

# Why We Think It's So Easy to Find a Top Performing Mutual Fund

By Allan Roth | Oct 23, 2009 | 2 Comments

On any given day, you can open a newspaper or surf financial web sites, and you'll see an advertisement for a top performing mutual fund. You can be sure it will have a disclosure stating that past performance is not indicative of future performance, just as you can be sure that we will ignore the disclosure. After all, it sports a **Morningstar** four or five star rating out of its five star maximum, so wouldn't it be the rational thing to rush out and buy it? Actually, not so much.

To begin with, Morningstar assures me that there are as many one star mutual funds out there to buy as those with five stars. There are also an equal number of two star funds as four star funds. Yet have you ever seen an advertisement for a one star fund? I'm guessing not. Furthermore, Morningstar itself advises that picking five star funds is not a good way to build a portfolio.

Let's just say I decide to start my own expensive mutual fund family with high expenses. Because I'm backed by Wall Street, I come out with 100 different equity funds. My high fees translate to an average Morningstar rating of 2.0. But with so many funds, the law of large numbers gives me a few outliers including one fund, say the Allan Roth Gold Leveraged Fund, that got very lucky and earned the five star rating.

Well guess which fund I advertise? My five star fund, of course. Naturally, I attract quite a bit of investor money just in time for this fund to crash and burn.

## My advice

What you are seeing advertised is anything but a representative sample of a mutual fund family's performance. Morningstar lists overall family performance and I'd put the family's rating before that of the individual fund rating. Look at the cost of the fund and make sure the expense ratio is well under 0.5 percent annually. I rarely invest in anything over 0.3 percent annually. Any fund with a letter in front of it indicates that it comes with a hefty sales load on top of the fee. My advice is to avoid those like the Emergency Room in flu season.

So the next time you see an ad for the hot performer, keep in mind the fund that you won't see advertised. If you were, it might look something like this.

Note: Graphic from "How a Second Grader Beats Wall Street"

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## Allan Roth

Allan S. Roth is the founder of Wealth Logic, an hourly based financial planning and investment advisory firm that advises clients with portfolios ranging from \$10,000 to \$50 million. He is mocked on a semi-regular basis by some financial professionals for his hourly fee model and its obvious inability to make him rich.

Roth is also the author of *How A Second Grader Beats Wall Street*. He teaches behavioral finance at the University of Denver and is an adjunct faculty member at Colorado College.

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**Allan Roth**

Allan Roth has a lot of credentials (CFP, CPA, MBA) and business experience (McKinsey consulting and officers of mega-billion dollar companies). But he insists that said credentials and business experience do not interfere with his ability to keep investing simple.

Roth has worked with many a lawyer over the years, so he feels compelled to note that his columns are not meant as specific investment advice, especially since any such advice would need to take into account such things as each reader's willingness and need to take risk, which can vary significantly. His columns will specifically avoid such foolishness as predicting the next "hot stock" or what the stock market will do next month. Roth's goal is never to be confused with Jim Cramer.

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