund's investment policies, and should reflect the investment objective stated in the fund's prospectus. "Prospectuses have very broad language often that would allow a fund to buy virtually anything under the sun," says Kinnel. "In practice, they often have much more narrow parameters than a prospectus would indicate."

ILLUSTRATION BY RON CHAN/ICON GRAPHICS BY KELLY GIBSON

Portfolio Concentration

You also want to determine the degree of portfolio concentration, which is the percentage of the fund's assets invested in its top 10 securities. A concentrated fund may have 50% or more of its assets invested in its top 10 holdings; a more diversified fund may limit its top 10 holdings to no more than 30% of its assets. Fabian favors mutual funds that invest solely in equities. "I don't believe in using bonds as a safety net or risk reducer," he says. "If investors understand their risk level and stay within their risk parameters, being fully invested in equities allows the ability to achieve long-term personal investment goals more quickly than simply following a typical asset allocation model."

Cash Position

A mutual fund's cash position plays a vital role in its overall performance, and there are many reasons why the level of cash fluctuates. Fund managers vary the fund's cash position depending on market conditions and investment opportunities. Many hold a small portion of the fund's assets in cash as a matter of policy to meet redemption criteria. Sometimes fund managers accumulate more cash than they would like because they cannot invest incoming assets fast enough. Holding cash is not an issue for index funds, which are fully invested always.

Turnover Rate

A mutual fund's turnover rate is an indicator of how frequently securities are bought or sold, but it may not be a reason to buy or sell a fund. In general, the higher the fund's turnover rate, the greater the effect brokerage commissions and other transaction costs will have on its returns. Funds with high turnover rates tend to generate capital gains, which means investors have to pay taxes if their shares are in a taxable account. But high turnover rates aren't always a bad thing. "Low turnover may be advantageous for tax ramifications, but it also demonstrates a manager's reluctance to sell underperforming stocks to the detriment of shareholders," says Fabian. "High turnover could lead to greater tax ramifications, but not all the time. Actually, high turnover can lead to a lower tax bill if a manager is good at balancing out his winners and losers. Therefore, turnover is not an important criteria for investors looking to put new money to work."

Comfort Quotient

After you have interpreted a mutual fund's annual report and compared it with the investment objective stated in its prospectus, you will need to determine whether the fund looks like a good investment for you. Here are some questions to ask:

Does the fund's objective match your investing goals?

Were the fund's objectives as stated in the prospectus met? If not, are you comfortable with the management's explanation for the shortcoming?

Does the fund's performance justify its risks?

What will be the tax consequences of selling shares of the fund?

The mutual fund annual report is a key to unlocking the answers to these questions. An investor who knows how to interpret the information in an annual report and compare it with the mutual fund prospectus is well-prepared to assess the strategies, risks, and performance of a mutual fund—and can sleep well at night with the knowledge that the mutual fund's objectives are commensurate with the investor's goals. ■

Diana Ascher is the associate editor of On Investing.

BETA AND R-SQUARED

"BETA IS ONE of the most misused risk measurements in the investment world," declares Douglas Fabian, president of Fabian Investment Resources. "Every fund's beta, no matter its objective, is based on the S&P 500, which may not be the proper benchmark to judge a fund by." R-squared is a better risk measurement, but it may be hard for the individual investor to understand. "The r-squared gives you an idea of the fund's correlation with a benchmark, usually the S&P 500," says Russel Kinnel, director of fund analysis at Chicago-based Morningstar, Inc., "essentially telling you how closely the [mutual fund's] performance is explained by the S&P 500." An r-squared of 1 indicates that all or most of the moves in the mutual fund can be explained by moves in the broad market. Knowing the r-squared of a mutual fund can help you in a couple of ways: If you bought a fund because you wanted to be similar to the S&P 500, you want a high r-squared; if you bought a fund to be very different from the S&P 500, you want a very low r-squared.

Fabian prefers a risk-assessment tool he calls drawdown—how much a fund loses or gives up from its peak price to its trough. "Risk needs to be measured only on the downside, not upside, and both beta and r-squared incorporate equal amounts of upside gain and downside loss in their measurement of risk," says Fabian.

Together these risk-assessment tools can give you a handle on how close a mutual fund's behavior is tied to the market and what its risk-adjusted performance is. Once you find your comfort quotient, you can invest confidently. —DA