Conversations on Picking Good Stocks and Funds

by Harold Evensky

Featured Tickers: IJK, IWP

Unfortunately, investors all too often buy the best story and not the best investment.

To protect yourself, step back and think about your investments with your brain and not your gut. For example, in selecting individual stocks don't confuse a good company with a good stock. When selecting funds, simply looking at gross returns and comparing them to the S&P 500 index may be a good strategy for losing money. In the following chats with a client and my students, I share some commonsense guidelines.

Deciding If You Should Really Buy That Stock

If you're managing your own portfolio, there are temptations that can lead you astray, causing you to veer away from the investment strategy you've settled on and costing you a lot of money. For example, sooner or later you're bound to hear a story about a company that's headed for success—a great investment. The tip may come from a friend, a neighbor, an article you've read, or even a new acquaintance you met at a bar. If you have some funds available, it's awfully tempting to think about investing in your new find.

That's the moment to step back—and beware. You might be falling into a classic investment trap. One of my clients, let's call him David S., came close to learning this the hard way.

David met someone who talked up a technology company we'll call Super Tech. Super Tech made what David considered to be a revolutionary computer. He bought 10 of their new computers for his office and said that his neighbor just ordered four for his office before we spoke. Seeing the stock go straight up, David felt it was time to invest his entire IRA balance of $50,000 into the company. That's when he called me.

First, I asked David how he determined that Super Tech's $4,000 computer was the right one for him to buy. David said he spent weeks researching the purchase. He went through the back issues of the three computer magazines he subscribed to. He consulted a few computer-rating books to narrow down the choices to four possibilities. David checked the computers out at a few stores, called a few friends, called dealers to bargain for the best price and bought the computer he was most satisfied with.

His research into the stock was far less vigorous. When asked about who the president of Super Tech was, whether or not Super Tech's market share was growing or shrinking and what the stock's valuation was, David could not provide answers. This is where we'll join the conversation.

Harold Evensky (HE): *Let's talk about a good stock. Would you agree that a stock is good because it represents ownership in a good company?*

David S. (DS): That makes sense.

HE: *Is Super Tech a good company?*

DS: Harold, that's a silly question. You know it is.

HE: *I wouldn't argue with that. What's it selling for now?*

DS: Right at $37.

HE: *So Super Tech's a good company, you think it's a company on the move and you can buy a share for about $37. Suppose I told you that this morning's Wall Street Journal had a big write-up on Super Tech and described it in such glowing terms that today it's selling up $20 from yesterday. So, it's trading at $57. Still want to buy it?*

DS: I don't think I would. That's pretty expensive.

HE: *Hold on. I didn't say Super Tech was in trouble. I said that the market experts agree with you and they think Super Tech's terrific. Why wouldn't you buy it?*

DS: It would be too expensive at that price.

HE: *Isn't Super Tech still a good company?*

DS: Sure.

HE: *Do you see the catch yet?*

DS: No.

HE: *It's simple. You fell into a classic investor trap. You've confused a good company with a good stock and a good price. When you raved about Super Tech and told me it was a great stock, you were talking about the company, not the stock. A company can be outstanding, but there is a price at which you just aren't getting what you pay for. The experts would say the stock is overpriced.*

DS: Okay…

HE: *The point is that in picking stocks, you've got to know two things and know them better than almost anyone else. 1.) You have to know all about the company and how well it's likely to do in the future. 2.) You have to know what is a fair price to pay for a piece of that future. If you're still the expert in medicine that I've known you to be, you haven't had time to know that stock and its price better than anyone.*

DS: That's pretty depressing. If that's true, how am I going to make money in the market?

HE: *It's not that complicated. You spend your time finding and hiring the people who do have the time and expertise to do the research. Why don't you come to our AAII meeting next week? I'm going to be talking about the three Ps of selecting professional fund managers. My way won't make you rich, but it won't make you poor. If you want to get rich, do it by being a great doctor. The real market pros have little sympathy for novices. They just take their money.*

DS: Okay, Harold. You've convinced me. I'm not buying the stock. I'll see you next week at the AAII meeting. But you'd better have something good to say, because I'll still have that $50,000, and I want to put it to work for me.

HE: *By the way, if you lose money on the investment in your IRA, you can forget about offsetting gains in your taxable accounts with the IRA loss. If you make a killing with your IRA investment, that capital gain will eventually be taxed at the higher ordinary income rates. So whenever you see a real opportunity like Super Tech, let's talk about making the investment with your taxable money.*

The Three Ps of Investing

In real estate, it's location, location, location. In investing, it's philosophy, process and people. Most investors look at past performance when evaluating a manager. That's a rearview mirror approach. If you're driving forward, keeping your eyes on the rearview mirror is dangerous. Looking backward is equally dangerous for investors. You can't buy past performance, so don't invest based just on looking backward. To avoid that mistake, here's a simple process that works for any investment manager you might hire—mutual funds, separate accounts or alternatives.

Philosophy

When you are evaluating money managers, find out what their investment philosophy is. What is their unique view of the investment world? How is it different from those of their competitors? Is it credible that a manager can overcome the drag of expenses and taxes and provide risk-adjusted returns better than other alternatives? Basically, you're looking for a good and credible story. How might you find it? Read the manager's letters, prospectus and marketing material; look for something more than "we buy low and sell high."

Process

A good story is nice, but how does the manager make it work in the real world? Answers to this question may be harder to pin down but, remember, it's your hard-earned money at risk.

People

Philosophy and process are essential, but ultimately it's people who make the difference. People will be making investment decisions about your money.

