

Inside Morningstar's 'Best Buy' Funds

Fund Spy | 01-19-07
by Christine Benz

How you can put Analyst Picks to work in your portfolio.

Whether you're buying a bottle of wine or a luxury car, consumer rating services—with their "best buys" and recommended lists—can make easy work of winnowing down your choices. In that same spirit, Morningstar.com offers Fund Analyst Picks. The goal behind our Analyst Picks is to take the universe of funds—at more than 6,000 at last count—and narrow it down to a more manageable group of 175 or so offerings that rank among the elite.

Here are some of the basics about our selection criteria, as well as guidance on how to use Analyst Picks when assembling your portfolio.

How We Select Them

To arrive at our Analyst Picks, we don't simply cull the funds with the best five- or 10-year records. You could easily do that yourself. Besides, the goal behind Analyst Picks isn't to tell our readers about yesterday's winners but rather to uncover funds with superior future prospects. Thus, while great long-term performance is one of the factors we consider when adding a fund to our picks list, we also look for each of our picks to have other attributes that will be key to their future success: sensible strategies, successful management, good stewardship, and low costs.

The soundness of management's strategy is a key consideration when we're selecting Analyst Picks, simply because most of the best funds we know use consistent, repeatable, clearly articulated approaches to security selection. Morningstar readers might think we have a distinct preference for value strategies; after all, we've been longtime supporters of bargain-hunting firms like Longleaf, Oakmark, and Davis/Selected. But our Analyst Picks list also includes its fair share of disciplined, well-executed growth strategies from firms like Turner, Wasatch, and Friess Associates (Brandywine funds).

In the same vein, we also favor funds whose management teams won't waver from their strategies in times of trouble. That goes hand in hand with experience. Simply put, the most seasoned and successful investment managers aren't prone to get caught up in fads or

MainStay ICAP Select Equity ICSLX

Kudos

The fund has trounced its typical large-value peer over its lifetime.

Manager Rob Lyon has built an impressive long-term record running sibling ICAP Equity.

Expenses are lower than the large-cap median.

ICAP employees own sizable stakes in the firm's offerings.

Risks

The fund is concentrated in its top holdings and favorite sectors, making it rife with stock-specific and sector risk.

The fund has been tax-efficient so far, but that could change given its fast-trading style.

Strategy

The fund's managers begin with a universe of 400 large-cap stocks and 50 mostly European ADRs. They then buy around 30 stocks with the best mix of attractive valuations, consistent or improving earnings, and catalysts for growth over the next 12 to 18 months. Catalysts can include a product launch, a management change, or a change in the macroeconomic environment. The fund's sector weightings have shifted quite dramatically at times. Management will sell a stock if it reaches a predetermined price target.

Management

Team leader Rob Lyon, who is ICAP's president and chief investment officer, has run the fund since its inception. Prior to joining ICAP in 1988, Lyon served as director of research at Fred Alger Management. Jerrold Senser, Gary Maurer, Tom Wenzel, and others on the ICAP team are all very experienced. They draw on research produced by several sector-specific analysts. ICAP has a big presence in institutional money management.

Inside Scoop

This distinctive, relative-value offering—a more concentrated version of ICAP Equity—is now part of the MainStay fund family. The managers search for undervalued companies and don't sit on their hands when a pick goes sour.

