

## Compare Mutual Funds with these Key Statistics

Comparing mutual funds is fairly simple when you have a good understanding of the key statistics and know how to employ them effectively. The key statistics listed below should serve you well in comparing mutual funds.

### Mutual Fund Returns

\*Average Return

\*Risk-Adjusted Return

### Mutual Fund Risk

\*Standard Deviation

\*Beta

### Risk-to-Return

\*Sharpe Ratio

\*Coefficient of Variation

\*Treyner Ratio

You'll find these statistics readily available on the Internet at sites like Yahoo! Finance. These key statistics should be used in the order in which they are listed.

Risk and return should not be used independently to compare mutual funds. Indeed, you need to use one of the measures of risk-to-return to compare mutual funds on a relative basis.

Published annual returns are usually computed by compounding monthly returns and multi-year averages are usually computed as the geometric mean of the annual returns, which yields a compound return and is the metric that will tell you how well you would have done if you had been invested in a fund over the period of interest. However, the arithmetic mean, i.e., a simple average of the annual means, is the appropriate metric for evaluating a mutual fund's ability to deliver good returns. The returns delivered over various periods of time will give you a good feel for a fund's ability to consistently deliver good returns. More weight should be given to the longer periods.

The returns published by independent sources should be total returns (they include dividend and capital gains distributions) net of fees and expenses. Be sure to verify this.

In investing, risk is measured in terms of volatility. Total risk is measured by the standard deviation of returns and it is the standard deviation that should be used to compare mutual funds. Beta is a measure of residual risk, i.e., the risk inherent in the overall market. Beta is an indicator of the volatility of a security relative to a broad market index such as the S&P 500.

Although we have a natural aversion to risk, risk is what justifies earning a return in excess of that of riskless securities like T-bills, but expected returns must be commensurate with the level of risk. If two mutual funds have equivalent returns but one has a significantly higher standard deviation, the one with the higher standard deviation should be rejected in favor of the other. If, on the other hand, two mutual funds have equivalent risk-adjusted returns, you may prefer the riskier of the two if you have a high risk tolerance, as it has the potential to deliver higher returns.

The risk-adjusted return is calculated by dividing a fund's return by its standard deviation then multiplying by the standard deviation of a relevant index. For example, if you are comparing emerging markets stock mutual funds, an appropriate index would be an emerging markets stock index. Using a relevant index rather than the S&P 500 isn't absolutely necessary but it has the advantage of providing you with the opportunity of comparing the individual funds with the index. If none of the funds you are comparing can beat the index on a risk-adjusted basis, then you should look at some other funds or buy the index.

The final quantitative step in comparing mutual funds is the use of some measure of risk-to-return. Here the Sharpe ratio is the hands-down winner for use in comparing mutual funds, as it is computed using total risk. The coefficient of variation is a quick and dirty substitute for the Sharpe ratio. The Treynor ratio considers the degree of diversification in its computation and is best used for evaluating the competence of funds' managers.

The Sharpe ratio is the excess return (the actual return less the risk-free rate) divided by the standard deviation. The result is the real return per unit of risk. When comparing similar mutual funds, preference should always be given the one with the highest Sharpe ratio. Choosing one with a slightly

lower Sharpe ratio might be appropriate if it displayed a lower degree of correlation with the other securities in your portfolio.

By themselves, the yield and expense ratio won't tell you a lot, but they should be factored into returns and you should verify that they have been. Yield is a consideration if one of your objectives is to produce a stream of income. Also, in taxable accounts, yield creates a tax liability.

Turnover will affect return to the extent that trading costs eat into returns, but it will always be reflected in the returns. In tax-deferred accounts, turnover that pays its way is not an issue. Turnover is an issue in taxable accounts, as it generates capital gains tax liabilities.

Finally, manager tenure should always be a consideration when evaluating and comparing mutual funds other than index funds. A mutual fund with a good long-term record under the same manager is highly desirable, and there should be a co-manager or fully indoctrinated protégé to carry on in the manager's absence.

Always compare apples to apples. Your comparisons will be most valid if you compare mutual funds that are in the same asset category, similar in size and managed by the same style. For instance, don't compare a huge large-cap growth fund with a tiny small-cap value fund.

If you use these key statistics effectively to compare mutual funds, you should be very satisfied with most of your selections. But nothing is certain in investing, so be prepared for an occasional disappointment.

### About the Author

Mike Kennedy created and operates [Your Complete Guide to Investing in Mutual Funds](#), a comprehensive resource for individual investors, where you can learn more about [comparing mutual funds](#).

Source: <http://www.article-idea.com>