Don Phillips is a managing director and board member of Morningstar. He is a good friend of mine and one of the most-respected professionals in finance. He has some simple advice regarding people: "You want people with passion for the job of money manager."

Did the managers you are considering invent the firm's philosophy and process or have they at least been around long enough to have developed a passion for it? If not, even if the investment passes the test of the first two Ps, move on to your next investment alternative.

—Harold Evensky

Determining If a Fund Is All It Claims to Be

One of the hats I wear is professor of practice in the personal financial planning department at Texas Tech University where I teach the graduate wealth management class. I gave the assignment of analyzing an actively managed fund. In doing so, I expected them to consider the Three Ps of Investing: philosophy, process and people [see the box on page 12 for an explanation].

Let's eavesdrop as my students and I discuss how to compare the fund's performance record.

HE: *What's a "sandbox?" How are you going to determine which sandbox the fund is in?*

Lisa: By sandbox we mean the nature of the underlying investments. In this case our active fund is a domestic stock fund, so we need to determine the size of the companies the fund invests in and the manager's valuation orientation, so that we can know the universe of managers to compare its performance to.

HE: *Can someone explain valuation orientation? And tell us how we go about determining the universe for comparison?*

Kristen: Generally, stocks are categorized as "growth," "value" or "core." Growth companies are those that investors believe will have significantly improving profits. The stock price tends to be relatively high compared to the company's current earnings, as investors are paying up for those rapidly improving profits.

Value stocks tend to be relatively cheap based on current earnings, as investors do not have great expectations for the firm's future profits.

Core stocks are those that have mid-range expectations for future profits.

Professionals use a variety of metrics to determine what category a stock falls in. One of the most common is the stock's price-to-book-value ratio [P/B]. That's simply a number that tells you how much you have to pay for a share of stock to buy $1 of the company's book value. For example, the stocks that make up the S&P 500 index have a price-to-book ratio of about 2.6, while the price-to-book ratio for the growth stock portion of that index is 3.8 and for the value portion is 1.9. When we look at a fund that's investing in S&P 500 kinds of stocks, we'll look to see how the fund's price-to-book ratio compares. If it's in the 1.9 range then we consider it a value fund, in the 2.8 range it's considered a growth fund and in between that it is considered a core fund.

HE: *Okay. And we compare the fund to an investable index—a mutual fund or exchange-traded fund (ETF) with the objective to track an index—and not to an actual index. Why is that?*

Clay: You taught us that an index is generally a more rigorous standard than a peer benchmark. But if our clients can't invest in an index, using one for comparison may be interesting, but not very practical.

Sean: The good news is that today, with the large universe of ETF index investments, we can invest in almost any index.

HE: *Very good. Sean, where might we look for the information we need to evaluate funds?*

Sean: Certainly we'd want to look at the fund family website. And to get an independent evaluation, we'd look to Morningstar data. It is available in programs for professionals and on the web for individual investors. [Editor's note: AAII's annual "Guide to the Top Mutual Funds" and "Guide to Exchange-Traded Funds" use Morningstar data.]

***HE:** Okay. What's next in our evaluation? And what did you find out about our assignment fund?*

Sean: I found the average price-to-book ratio and market capitalization [size as measured by stock price multiplied by the number of shares outstanding] of the stocks in the fund to be in line with the mid-cap growth universe. For comparison, I selected two exchange-traded funds: iShares S&P Mid-Cap 400 Growth (IJK) and iShares Russell Mid-Cap Growth (IWP). Besides the capitalization and price-to-book metrics being similar to our active fund, the correlations with both indexes were high at 0.94.

***HE:** Thank you, Sean. And?*

Kristin: Regarding performance, I found that during its 10-year-plus history, our fund's return compared to the benchmark funds was most impressive; it was almost 20% better than the index ETF returns.

***HE:** So, it does stand apart, so to speak? What do you think, Linda?*

Linda: Not so fast, is what I think. When I looked more closely, I found that all of that 20% outperformance was attributable to returns more than five years ago. When I looked at the most recent three years, when the current management was in place, I found that all the outperformance disappeared.

***HE:** Terrific. Kiran, what did you find?*

Kiran: I looked at tax efficiency.

***HE:** And?*

Kiran: Throughout the last three years, there was almost a 1% extra tax drag on the active fund as compared to the much more tax-efficient index funds.

***HE:** Conclusions?*

Kiran: My conclusion would be that, while the active fund seems to be of decent quality, if I were making a recommendation to my client, I would recommend one of the index ETF alternatives.

***HE:** And why is that?*

Kiran: Recent performance of all three funds was quite close on a pretax basis; however, on an aftertax basis the index alternatives would deliver more aftertax returns to my taxable clients. Also, with an index investment, I'm basically sure of par performance: That is, after expenses an index will consistently be in the top half of the performance universe, whereas an active manager may do well for one period, but poorly the next. So, unless I find an active manager I believe can

consistently outperform an index alternative, I'll stick with the index. It's like going out on the golf course and being guaranteed to shoot par.

HE: *And the moral?*

Kristin: The next time I read a glowing article about a hotshot manager, I won't add that manager to my clients' portfolios until I determine what sandbox the manager's playing in, put him through the screen of the three Ps, and select an investable benchmark to compare his risk and returns to. And if it's for a taxable account, I won't forget to consider taxes.

The conversations included in this article were excerpted from Evensky's new book, "Hello Harold: A Veteran Advisor Shares Stories to Help Make You Be a Better Investor" (Amazon Digital Services, 2015).

Harold Evensky CFP, is chairman of Evensky & Katz, a fee-only investment advisory firm, and professor of practice in the personal financial planning department at Texas Tech University.