AMERICAN FUNDS®
From Capital Group

Two Simple Steps Can Enhance Portfolios

"[F]irms with the highest levels of manager tenure, manager retention, and ownership of mutual fund shares also have delivered better outcomes for investors. The same is true of firms that offer funds with lower expense ratios."

2014 Morningstar U.S. Mutual Fund Industry Stewardship Survey

The erroneous belief that active managers can't beat their indexes has been a key driver behind a move into passive investments such as index funds and ETFs. While it's true that data shows that active managers, on average, have beaten their benchmarks less than half the time, that's only part of the story. Some active managers have done considerably better than average.

Morningstar and other objective sources have demonstrated that select active managers have generated higher returns than market indexes over time, with reduced volatility.

Investors can enhance their portfolios by focusing on active managers of funds that share certain qualities. Among these are low expenses, low portfolio turnover and relatively high manager tenure. We conducted an in-depth study that showed two criteria that should be included within a thorough due diligence process. Look for funds with relatively low expense ratios and investment firms whose managers invest more of their own money into the funds they manage.

Key characteristics to consider

- Expense ratio
- Turnover
- Manager tenure
- Manager ownership
- Incentive structure

Two important screening criteria

Expense ratio
Funds with lower expense ratios have tended to outpace benchmarks over time.

Manager ownership
Investment firms whose managers invest more of their own money in their funds have tended to outpace benchmarks over the long term.

Multiple Perspectives. One Approach.®

Two steps dramatically narrow the field

As part of our research, we looked at the broad universe of actively managed, large-cap equity funds in the Morningstar database and identified funds that ranked within the least expensive quartile and those funds whose firms ranked in the highest quartile of management ownership.

Funds that possess both traits are rare. Of a total universe of over 3,000 U.S. and international actively managed large-cap equity funds, we found that only 105 – less than 3.5% – had both low expenses and high manager ownership.

Large-cap actively managed equity funds with low expense ratios and high manager ownership

Source: Capital Group, based on Morningstar data. Domestic funds are those in the Morningstar Large Value, Large Blend and Large Growth categories. International funds are those in the Morningstar Foreign Large Value, Foreign Large Blend and Foreign Large Growth categories. Size of quartiles varies because those funds in the Morningstar database that did not include an expense ratio or firm-level investment ownership were excluded from the analysis. All the American Funds in these categories made it through the screen. Included are seven U.S.-focused American Funds: AMCAP Fund®, The Growth Fund of America®, The New Economy Fund®, American Mutual Fund®, Fundamental Investors®, The Investment Company of America®, Washington Mutual Investors Fund℠; and two international-focused American Funds: EuroPacific Growth Fund® and International Growth and Income Fund®.

	Total fund universe	Lowest cost quartile	Highest manager ownership quartile	Both low cost and high ownership
U.S. equity	2,466 funds	509	447	85
International equity	571 funds	122	109	20

How to use these two screening criteria on Morningstar

Subscribers can use Morningstar Direct software to screen for expenses and track manager ownership as a percentage of assets at the firm level.

On Morningstar Direct*:

- Create a new open-end fund advanced search
- Choose a broad large-cap domestic fund universe
  - Select U.S.
  - Then select Large Value, Large Blend and Large Growth.
  - To avoid duplication, screen for the oldest share class available.
- **To screen for low expense ratio:**
  - With the universe selected, the snapshot page will show a set of default screens, including "Annual Report Net Expense Ratio." You can sort by this column for lowest to highest expense ratios by double clicking the column name.
- **To screen for manager ownership:**
  - You must manually add a field for manager ownership.
  - Under Available Data Points, select "Firm % Assets Manager Investment Over $1 million." This selection will allow you to sort the chosen fund universe for high manager ownership levels.

Our research shows the threshold for top-quartile ownership is firms with approximately 55% or more of assets in the million-plus category. Morningstar considers firms with more than 80% of assets above $1 million to have a high ownership score. Either threshold should help you identify firms with high client alignment.

