



Our Analysis of FundGrades

For an overview of the FundGrades methodology, see the accompanying [article](#) in this issue.

The value of the FundGrades system to advisors will depend on how it is used. For advisors analyzing funds in an asset allocation framework, FundGrades will be of significant value. When selecting funds for a particular asset class, to fit within an asset allocation model, FundGrades shows clearly (through the “best fit” list of asset classes) how the fund correlates with the asset class benchmark. FundGrades stands alone as the vendor providing this sophisticated data to the market free of charge.

For advisors doing side-by-side comparisons of funds, FundGrades will be similarly valuable. FundGrades provides a framework for meaningful comparisons along the five dimensions it grades – diversification, expense, relative risk, return, and risk of material underperformance. In particular, for advisors acting in fiduciary roles, subject to ERISA guidelines, FundGrades can provide the required level of prudent due diligence. In this context, FundGrades can be used in a straightforward manner – funds with higher grades will be more appropriate.

For advisors seeking funds that deliver [alpha](#), FundGrades provides value if used in the proper manner. Specifically, advisors will want to avoid funds with high diversification grades, since these are likely to be index hugging funds. FundGrades’ identification of these index huggers offers great value in the selection process. FundGrades does not employ a capital asset pricing framework; there is no attempt to isolate the beta and alpha of a fund. So, advisors will want to combine the relative risk, return, and risk of material underperformance grades with additional data that breaks down returns into beta and alpha. FundGrades’ identification of the proper benchmark against which to measure a fund provides an important element in this analysis, as is the isolation of relative risk and return as separate metrics. Morningstar and, to some extent, Lipper combine risk and return into a single metric, and the FundGrades approach offers an improvement through its more granular approach. FundGrades is not designed to support advisors in alpha-seeking environments. But the rigor and comprehensiveness of the FundGrades methodology suggests that it should have predictive value, and we look forward to the results of analysis along these lines.

Perhaps the greatest value for advisors is the exposure of the weaknesses of peer group comparisons commonly used by other mutual fund rating vendors. As we illustrate in the section below (FundGrades in the Advisor Perspectives



Universe), some peer groups are considerably easier to beat than others. Other vendors may rate funds very highly, simply because the fund is assigned to a peer group with an easy benchmark to beat. FundGrades eliminates this inconsistency – first, by insuring that funds are compared to the proper benchmark and, second, by measuring the risk and return of the fund in a consistent manner against the benchmark.

Lastly, FundGrades deserves accolades for providing this service free of any commercial interests. This is a clear distinction from other mutual fund rating services, who readily accept advertising from fund companies. Advisors operating in fiduciary roles must be cautious of using data from sources that are in a potential conflict-of-interest, and FundGrades solves this problem.

FundGrades in the Advisor Perspectives Universe

We looked at the top five actively managed mutual funds among the Advisor Perspectives [most popular mutual funds](#), and we compared data presented by Morningstar against data presented by FundGrades. These five funds represent a reasonable cross-section of asset classes:

- (1) PTRAX – PIMCO Total Return Fund – Govt/Corp Bonds
- (2) AEPGX – American Funds EuroPacific Growth – Foreign Equity
- (3) DODFX – Dodge & Cox International Stock Fund – Foreign Equity
- (4) VSITX – JP Morgan Tax Free Select – Muni Bonds
- (5) GFAFX – American Funds Growth of America Fund – US Equity

We observed the following:

- These five funds are rated either 4- or 5-star by Morningstar, yet their overall grades from FundGrades range are C-, C, C, C, and B-. In fact, the B- grade was earned by a 4-star fund.
- The discrepancies in ratings and overall grades should not come as a total surprise, since the Morningstar methodology places a heavy emphasis on past returns when rating funds. But none of these funds earns high grades for returns – their returns grades are D+, C, C, C+ and C+. It would be unwise jump to any conclusions based on this sample of five funds, but there appear to be dramatic differences in the way funds are portrayed in these two methodologies.
- For four of the five funds, FundGrades and Morningstar agree on the proper asset class. Only for PTRAX (the PIMCO Total Return Fund) is



there a discrepancy. Morningstar classifies this as Intermediate Term Bond. FundGrades identifies the closest fit as Govt/Corp Bonds, and the asset class of Intermediate Govt/Credit is the third best fit.

- Despite the fact that FundGrades and Morningstar agree on the proper asset class assignments, these funds clearly illustrate problems in the Morningstar peer group methodology. For example, PTRAX is a 5-star fund, yet its return grade is C+ and its relative risk grade is D, implying that returns are just barely better than the benchmark, despite exhibiting significantly more risk than the benchmark. (These grades were based on an asset class of Govt/Corp Bond. If the asset class of Intermediate Govt/Credit is used, the return grade improves to B- but the relative risk drops to F). The explanation is that the Morningstar peer groups employ benchmarks which are easy to beat, and the benchmarks can be beaten without good risk control. AEGPX exhibits a similar pattern (5-star rating with relative risk and return grades of C) as does DODFX (5-star rating with a relative risk grade of D and a return grade of C+). The implication of this analysis is index funds would be a reasonable substitute for these actively managed funds, which exhibit return and risk that closely track the index (an index fund has return and risk grades of C).
- A similar scenario plays out with VSITX (4-star with a relative risk grade of A and a return grade of D+) and GFAFX (4-star with a relative risk grade of A- and a return grade of C). In these two cases, the Morningstar benchmarks are harder to beat (as compared to the other three funds), so strong risk grades and similar return grades relegate these funds to lower star ratings. The corollary is that poor returns combined with low risk still earn funds a 4-star rating.
- When looking at the best fit data, the correlation coefficients against different asset classes are sometimes very similar. For example, for GFAFX (the Growth of America Fund), the best fit is mid cap growth, with a correlation coefficient of .921. But there are five other asset classes with correlation coefficients within .02 of mid cap growth, including world equity (the fund has 20% of its holdings in foreign stocks, according to Morningstar).

