



Truth in Labeling – New Research from FundGrades

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We have [written](#) previously about FundGrades.com, a free research tool that grades funds with an overall combined grade based on diversification, expense, relative risk, return and underperformance risk. This article is based on a [recent paper](#) by Dave Loeper, CEO of Financeware, Inc., the provider of www.fundgrades.com, showing new ways advisors can utilize this system.

When creating a portfolio to optimize asset allocation, how important is a fund's label?

Using research from FundGrades.com, advisors can determine whether the labeling of a fund is an accurate guide to its diversification value in an overall portfolio allocation strategy. To be confident the target asset allocation is achieved, advisors must examine both how funds behave and how diversified they are both individually and when combined into a portfolio.

For example, a seemingly diverse portfolio consisting of funds designed to match a broad-market index based on their asset class labels, may unwittingly behave like one composed entirely of mid-cap funds if behavior and diversification are ignored. Thus, when creating a portfolio, we must look beyond just the labels and pay attention to how *funds behave as a combined portfolio* relative to the asset classes and weights selected in the overall allocation strategy.

Advisors should pay attention to diversification, in addition to examining relative risk and return. If we focus only on risk, return *and the asset class labels*, it is easy to misinterpret the behavior of any portfolio, and thus be fooled. One might overestimate performance and conclude that a fund behaves more favorably than it actually does. To truly measure a fund's behavior in an allocation strategy, we also must look at its diversification grade. As an example, Exhibit 1 grades the performance of the iShares S&P Mid Cap 400 ([IJH](#)) fund over the past six years and shows that the fund receives above average return grades relative to an obviously erroneous benchmark of total



domestic equities. (Fundgrades permits the user to select any of 31 benchmarks against which to grade any fund.) Three years ago, the fund received a B for return and a C relative risk (see the row Prior 3 Years in Exhibit 1), implying relative performance alpha. If we ignored the fact the fund is not diversified and looked only at performance, one could erroneously conclude that the fund is successful and falsely label this mid cap index fund as a “total market active winner.” In fact, any active fund that merely bought this mid cap index fund would receive the same grades.

Exhibit 1 - Comparison of IJH against a Total Market Domestic Equity Benchmark

		Portfolio Grades					
		Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
IJH	Last 3 Years	C-	D+	A+	F	C+	C-
	Prior 3 Years	B-	D+	A+	C	B	C+
	Last 6 Years	C+	D+	A+	D+	B-	C

However, the diversification grade exposes the inaccuracy of the label “total market active winner.” Over all three time periods, the fund received a D+ for diversification, illustrating this is a poor benchmark for grading this fund. Of course, being a mid cap index fund, you would already know this, but what about the funds you might choose that are not so obviously misclassified?

Let’s contrast investing solely in this mid-cap fund to what, from a labeling perspective, would be an apparently more diversified portfolio of large-cap and small-cap funds, in order to achieve the desired allocation of the total domestic equity market. In Exhibit 2, we select four funds that Morningstar has rated “four stars.” Market cap is weighed at 70% large versus 30% small, so there is a slight bias toward small-cap (relative to a broad-market index), but not enough to materially alter results and styles are equally weighted eliminating any style bias.



Exhibit 2 - Portfolio weights for the “more diversified” portfolio of four star funds based on Morningstar’s asset class labels and the combined portfolio grades as weighted relative to the target allocation of Total Domestic Equities:

Ticker	Description	Selected Asset Class	Weight
MALHX	BlackRock Large Cap Growth Inst	Large Cap Growth	35%
DFUVX	DFA U.S. Large Cap Value III	Large Cap Value	35%
FVFRX	Franklin Small Cap Value R	Small Cap Value	15%
NBMVX	Neuberger Berman SmallCap Gr Adv	Small Cap Growth	15%

Note: DP refers to the “diverse portfolio” as weighted with these specific funds

Diverse Portfolio		Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
DP Relative to domestic equities	Last 3 Years	C-	C	B-	F	C	C+
	Prior 3 Years	C-	D	B-	D+	C	C+
	Last 6 Years	C-	D+	B-	D-	C	C+



We would expect the diverse portfolio to be less risky and more diversified than the mid cap index fund in Exhibit 1 when compared to our total domestic market benchmark. Yet, for the last three, prior three and six year periods, we see the relative risk of this seemingly “more diversified” portfolio being the same or higher than the mid cap index fund relative to the targeted total domestic equity benchmark. (Mind you, we were attempting to assemble a more diversified portfolio of funds that includes all market caps and styles in similar proportion to the domestic equity market.) To make matters even worse, the additional risk this combination of funds produces has a lower return grade in ALL time periods relative to the mid cap index fund. More risk and less return; was that what we were attempting to accomplish by diversifying?