Role in Portfolio

Core

Morningstar Fund Analyst Picks

Name	Stewardship Grade	Style Box	Total % Return			Expense Ratio	Role in Portfolio
			1 Yr	3 Yr	5 Yr		
Domestic							
Large Value							
Amer Funds WashingtonA	B	■ ■ ■ ■ ■	18.04	10.34	7.56	0.57	Core
Dodge & Cox Stock *	A	■ ■ ■ ■ ■	18.53	15.6	12.84	0.52	Core
MainStay ICAP Sel Eq I	A	■ ■ ■ ■ ■	20.6	15.83	10.53	0.8	Core
Schneider Value	A	■ ■ ■ ■ ■	23.34	17.12	—	0.85	Supporting
Sound Shore	A	■ ■ ■ ■ ■	16.56	12.82	9.85	0.98	Core
T. Rowe Price Eq Inc	A	■ ■ ■ ■ ■	19.14	12.64	9.35	0.71	Core
Vanguard U.S. Value	B	■ ■ ■ ■ ■	14.1	11.33	8.78	0.39	Core
Weitz Value	A	■ ■ ■ ■ ■	21.85	11.1	7.91	1.12	Core
International							
Foreign Large Value							
Causeway Intl Value Inv *	A	■ ■ ■ ■ ■	25.74	19.66	17.24	1.15	Core
Dodge & Cox Intl Stock	A	■ ■ ■ ■ ■	28.01	25.56	20.78	0.7	Core
Harbor Intl Instl	B	■ ■ ■ ■ ■	32.69	23.67	20.07	0.85	Core
MainStay ICAP Intl I	A	■ ■ ■ ■ ■	24.3	23.4	16.82	0.8	Core

Data as of 12-31-06 * This fund is closed to new investors.

Inside Morningstar's 'Best Buy' Funds

Fund Spy

by Christine Benz

short-term trends. They are also likely to demand more from their analysts, deepening the quality of the bench at their firms.

Although investment prowess is a central criterion in our picks process, our evaluation of a fund and its management doesn't end there. We're also looking at whether the fund company, its management team, and the fund board are acting in the interests of shareholders. We like to see managers who are compensated based on long-term performance and who invest in the funds they manage, boards that are engaged and communicating with fundholders, and shareholder reports and letters that are honest, thoughtful missives. Those are signs that management cares about its main constituency, the fund's shareholders. No fund with a Stewardship Grade below C can make our Analyst Picks list.

Reasonable costs are another component of shareholder-friendliness, and our research has shown that expenses have greater predictive value than any other data point in the fund universe. True, there will always be a handful of costly funds with great performance, but they're less likely to enjoy continued success than those with lower expenses. Thus, a fund can't make our Analyst Picks list if its expenses are substantially higher than the median for its category.

Although most of our Analyst Picks are accepting money from new shareholders, we've included a few funds that are closed to new investors. That means that we'd recommend adding to your holdings if you own one of these closed funds or are otherwise eligible to contribute to it. (Investors in 401(k) plans, for example, can often purchase additional shares of closed funds.)

For each category, we assign an analyst to serve as the Analyst Picks guru, meaning that he or she is responsible for knowing the funds in that group inside and out and for staying abreast of the best and brightest within that category. (That same analyst is also responsible for alerting Morningstar.com's Premium Members to any dogs within that group—so-called Analyst Pans.) To help vet the picks and pans lists, each analyst meets regularly with a committee composed of myself, associate director of fund analysis Scott Berry, director of fund research Russel Kinnel, and Haywood Kelly, Morningstar's chief of securities analysis.

Picks vs. Stars

As the preceding makes clear, our Analyst Picks selection process is largely qualitative and forward-looking in nature. The Morningstar Rating for funds, by contrast, is strictly quantitative—analysts can't add stars to funds they like or yank them from those they don't. Morningstar's fund star rating is designed to give investors a quick snapshot of how a mutual fund has balanced risk and return in the past. If you know you want a given type of fund, you can use the star rating to winnow that group down to a more manageable list of offerings that deserves further research. You can also use the star rating to help monitor your funds' performance. If your one-time 5-star fund is now sporting a single star, you should research what has driven the downturn.

Because the star rating captures only a fund's past risk/reward profile, you'll often see funds with high star ratings that aren't picks, while not all of our picks rate 4 or 5 stars. For example, Harbor International Growth (HAIGX), a 2-star fund, is one of our Analyst Picks within the foreign large-cap growth category. Yes, its past track record is poor, but we liked the fund's low costs and prospects under a relatively new manager. Conversely, not all funds with screaming gains will make our list, particularly if they charge too much or are taking outsized risks.