We wanted to look at a fund which earns high grades with FundGrades, and LLSCX (The Longleaf Partners Small Cap Fund) is such a fund. This fund was featured in David Swensen's book *Unconventional Success: A Fundamental Approach to Personal Investment*. This is a 5-star fund that earns high grades for both return (B) and relative risk (A-), using the FundGrades best fit asset class of mid cap blend. Morningstar classifies this as small cap value, and



FundGrades would assign higher grades (B+ for return and A for relative risk) in this asset class. FundGrades also shows that this fund earns poor marks for diversification and does not have a good fit with any asset class, which is behavior that would be expected in a value oriented fund with concentrated positions. FundGrades therefore supports the praise given to this fund by David Swensen.

Tables with the data for these five funds are below.

(1a) PTRAX - Morningstar

Ticker	Fund	Morningstar Category	Morningstar Rating
PTRAX	Pimco Total Return Fund	Intermediate Term Bond	5 star

(1b) PTRAX – FundGrades

Best Fit: **Govt/Corp Bonds**

Fund Grades						
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
3 years	C	C-	B-	D	C+	B

Grade this Fund Versus Another Asset Class

Asset Class	Diversification Grade	Correlation To Fund	Asset Class Type
Govt/Corp Bonds	C-	0.944	Domestic Fixed Income
Broad Investment Grade	C-	0.943	Domestic Fixed Income
Intermediate Govt/Credit	D+	0.932	Domestic Fixed Income
Intermediate Govt Bonds	D	0.902	Domestic Fixed Income



(2a) AEPGX - Morningstar

Ticker	Fund	Morningstar Category	Morningstar Rating
AEPGX	American Funds EuroPacific Gr A	Foreign Large Blend	5 star

(2b) AEPGX – FundGrades

Best Fit: **Non-US World Equity**

	Fund Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
3 years	C	C	C	C	C	C+

Grade this Fund Versus Another Asset Class

Asset Class	Diversification Grade	Correlation To Fund	Asset Class Type
Non-US World Equity	C	0.954	International Equity
Developed Foreign Stock	C-	0.949	International Equity
World Equity	D	0.917	International Equity
Emerging Markets	D	0.904	International Equity

(3a) DODFX - Morningstar

Ticker	Fund	Morningstar Category	Morningstar Rating
DODFX	Dodge and Cox International Stock Fund	Foreign Large Value	5 star



(3b) DODFX - FundGrades

Best Fit: **Developed Intl Stock**

	Fund Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
3 years	C-	C	B-	D	C+	C-

Grade this Fund Versus Another Asset Class

Asset Class	Diversification Grade	Correlation To Fund	Asset Class Type
Developed Foreign Stock	C	0.957	International Equity
Non-US World Equity	C	0.953	International Equity
World Equity	D	0.899	International Equity
Emerging Markets	F	0.816	International Equity

(4a) VSITX – Morningstar

Ticker	Fund	Morningstar Category	Morningstar Rating
VSITX	JP Morgan Intermediate Tax Free Select Fund	Muni National Intermediate	4 Star

(4b) VSITX - FundGrades

Best Fit: **10 Year Muni Bonds**

	Fund Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
3 years	B-	A-	B-	A	D+	D



Grade this Fund Versus Another Asset Class

Asset Class	Diversification Grade	Correlation To Fund	Asset Class Type
10 Year Municipal Bonds	A-	0.986	Domestic Fixed Income
Broad Municipals	C+	0.966	Domestic Fixed Income
Intermediate Municipal Bonds	C	0.954	Domestic Fixed Income
Govt/Corp Bonds	D	0.901	Domestic Fixed Income

(5a) GFAFX - Morningstar

Ticker	Fund	Morningstar Category	Morningstar Rating
GFAFX	American Funds Growth Fund of America	Large Growth	4 star

(5b) GFAFX - FundGrades

Best Fit: **Mid Cap Growth**

	Fund Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
3 years	C	D+	B-	A-	C	D+



Grade this Fund Versus Another Asset Class

Asset Class	Diversification Grade	Correlation To Fund	Asset Class Type
Mid Cap Growth	D+	0.921	Domestic Equity
Mid Cap Blend	D	0.915	Domestic Equity
Total Domestic Equity	D	0.912	Domestic Equity
Small Cap Growth	D	0.902	Domestic Equity
World Equity	D	0.901	International Equity
Total Domestic Growth	D	0.901	Domestic Equity
Large Cap Growth	D-	0.887	Domestic Equity
Large Cap Blend	D-	0.886	Domestic Equity

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