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**Looking through the lens
to select the right fund**

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What the investor needs from their investment is, of course, a "return" or "profit". This is the first thing on his or her mind or his/her first goal. Since no one likes to take "risks", the investor may invest in something that yields high "return" and has low "risk", which is almost impossible. The reason is simply because, based on the investment principle, the "return" and "risk" fluctuate in the same direction.

"However, we can manage the investment to yield the same amount of return but take lower risks. The other way, we can take the same level of risk but enjoy more return by appropriately allocating the investment to different assets, which has been done by the institute investors and mutual funds for a long time.

The "return" of a mutual fund is now easy to find in the "Fund Fact Sheet", "business newspapers", "websites of the asset management companies" whose funds you are investing in, "website of Association of Investment Management Companies (www.aimc.or.th)" or recently on the "website of Morning Star (www.morningstarthailand.com)". The "return" of mutual funds is compared to the "benchmark" that each fund chooses to compare its performance with. For instance, most funds that invest in Thai stocks choose the SET index as the benchmark against their performance. This helps reflect what the funds are investing in.

The investor can preliminary use these as criteria to compare the performance of his/her mutual funds and see how the funds with investment policies in a certain asset classes perform against the benchmark. Normally, the mutual fund displays its performance in a period dating back from the date displaying the information, such as in the past three months, six months, year, three years, five years, ten years and from the date of establishment. If the fund uses the same benchmark, the investor can compare the return.

The "return" of a mutual fund is easy to find

- Fund Fact Sheet
- Business newspapers
- Websites of the asset management companies
- www.aimc.or.th
- www.morningstarthailand.com



To pick a good mutual fund, we should first understand how the fund managers think. Most of them tend to choose their stocks or assets by looking three to five years ahead to see if the stocks they hold or the assets they invest in will grow and if their value will increase. Therefore, the investor should also look at the fund's return in the past three to five years to see if the fund has yielded a steady return and meets its goal. Nevertheless, in some funds, the fund managers focus on a short-term return, which may cause the funds' performance to highly fluctuate and have high risk. Anyway, it depends on which style of investment the investor prefers and if he/she is happy with the return earned.

"Even though the past performance does not confirm or guarantee the investor's future return, the tendency of his/her returns is hypothetically based on the return in the past, which is a tool to indicate a trend of future return. The fund looks at the overall return tendency.



Look deeply at a risk-adjusted return

It is possible to compare the "performance" or "return" of mutual funds. However, looking only at the "return" will not give you a 360-degree view. To include the risk in assessing a mutual fund's performance, the investor should use "risk-adjusted return" as a better option to measure the fund's performance.

If the investor would like to compare the performance of different funds, besides the "return", he/she needs to look for the "risk". In financial aspects, "risk" means "standard deviation (SD)", also known as "variability".

Standard deviation is the statistical value indicating the "probability" that the actual return from any asset invested may deviate from the "expected return"

"If the standard deviation is "high", it means the assets or portfolio has a high risk because the rate of return (ROR) is distributed far from the expected return and the deviation is also highly probable. If the standard deviation is "low", it means the assets or portfolio has a low risk."



— 3 popular methods to measure mutual funds' performance —

1

Sharpe Ratio

The Sharpe ratio measures a mutual fund's return that is higher than ROR of risk-free assets. The value is adjusted with the fund's risk, which is the standard deviation. It looks at the "return" per unit at the same risk level. In other words, the fund with a higher Sharpe ratio, when compared to another funds, means that the fund manager can generate a higher return per unit at the same risk level. However, as the concept, the "Sharpe ratio" should be used to compare the funds having the same investment policy.

Example: Fund A, B and the SET index have a Sharpe ratio of 1.12, 0.95 and 0.85, respectively. It means Fund A yields a higher return than Fund B and the SET index when we compare them at the risk level of one unit.