MainStay ICAP Int'l I ICEUX

Kudos

This fund's record as a Europe-stock fund was strong.

Sound lineage on the domestic side.

Below median expenses.

Recently broadened mandate makes the fund easier to fit into a portfolio.

Risks

Concentrated portfolio courts issue-specific risk.

High turnover could lead to tax inefficiency, although that hasn't been a problem in recent years.

ICAP is less proven in the Japanese market than it is in Europe.

Strategy

Like its siblings, this fund homes in on undervalued stocks with catalysts for growth. Management favors a concentrated portfolio of large developed-market multinationals, but it is not guided by the popular MSCI EAFE Index. The firm uses top-down analysis, in addition to company-level research. The fund also sports a high turnover rate, which comes less from churning stocks than from trading around positions in an attempt to add value. ICAP does not hedge its foreign-currency exposure.

Management

Rob Lyon and Jerry Senser won Morningstar's International Fund Manager of the Year award in 2005. Lyon has been the lead manager here since the fund's 1997 inception. Senser was named comanager in 2003 and along with Lyon comanages the domestic ICAP Equity and Fund Analyst Pick ICAP Select Equity.

Inside Scoop

This distinctive international fund, run in a relative-value investment style, became part of the MainStay fund family in August 2006. Its managers build concentrated portfolios of mostly large-cap developed-market companies. The fund was once a Europe-only portfolio but became a broad foreign offering in 2005.

Role in Portfolio

Core

Inside Morningstar's 'Best Buy' Funds

Fund Spy

by Christine Benz

How to Use Them

If you're looking at our Analyst Picks list for ideas, you can rest assured we've put all of the funds through their paces and believe that they have a strong shot at outperforming their rivals. (Our Analyst Picks criteria are so stringent that if we can't find any worthy funds within a given category, we'll go without; that's currently the case with the Japan-stock category, for example.) Our Analyst Picks list is also an ideal way to surface off-the-beaten path funds whose strong future prospects aren't reflected in their past records. For example, we made Wasatch Heritage Growth (WAHGX) an Analyst Pick shortly after it launched. Although the fund was brand-new and its managers unproven, we're impressed by the research effort that infuses all Wasatch funds. We also appreciate the firm's shareholder-friendliness, as evidenced by its timely closing of other Wasatch funds.

As much as we stand behind our picks and our processes for choosing them, it's a mistake to view the Analyst Picks as a "must-own" list. While all of the funds on the list are tops within their categories, you may simply not need a fund within a given group. Also, think twice before supplanting a fund you own with one on our Analyst Picks list. It may well make sense to, but you should take tax and transaction costs into account before swapping out of a perfectly serviceable fund. By the same token, you shouldn't overreact if and when we take one of your holdings off our Analyst Picks list. For example, in 2005 we removed American Funds Growth Fund of America (AGTHX) from our large-cap growth Analyst Picks list because we were concerned about the fund's unchecked asset growth. Although we no longer believe the fund to be in the top tier of large-growth offerings, we'd definitely recommend that current shareholders hang on to it.

Similarly, not all categories are suitable for everyone, and we aren't recommending that investors own one fund from each category. Rather, we're offering up choices in a variety of categories and leaving the decision of what may be suitable to investors themselves. In fact, outside of real estate funds, most of us here would agree, for instance, that few investors need to own a sector fund.

This article originally appeared on Dec. 21, 2006.

Christine Benz is Morningstar's director of mutual fund analysis. She is also the author of the second edition of the Morningstar Guide to Mutual Funds: 5-Star Strategies for Success. Although she reads every e-mail she receives, she cannot respond to each message individually or provide individualized portfolio advice. Christine Benz does not own shares in any of the securities mentioned above.

