Understanding fund management styles

Your fund's management style can make a big difference to your portfolio

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You invest in equity mutual funds. Good. You've taken an important step toward financial independence. But let me ask you a question: do you know how your fund managers are investing your money?

It's an important question, one that has important implications for your long-term financial success. There are many ways you can invest in the stock market. Most mutual fund managers are noted for a particular investment style—a method or approach they use to help them determine which securities they should buy or sell. Understanding the basic principles behind these investment styles is a key part of becoming a well-informed, successful investor.

Let's take a closer look at the most common investment styles: value and growth. By understanding the differences between the two, you can build a better portfolio.

Value investing

Value investors focus on finding investment bargains—that is, solid investments that are currently selling for a good price. Funds that use this approach are generally considered more conservative investments (because there is less potential for an investment to go down if it's already selling low). Fund managers who follow a value style typically research potential investments extensively, studying a company's balance sheet and comparing it to the current price. If the underlying fundamentals and future prospects are solid but the trading price is low, the share is probably undervalued. Over time, the trading price is likely to rise, reflecting the company's true market value. Most value investors are prepared to hold their investments for 2 to 5 years as their investments gradually come back into favour. As a result, funds that favour this approach also tend to be lower risk than funds which buy on short-term market trends.

Growth Investing

Growth investors focus their investment effort on companies that have the potential for strong earnings growth. Typically, "growth" equities trade high above their "book" value (the exact opposite of what "value" investors look for), reflecting the expectation that these companies will earn more in the future. In theory, most any company can be a growth company, but in practice, growth funds tend to focus on small and mid-size companies—these are the companies that have more room to expand rapidly. Some, though not all, growth funds can be more volatile than value funds. But when it comes to growth investing, higher risk is tempered by the opportunity for greater returns.

So which style is better for you? That depends. Value funds bought in the 1980s and held throughout that decade outperformed growth funds during that time. In the 1990s, the reverse was true. Today, the trend seems to have shifted back to value—although only time will tell.

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(continued from page 1)

Your own goals and investment preferences will most likely lead you to favour one strategy more than another. But that doesn't mean you should restrict yourself to a single approach. I have always believed that a good balance of value and growth investments is essential to every investment portfolio. Holding complementary styles within your portfolio will help you reduce volatility and maximize returns in a variety of market conditions. And isn't that the whole point of investing?

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