*Expense ratio information is freely available on Morningstar. However, screening for manager ownership requires one of Morningstar's subscription services. If you prefer not to subscribe to a paid service, you can find manager ownership through a fund's Statement of Additional Information (SAI). Checking fund SAIs is an effective way to verify whether the managers in your current portfolios have high levels of manager ownership.

Screening for expenses and manager ownership led to much better results

How have actively managed funds with low expenses and high manager ownership compared with the unmanaged index and the broader universe of equity funds?

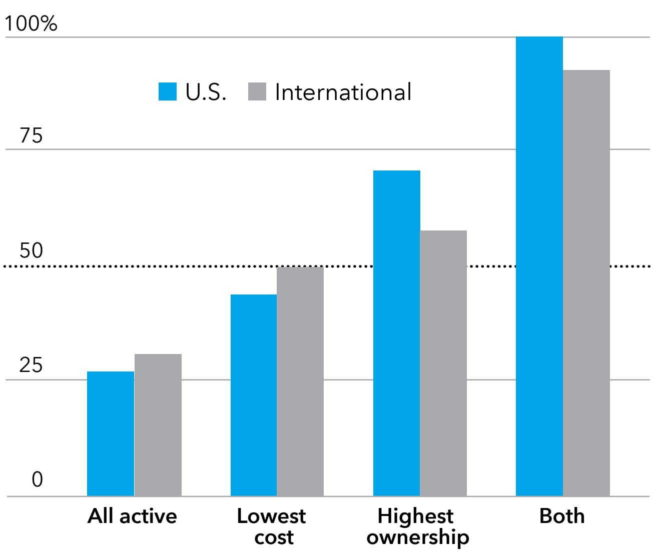
To find out, we compared average annualized returns for rolling 10- and 5-year periods for various categories of active strategies versus broad market indexes. As you can see below, the group of active equity funds with lower expenses and the group with high manager ownership had higher success rates than the broad universe of active funds. By success rate, we mean the percentage of rolling periods in which the category of active funds outpaced its respective index.

More importantly, the small group of active funds that met both criteria – those with lower expense ratios and high manager ownership – had notably higher success rates over the 20 years ended December 31, 2013. This pattern was similar for both monthly 10- and 5-year rolling periods.

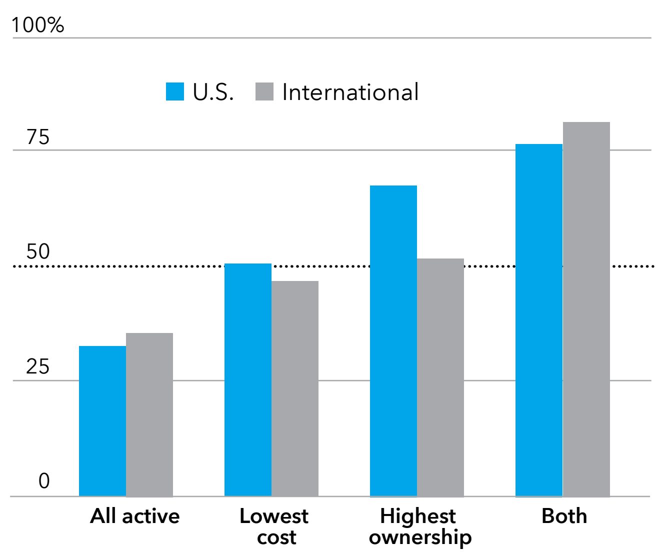
It is important to remember that past results are not predictive of returns in future periods, yet the historical record shows that low-cost, high-ownership active strategies have generally outpaced relevant indexes.

