Part II: Answers to the Mutual Fund IQ Quiz

(A score with more than three incorrect answers is unsatisfactory.)

1. A mutual fund's performance is best measured by:

   (a) Price appreciation and net asset value.
   (b) Total return.
   (c) Yield and capital gains distributions.

   Answer (b). A mutual fund's performance, up or down, is measured by total return. It captures increases/decreases in a fund's price (net asset value or NAV), distributions of interest or dividends from a fund's securities (yield), and any realized capital gains/losses from the sale of securities in a fund's portfolio.

2. When it comes to selecting a specific mutual fund to invest in, which of the following information sources would be the most helpful?

   (a) A fund's prospectus and annual report.
   (b) Information from a 401(k) plan-provider.
   (c) A Morningstar fund report.

   Answer (c). A fund's prospectus and annual report are regulatory documents, which, while somewhat useful, can run to several dozen pages and are not easy to read. Plan-provider fund profiles are usually limited to very basic data. A Morningstar fund report contains almost everything you need to know to evaluate a mutual fund. And, it does this in a one-page comprehensive presentation that is relatively easy to understand. Morningstar's independent objective fund reports are highly regarded by the investment community.

3. Stock funds always provide higher returns than bond funds.

   (a) True
   (b) False
   (c) True in an up market and false in a down market.

   Answer (b). First, stating the obvious, not all stock funds are winners. It is also true that over the long term, returns from stocks have generally, but not always, outpaced bond returns. There are times when the economic environment and market conditions favor bonds.

4. Asset allocation affects an investment portfolio's:

   (a) Risk.
   (b) Return.
   (c) Both risk and return.

Answer (c). Asset allocation involves apportioning an investment portfolio among the three principal financial asset classes – stocks, bonds, and cash/cash equivalents. Each of these has different risk and return characteristics. Thus, your choice of the percentage of each one as a component in your portfolio establishes your overall risk-return investment position.

5. Is a material change in a mutual fund's investment objective **(style category)** a matter of concern to fund investors?

    (a) Not a major concern.
    (b) Depends on the type of fund.
    (c) None of the above.

    Answer (c). You invest in a particular fund for a number of reasons. One of your basic considerations is that the fund's investment objective, or style, is a good fit in your portfolio. Let's say, you choose to maintain a conservative investment strategy, but a large-cap value fund (relatively safe) you've had in your portfolio changes its holdings to small-cap aggressive growth stocks. Depending on the weighting of this fund in your portfolio, you may end up with far more risk than you want, regardless of the return. Such a shift in risk in any fund is a serious concern that needs to be addressed.

6. The goal of a broad-market based index mutual fund is to:

    (a) Beat the investment return of a specified stock or bond index.
    (b) Invest in the best-performing sectors of the stock market.
    (c) Track the investment return of a specified stock or bond index.

    Answer (c). It's tough to beat the market. Therefore, index fund investors simply try to capture as much of a market return as possible. They do this by investing in low-expense, low-turnover index funds that track a market index as closely as possible. Sector funds should not be confused with index funds. The former focus on a relatively narrow selection of stocks in a particular industry; the latter track whole markets and broad segments thereof.

7. Is the market-capitalization of the holdings in a fund useful for fund selection?

    (a) For a value investor – no.
    (b) For a growth investor – no.
    (c) For a bond investor – no.

    Answer (c). In the investing world, market-capitalization, or simply market-cap, is used as a measure of a company's size – large, medium, and small. All stock funds use size as one of the factors in determining their investment style. A company's size affects its investment quality in a number of ways – market potential, operational stability and flexibility, financial strength, etc. Market-cap is not an evaluative fund investment metric used with bond issuers.

8. Investors can avoid risk by selecting target-date mutual funds:

    (a) Yes.

(b) No.
(c) Depends on the investor's time horizon.

Answer (b). One of the functions of a target-date fund, and all mutual funds for that matter, is to manage risk through asset allocation. But to think of any mutual fund as risk free is a mistake. Risk is an inherent part of the investing process. Quality investments and a long-term approach to investing can mitigate investment risk but not eliminate it altogether.

9. If two mutual funds hold the same exact securities, but one has a higher expense ratio than the other, which of the following statements is true?

(a) The fund manager with the higher expense ratio will produce a higher return.
(b) The fund with the lower expense ratio will have a higher return.
(c) No effect – operating expenses are for the account of the fund manager.

Answer (b). Operating expenses, expressed as a fund's expense ratio, are charged against a fund's assets and are not paid by a fund's managers. It is a matter of record that, in general, lower cost mutual funds historically outperform higher cost funds.

10. When selecting a bond index fund, what matters the most?

(a) Duration, credit quality, and the expense ratio.
(b) Total return and manager performance.
(c) Manager performance.

Answer (a). An index fund's management is on "autopilot." Its "manager" does not make buy/sell decisions on securities but rather focuses on maintaining the efficacy of the market index being tracked. With any bond fund, indexed or managed, duration, credit quality, and expenses are key components that impact total returns.

11. Which of the following is an attribute of asset allocation?

(a) Provides a basis for selecting high-return, low-risk mutual funds.
(b) Establishes a portfolio's risk-return position.
(c) Increases portfolio return by helping to select specific mutual funds.

Answer (b). Asset allocation relates to the apportionment of stock, bond, and cash/cash equivalent investments in a portfolio. This decision determines an investor's overall risk-return position. Selecting individual mutual funds to implement this strategy defines portfolio diversification.

12. Which type of mutual fund has generally offered the best protection against inflation?

(a) Stock fund.
(b) Money market fund.
(c) Hybrid fund (50% stocks and 50% bonds).

Answer (a). Money market fund's are low risk, and accordingly have relatively low returns, which generally provide scant inflation protection. Bond and stock returns have historically been in the range of 4% to 6% for the former and 10% for the latter. Annual inflation rates have averaged around 3.5%.

13. When considering a fund selection, matching a fund's positive performance record to a current manager's time on the job (tenure) is:

(a) Important.
(b) More important for stock funds.
(c) Important only for bond funds.

Answer (a). With mutual funds, matching manager tenure and fund performance is important. For example, if a fund has a steady, positive five-year total return record and current management has only been on board for a year or two, manager tenure and fund performance don't match. The current manager can only take credit (or blame) for one of those five years. This mismatch is not necessarily a "deal breaker," but it does bear watching.

14. Rebalancing an investment portfolio's asset allocation should be done:

(a) Every two to three years.
(b) As needed.
(c) Annually.

Answer (b). Rebalancing refers to the process of periodically realigning a portfolio's asset allocation to maintain a desired risk-return position. While rebalancing a portfolio may seem advisable, there is no universal agreement among investment professionals as to its necessity or benefit. It's best to let circumstances dictate any action as opposed to adhering to a fixed schedule.

15. Does a fund's portfolio turnover rate have fund performance consequences?

(a) Yes.
(b) No for stock funds
(c) No for stock funds and balanced funds.

Answer (a). Portfolio turnover refers to the frequency of security transactions (purchases and sales) in a fund's portfolio. More trading volume results in higher brokerage commissions. These costs are not included in a fund's expense ratio; however, they are a cost that reduces investment returns on all types of funds. Also, frequent trading requires fund managers to make a lot of correct calls.