2

Treynor Ratio

The Treynor ratio measures a mutual fund's return that is higher than ROR of risk-free assets, such as government bonds. The value is adjusted with the fund's systematic value at risk (Beta, referring to the market, is another factor to measure the volatility of return). Even though Treynor's concept is similar to the Sharpe ratio, the only difference is that the Treynor ratio uses a systematic risk.

A "high" Treynor ratio means the fund manager can generate high excess return per unit of systematic risk. If the Treynor ratio of the fund you are interested in is higher than the Treynor ratio of the market's return, it means that the fund yields a better return than the market does. If its ratio is **"lower"** than the market's return, it means that the fund yields a lower return than the market does."

3

Jensen's Alpha

Jensen's Alpha compares the difference between a mutual fund's rate of return with the risk-adjusted return.

Alpha tells how many percentages the mutual fund's return on investment (ROI) outperforms the expected ROI or the market's return. For example, an alpha of 4% means the fund that we invest in yields a 4% higher return than the market does. If we invest in a fund with a very high alpha, it tends to perform better and indicates that the fund is managed so well that it generates a high alpha. Therefore, a fund's higher alpha means it yields a higher return than the expected return at one unit of systematic risk. As an advantage, this method is perfect to directly measure the skills of fund managers because it compares whether the fund generates a higher return than the market does.

"These three methods are clearly different. The Sharpe ratio measures the return by mainly comparing it with risk-free assets. The return of risk-free assets must have a positive value. If the Sharpe ratio is negative, there is no need to look further because the return will definitely be low. Jensen's Alpha focuses on measuring a fund's return by comparing it with the benchmark to see if the fund yields a better return than the benchmark. The Treynor ratio measures a mutual fund's return by comparing it to the market's return to see how well the fund generates a return when comparing it to the overall market. These are key difference of the three concepts to measure the return of a mutual fund."

Besides "Sharpe's ratio", the "Information ratio (IR)" concept can be applied if the mutual funds are in the same types and the same standard criteria. The funds can be compared for the investors' further consideration and analysis. IR will serve as another reference for the investor to make a decision.

For IR calculation, the concept is similar to Sharpe's ratio, but a bit more complicated. It shows the fund's capability to yield a higher return than the risk-adjusted benchmark (S.D.). Below is the formula:

$$\text{Information Ratio} = \frac{\text{Return} - \text{Benchmark}}{\text{Fund's Standard Deviation}}$$

Example: There are two equity funds. During the past year, Fund A yielded a return of 41.25%, with an S.D. of 19.97% and an IR of 0.98%, while Fund B yielded a return of 31.85%, with an S.D. of 13.01% and an IR of 0.21%.

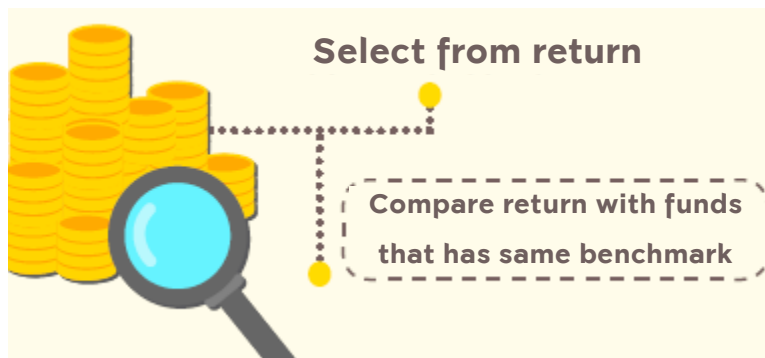
If considering only the fund's return, the investor may choose Fund A because it yielded a higher return in the same period compared to Fund B. However, many may pick Fund B because its risk, or volatility, is lower than Fund A even though it yielded a lower return.

"However, when considering the IR, the investor would rather select Fund A because its higher IR means that, at an equal risk level, Fund A generates a return of 0.98%, which is more attractive than Fund B that yields a return of 0.21%."

As a result, the investor should focus on "risk-adjusted return" to compare if the return generated by the fund manager is higher or lower than the market's average return.

2 key points to pick good funds

1



2

