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5 More Under-the-Radar and Up-and-Coming Funds

Fund Spy | 02-09-17 | by Greg Carlson

A version of this article was originally published in the fourth-quarter 2016 edition of Morningstar Prospects, which highlights promising managers that Morningstar Manager Research analysts currently do not cover but may cover in the future. The full list and publication are available to subscribers of Morningstar Direct.

Morningstar Prospects--a list of up-and-coming or under-the-radar investment strategies that Morningstar Manager Research thinks might be worthy of full coverage someday--added 14 new strategies in the fourth quarter of 2016. Here's a look at five of them.

Run by a Veteran Muni Team

In August 2015, Baird Advisors welcomed Duane McAllister and two members of his municipal team to its roster of fixed-income investment personnel to run newly launched Baird Core Intermediate Municipal Bond (BMNSX). Prior to joining Baird, McAllister served as a managing director at BMO Global Asset Management, where he was the lead portfolio manager for a number of municipal strategies. An emphasis on bottom-up fundamental security analysis and vigilant risk management led to enviable performance during his July 2007 to mid-May 2015 tenure on BMO Intermediate Tax-Free (BITAX), which outperformed all muni-national intermediate Morningstar Category peers on both an absolute and risk-adjusted basis, as well as the fund's Bloomberg Barclays Municipal Bond Index. Erik Schleicher and Joseph Czechowicz, who started their careers with McAllister at BMO, accompanied him to Baird, where the team continues to follow its rigorous, security-selection-driven process.

Unlike many of the more narrowly focused Baird municipal offerings, this fund may employ greater flexibility by mandate, considering all sectors and the full gamut of credit-quality options. From the fund's inception in September 2015 through January 2017, McAllister and his team didn't miss a step; absolute returns for this fund outpaced its Bloomberg Barclays 1-15 Year Municipal Index by nearly 0.8 percentage points while landing in the top quintile of the category. Risk-adjusted returns during the same period were even more compelling.

A Wider-Ranging Mid-Growth Fund

Davenport Equity Opportunities (DEOPX) isn't a pure mid-growth offering; managers George Smith and Christopher Pearson aim to beat the Russell Midcap Index (a blend-oriented benchmark) and the S&P 500 by owning companies they believe can compound profit growth over the long haul. But they tend to find such firms in the mid-cap universe and the smaller end of large cap, and they typically prefer those that already have a track record of profit growth, so the fund lands in the mid-growth category. But the fund tends to be more valuation-sensitive than its typical peer and owns more large-cap stocks; its top holding was recently Capital One Financial (COF), which landed in large-value. In its six-year history, the fund has lagged its typical peer twice: in 2013's furious rally and in 2015, when some of its picks were hit by the decline in energy prices. All told, the fund surpassed more than 90% of its peers and the Russell Midcap and Russell Midcap Growth indexes on both a total-return and risk-adjusted basis from its December 2010 inception through January 2017, though it has slightly trailed the S&P 500 thus far. The managers are fairly experienced: Smith is a 16-year veteran of Davenport & Company, while Pearson joined the firm in 2008.

A Theme-Based Alts Strategy

Dreyfus Global Real Return (DRRIX) is subadvised by London-based Newton Investment Management (an affiliate of Dreyfus' parent BNY Mellon). The firm has a 30-year history of running global multiasset portfolios, and its management team has run versions of the global real-return strategy (with around $19 billion in total assets under management) on which this multialternative fund is based since 2004. The real-return portfolio management team is composed of eight people. The named managers for the U.S. fund are Suzanne Hutchins and Aron Pataki. Hutchins had worked for Newton for 14 years before leaving in 2005; she rejoined the firm in 2010. She has a general management role in the group and also chairs the real-return committee meetings. Pataki joined Newton in 2006 and focuses on risk management. Iain Stewart is the overall leader of the real-return group and is a named manager on U.K. versions of the strategy.

The strategy aims for a cash-plus-4% return during five-year periods, with volatility closer to that of bonds. The team uses a theme-based approach, with longer-term structural trends identified formally by Newton's global strategy group. The portfolio typically features around 15 themes; the list tends to evolve during three- to four-year periods. Recent themes include aging populations, China's influence, central bank interventions, and demand for healthcare, among others. These are translated into specific investment ideas by Newton's research analysts and the real-return team; the fund invests directly in securities in the long book rather than via a fund-of-funds structure but does not use direct shorting or leverage. Management divides the portfolio conceptually into two buckets: one return-seeking and one hedging or stabilizing. The return-seeking bucket consists of investments in traditional beta-oriented asset classes such as equities, corporate bonds, and convertibles. The stabilizing bucket is intended as more of a diversifier or hedge. Management has wide latitude to shift allocations and exposures based on its macro views, as well as its assessment of relative value between asset classes.

Institutional Expertise

In March 2012, Hartford Funds Management decided to shutter its internal fixed-income management effort and outsource those duties to subadvisor Wellington Management. As a result, intermediate-term bond fund Hartford Total Return Bond (HABYX) experienced a significant personnel upgrade when it was taken over by Wellington fixed-income veterans Campe Goodman and Joe Marvan. Wellington is an institutional investment management powerhouse. In fixed-income alone, the firm is responsible for nearly $500 billion in assets under management and boasts a deep team of fixed-income portfolio managers and analysts with expertise across sectors, as well as a robust risk-management infrastructure. Like some of its peer group's bolder entrants, the team has the flexibility to take risks outside of the fund's Bloomberg Barclays U.S. Aggregate Bond Index, including high-yield corporates, bank loans, emerging-markets debt, and currency plays. Wellington's impressive capabilities give the team the tools to succeed with a more wide-ranging approach. Of course, every basis point counts in the realm of fixed income, particularly in the low-yielding environment of recent years, which is why the below-average 0.45% expense ratio on the fund's institutional Y share class, where roughly half its assets reside, enhances its prospects. The case looks less clear-cut for investors who only have access to one of the fund's other share classes, most of which charge average or above-average fees.

Foreign Dividend-Payers on the Cheap

Vanguard International Dividend Appreciation ETF (VIGI) is the foreign cousin of Gold-rated Vanguard Dividend Appreciation ETF (VIG). Like its U.S.-focused relative, the fund boasts a low fee, a sensible process, and a solid parent. At 0.25%, its price tag is well below the median levy of 0.47% taken by its exchange-traded fund peers (defined as foreign-equity funds that have been tagged with Morningstar's "Dividend Screened/Weighted" strategic-beta attribute). This is also a fraction of the 1.04% median toll taken by members of the foreign large-growth category.

As is the case with its sibling, the fund's underlying index--the Nasdaq International Dividend Achievers Select Index--looks to home in on stocks that have a long history of paying and growing their dividends. The result is a portfolio of high-quality stocks. As of the end of December 2016, the stocks in this portfolio had an average return on invested capital of 15.9%, versus 12.4% for the average fund in its category. Additionally, 83% of the portfolio was invested in stocks that our analysts deem to have wide or narrow Morningstar Research Services Economic Moat Ratings, versus 77% for its average peer. Economic moats are evidence of a high-quality firm with sustainable competitive advantages.

Greg Carlson does not own shares in any of the securities mentioned above. Find out about Morningstar's editorial policies.