Two steps raised the success rate
Active success rates in large-cap equities (net of fees)

Percent of monthly 10-year rolling periods in which the category of funds collectively outpaced indexes



Percent of monthly 5-year rolling periods in which the category of funds collectively outpaced indexes



Source: Capital Group, based on Morningstar data. Based on rolling monthly periods from January 1994 to December 2013. U.S. funds are those in the Morningstar Large Value, Large Blend and Large Growth categories. U.S. index is S&P 500. International funds are those in the Morningstar Foreign Large Value, Foreign Large Blend and Foreign Large Growth categories. International index is MSCI ACWI ex USA. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

Methodology

Compiling the fund universe

The database built to represent the universe of both large-cap domestic and large-cap foreign funds drew from Morningstar's U.S. Open-End Large Value, Large Blend and Large Growth U.S. and Foreign categories, with live and dead funds combined to eliminate survivorship bias. For live funds, only the oldest share class was used. For dead funds with multiple share classes, the median monthly returns were used. For fee-related illustrations that include dead funds with multiple share classes, the median expense ratios were used. This screening resulted in seven qualifying domestic American Funds (AMCAP Fund, The Growth Fund of America, The New Economy Fund, American Mutual Fund, Fundamental Investors, The Investment Company of America and Washington Mutual Investors Fund) and two qualifying foreign American Funds (EuroPacific Growth Fund and International Growth and Income Fund). Funds are identified as domestic or foreign based on Morningstar categories. A number of the U.S.-focused American Funds can invest some assets in non-U.S. securities; likewise, the two foreign-focused American Funds can invest some assets in U.S.- issued securities.

Tracking least expensive quartile/highest manager ownership

In conducting our research, we searched Morningstar's database for large-cap actively managed funds that were in both the lowest quartile ranked by expense ratio and the highest quartile ranked by manager ownership at the firm level. For this analysis we relied on Morningstar Direct data analysis software.

Least expensive quartile was calculated using annual report Net Expense Ratio (NER) for all observed Morningstar categories for the 20-year period indicated. For funds with missing expense ratios, gaps between two available data points were filled in using linear interpolation. Linear interpolation is a statistical method used to estimate the values between two known data points in a time series. Highest manager ownership quartile was calculated using weighted averages of Morningstar screens of manager holdings at the firm level. Each fund was assigned the weighted average of its firm manager holding. Funds without values were excluded from the quartile rankings. The combination of least expensive NER and highest manager ownership quartiles (the screened active core) was the result of a cross-section of the two screens. Only those funds with both the lowest expense ratios and the highest manager ownership were included.

Investors who wish to identify funds that ranked in the least expensive quartile by NER can rely on the following rule of thumb: The least expensive quartile of funds ranked by net expense ratio roughly corresponded with those reporting expenses below 0.99% for large-cap domestic funds and below 1.10% for large-cap foreign funds. Expense ratios for institutional and advisory share classes would be approximately 25 basis points lower, or below 0.74% for large-cap domestic funds and below 0.85% for large-cap foreign funds. Investors who wish to identify funds that ranked in the top quartile by manager ownership can rely on the following rule of thumb: The top quartile of funds ranked by manager ownership roughly corresponded with firms that had 55% or more assets in the fund family complex in which at least one fund manager had invested a minimum of $1 million.

The Securities and Exchange Commission requires that mutual funds disclose all fees and expenses in a standardized table published in the front portion of the fund prospectus. The SEC also requires that a fund disclose in its statements of additional information (SAI) certain information about its portfolio managers, including ownership of securities in the fund. Ownership disclosure is made using the following seven ranges: none; $1 to $10,000; $10,001 to $50,000; $50,001 to $100,000; $100,001 to $500,000; $500,001 to $1,000,000; and over $1,000,000.

Investment Disclosure

Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility, as more fully described in the prospectus. These risks may be heightened in connection with investments in developing countries. The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings. Investments in mortgage-related securities involve additional risks, such as prepayment risk, as more fully described in the prospectus. Higher yielding, higher risk bonds can fluctuate in price more than investment-grade bonds, so investors should maintain a long-term perspective.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

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