Average Annual Total Returns as of 12/31/06 (with Maximum Sales Charges)

MainStay ICAP Select Equity Fund	1 year	5 years	10 years	Since Inception	Symbols
Class A (max. 5.5% load)	13.66%	9.01%	—	10.26% (8/31/06)	ICSRX
Class C (max. 1% CDSC)	18.40	9.43	—	10.13 (8/31/06)	ICSVX
Class I (no-load)	20.60	10.53	—	11.23 (12/31/97)	ICSLX

MainStay ICAP International Fund	1 year	5 years	10 years	Since Inception	Symbols
Class A (max. 5.5% load)	17.19%	15.22%	—	11.71% (8/31/06)	ICEVX
Class C (max. 1% CDSC)	22.05	15.65	—	11.57 (8/31/06)	ICEWX
Class I (no-load)	24.30	16.82	—	12.69 (12/31/97)	ICEUX

Total Gross Annual Fund Operating Expenses for MainStay ICAP Select Equity Fund and MainStay ICAP International Fund are Class A: 1.26%, Class C: 2.01%, Class I: 0.87% and Class A: 1.32%, Class C: 2.07%, Class I: 0.93%, respectively.

For the MainStay ICAP International Fund only, a redemption fee of 2.00% of the current value of the shares redeemed may be imposed on redemptions of Class A, Class C, and Class I shares made within 30 days of purchase.

Performance data quoted represents past performance. Past performance is no guarantee of future results. Due to market volatility, current performance may be less or higher than the figures shown. Investment return and principal value will fluctuate so that upon redemption, shares may be worth more or less than their original cost. Performance figures reflect certain fee waivers and/or expense limitations, without which total returns may have been lower. The fee waivers and/or expense limitations are voluntary and may be discontinued at any time. For current to the most recent month-end performance information, please visit www.mainstayfunds.com.

Average annual total returns include the change in share price and reinvestment of capital gains and distributions. On 8/31/06, ICAP Select Equity and ICAP International Fund were reorganized as MainStay ICAP Select Equity and MainStay ICAP International Fund Class I shares. Performance for MainStay ICAP Select Equity and MainStay ICAP International Funds include the historical performance of the ICAP Select Equity and ICAP International Funds (no-load shares) from inception (12/31/97) through 8/30/06 adjusted to reflect the applicable sales charge and fees and expenses for such shares.

Performance for Class A and C shares, first offered 8/31/06, include the performance of Class I shares adjusted to reflect the sales charge (or CDSC) and fees and expenses of such shares. Prior to the reorganization, ICAP Select Equity and ICAP International Funds had no sales charge and their total net expenses were capped at 0.80%. The total expenses of MainStay ICAP Select Equity and MainStay ICAP International Funds are currently capped at 0.80%. Fund performance for all share classes prior to 8/31/06 has not been adjusted to reflect the current expense cap; had it been, the performance shown would have been lower. Class I shares are generally available only to corporate and institutional investors.

Before You Invest

Foreign securities can be subject to greater risks than U.S. investments, including currency fluctuations, less liquid trading markets, greater price volatility, political and economic instability, less publicly available information, and changes in tax or currency laws or monetary policy. These risks are likely to be greater for emerging markets than in developed markets. The Funds may invest in derivatives, which may increase the volatility of the Funds' net asset value and may result in a loss to the Funds. The Funds may experience a portfolio turnover rate of over 100% and may generate short-term capital gains which are taxable. MainStay ICAP Select Equity Fund is non-diversified. By concentrating in a smaller number of investments, the Fund's risk is increased because each investment has a greater effect on the Fund's performance.

For more information about MainStay Funds, call 1-800-MAINSTAY (1-800-624-6782) for a prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses carefully before investing. The prospectus contains this and other information about the investment company. Please read the prospectus carefully before investing.

Mutual funds are not insured by the FDIC or any federal government agency, may lose value, and are not deposit of or guaranteed by any bank or bank affiliate. Past performance is no guarantee of future results.

Securities distributed by NYLIFE Distributors LLC, 169 Lackawanna Avenue, Parsippany, New Jersey 07054.