The diversification grades in Exhibit 2 for our supposedly consciously diversified portfolio (based on labels) exposes that the portfolio as combined is not materially more diversified than a portfolio comprised of a just mid cap index fund (Exhibit 1). Diversification grades for both our supposedly diversified portfolio and the mid cap index fund range from D to C relative to the allocation target of total domestic equities. Over the last six years, both the diversified portfolio and mid cap index fund graded D+ for diversification, meaning both are equally bad fits for a target of total domestic equities.

So, neither the “diverse” portfolio as constructed nor the mid-cap index fund behave like the diversified domestic equity portfolio that we hoped to create. Although the mid-cap fund had higher return grades, we know that this fund is not good choice for our allocation target because it is not diversified and is making a big bet against our allocation target. But, the diverse portfolio is also not a good choice because it is not really materially more diversified than the mid-cap fund. Why is this the case? The components of the diverse portfolio do not have high correlations to their respective labels and in fact behave more similarly to their mid cap counter parts.

In Exhibit 3, we see how fundgrades.com grades the funds in the diverse portfolio relative to their Morningstar labels. All of these funds receive below average grades in diversification. In fact, three of the four funds have a diversification grade that is either the same or worse than that of the mid-cap index fund, relative to total domestic equities. Thus, although combining these funds based on their label might appear to build a diverse portfolio, they are not behaving like their labels and the portfolio will be no more diversified.



Exhibit 3 - Individual fund grades relative to their “label”

Note: The following grades are based on the last three years of data

Ticker	Description	Asset Class	Fund Grades					
			Overall	Diversity	Expense	Relative Risk	Return	Risk of Material Underperformance
MALHX	BlackRock Large Cap Growth Inst	Large Cap Growth	D+	D	C+	F	C+	C+
DFUVX	DFA U.S. Large Cap Value III	Large Cap Value	C-	D	A+	F	C	C+
FVFRX	Franklin Small Cap Value R	Small Cap Value	C	C-	C-	B-	C	C
NBMV X	Neuberger Berman SmallCap Gr Adv	Small Cap Growth	C	D+	C	C	B-	B

Instead, these funds have actually behave more like their mid-cap style counterparts. Exhibit 4 grades each of these funds relative to their mid-cap style benchmarks, and each fund receives the same or better diversification grades than their Morningstar asset class labels, varying between C- and D+.



Exhibit 4 - Individual fund grades relative to mid-cap benchmarks:
 Note: The following grades are based on the last three years of data

Ticker	Description	Asset Class	Fund Grades					
			Overall	Diversity	Expense	Relative Risk	Return	Risk of Material Underperformance
MALHX	BlackRock Large Cap Growth Inst	Mid Cap Growth	D+	C-	B-	D+	D+	D+
DFUVX	DFA U.S. Large Cap Value III	Mid Cap Value	C+	D+	A+	B	C	C-
FVFRX	Franklin Small Cap Value R	Mid Cap Value	D	C-	C-	D-	C-	D+
NBMVX	Neuberger Berman SmallCap Gr Adv	Mid Cap Growth	D+	C-	C-	F	C+	C+



Ultimately, the data shows that the labeling of a fund is not an accurate guide to its diversification value in an overall portfolio allocation strategy. If we use these categories to predict behavior, we are at risk of being fooled by faulty labels. For example, returning to Exhibit 4, which grades the funds in the diverse portfolio relative to their best fitting mid-cap counterparts, the data shows that these funds combine to behave like an entirely mid-cap portfolio. Thus, these funds are not behaving like their labels.

If we do not examine diversification relative to the allocation we are attempting to implement for clients and instead choose funds based merely on their label, we run the risk of being fooled. Fundgrades allows you to examine whether funds behave like their labels, and allows you to examine funds in combination to avoid misleading your clients and giving a false appearance of diversification. To avoid constructing portfolios that do not match the targeted asset allocation for a client, we must look beyond labels and to see how funds behave relative to their labeled asset class, and how they behave in combination. After all, as the Nobel Prize winning physicist Richard Feynman states, “For a successful technology, reality must take precedence over public relations, for Nature cannot be fooled.”

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