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BOOK REVIEW

Mark Kritzman, Senior Editor

MUTUAL FUND SELECTION: *FROM THEORY TO PRACTICE*

Moshe Levy and Richard Roll
(*Reviewed by Ming Xian*)

With the rapid growth of the mutual fund industry, mutual funds now outnumber individual stocks in the U.S.. Selecting the right fund has hence become a critical economic decision, not only for individual investors but also for the broader economy. In the book *Mutual Fund Selection: From Theory to Practice*, Moshe Levy and Richard Roll offer a comprehensive examination of methodologies for selecting mutual funds, aimed at both institutional and individual investors. The authors break down the mutual fund selection problem into two parts: which performance measure one should aim to maximize, and what is the best way to rank funds. The goal of the book is to demystify the complexities of the mutual fund industry and empower investors with enhanced financial literacy.

To decide which criteria to use for mutual fund selection, the authors delve into various performance metrics such as Sharpe Ratio, Alpha, and Geometric Mean, and they evaluate the effectiveness of each measure in the fund selection process. Assuming the return characteristics of funds are known, the authors suggest that the monthly Sharpe ratio is the single most important measure among all for fund selection, regardless of the investor's investment horizon. In addition, the authors argue that while the ratings of Morningstar and Lipper provide a benchmark, they often fail to account for individual investor preferences and risk tolerance, nor do they take into consideration combinations of the funds with the risk-free asset. Another key idea is to focus on long-term growth potential instead of just immediate return. They introduce the concept of stochastic dominance to compare different investment options, providing a more nuanced understanding of risk and return.

To enhance the predictability of mutual fund performance, the authors introduce an innovative approach through a refined metric called "the Shrinkage-Adjusted Sharpe Ratio (SAS)," offering empirical evidence to support its effectiveness. This method refines traditional models by adjusting for estimation errors and fees, which provides a more reliable basis for comparing the future performance potential of different mutual funds.

In terms of investment strategies, the authors debate the merits of active versus passive

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investments, aiming to promote a balanced understanding of both approaches. No strategy guarantees consistent performance; instead, it is more important is to align strategy selection with personal risk tolerance and market conditions. Though active funds remain popular, Levy and Roll remind investors of the risk that 92% of active funds underperform and may do miserably. They also discuss the economic rationales behind the persistent popularity of active funds despite their higher costs and mixed performance records. Investors can leverage SAS or other sophisticated methods to identify funds with the potential to outperform in the future.

When it comes to asset allocation, a popular practice is to invest in target date funds (TDF), which automatically adjust their asset allocation mix according to a specified timeline leading up to the investor's retirement date. Unlike traditional linear glide paths that uniformly reduce risk over time, the authors propose the concept of exponential guide paths to optimize asset allocation over time, as it adjusts asset allocation in a manner that is more sensitive to changes in market conditions and the investor's financial status. They assert that through more sophisticated, tailored glide paths and a deeper engagement with investor education, TDFs can become more effective tools for retirement planning.

While effort and skill are crucial for investment success, the role of luck is often underestimated. In the final section, Levy and Roll provide a sobering reminder that even the most sophisticated strategies cannot fully eliminate the influence of luck, and they recommend strategies to mitigate the effects of luck on investment decisions, such as longer evaluation periods for fund performance and using statistical methods that differentiate luck from skill more clearly. Fund managers should form a realistic view on luck and skill, which ideally can prevent them from overconfidence and excess trading, therefore leading to better overall performance.

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