

Reintroducing American Funds

Morningstar Research | Alec Lucas

Capital Group recently made its entire American Funds open-end lineup available commission-free on Fidelity's and Schwab's brokerage platforms, providing greater access to one of the industry's flagship firms. Investors who have avoided the lineup may want to reconsider it. Indeed, the firm's competitive advantages run deep, especially in equities. Below is a select overview of the firm and lineup. It elucidates American Funds' key competitive advantages and areas for improvement.

Lineup Overview

American Funds' funds come in several series, such as a target-date retirement series and a college target-date series. At the core, though, is a 35-fund lineup composed of 14 equity funds, four allocation funds, and 17 bond funds. Their scope is global and covers most asset classes, with some overlap. It's not exhaustive, however. The firm doesn't have a fund in the foreign large-value Morningstar Category, for example, and smaller-cap strategies are lacking. Of the 27 funds in American Funds' core lineup that are assigned Morningstar Analyst Ratings, 22 are Morningstar Medalists, including all of its equity and allocation funds. Exhibit 1 lists the medalists by the tickers of their no-load F1 shares, newly available to retail investors at Fidelity and Schwab.

Multimanager System: Built for Scale, Diversity of Style, and Succession

The first thing that stands out about American Funds' retail lineup is its size. As of August 2016, the firm's 35 U.S. open-end mutual funds, excluding money markets and funds of funds, held nearly \$1.3 trillion in assets under management, which ranked second only to Vanguard's \$2.7 trillion. American Funds' equity and allocation funds are some of the industry's largest. Indeed, at the end of 2016's third quarter, they accounted for 10 of the 15 biggest actively managed U.S. open-end funds.

American Funds' mammoth equity funds are different from active peers of similar size led by a single manager or a team of managers. American Funds' multimanager system helps to handle its huge asset bases by blending the two approaches. It lets individuals invest in line with their convictions and according to their distinct styles while at the same time benefiting from collaboration, dialogue, and debate with their peers.

Unity in diversity is at the heart of the multimanager system. It divides each fund's portfolio into separately run sleeves. Managers oversee their own sleeves, and the analyst-run research portfolio collectively constitutes another sleeve. High portfolio turnover is frowned upon, but managers have freedom and need meet only a fund's general mandate, such as an income target, in running their sleeves. They also benefit from consulting with analysts who are fellow investors. Indeed, the clearest indication of investment recommendations are the particular stocks and weighting of those stocks in analysts' own sector-focused sleeves of the portfolio. At the end of the day, though, managers and analysts make their own buy, sell, and sizing decisions. The result is a collection of high-conviction portfolios run in a variety of styles. It is the role of each fund's principal investment officer, in consultation with a senior oversight board, to ensure that the styles complement one another in service of the fund's mandate. When done well, the combination of separately managed sleeves mutes volatility but doesn't limit strong investment results over a full market cycle.

The multimanager system helps train analysts to become portfolio managers. The opportunity to run sector-specific money facilitates analysts' transition into diversified portfolio management. That process is slow and deliberate. Analysts tapped to become portfolio managers start with small slivers of the portfolio. At this stage, the firm makes a habit of not publicly naming them in order to give them space over a multiyear period to hone their investment processes. If results are good and their style is complementary to the other managers', Capital Group may eventually name them as managers on the fund.

American Funds Core Medalists

Name	Ticker	Morningstar Analyst Rating	Morningstar Category	Annl Report Net Exp Ratio (%)	Tot Ret Annl 10-Yr (%), as of 11/30/2016
American Funds' Equity Medalists					
American Funds Washington Mutual	WSHFX	Gold	Large Value	0.66	6.43
American Funds American Mutual	AMFFX	Gold	Large Value	0.66	6.61
American Funds Fundamental Investors	AFIFX	Gold	Large Blend	0.67	7.11
American Funds AMCAP	AMPFX	Gold	Large Growth	0.73	7.49
American Funds New Economy	ANFFX	Gold	Large Growth	0.83	7.24
American Funds Cptl World Growth & Inc	CWGFEX	Gold	World Stock	0.81	4.48
American Funds New Perspective	NPFEX	Gold	World Stock	0.81	5.88
American Funds Int'l Growth and Inc	IGIFX	Gold	Frn Lg Blend	0.96	—
American Funds Europacific Growth	AEGFX	Gold	Frn Lg Growth	0.86	2.85
American Funds New World	NWFFX	Gold	Diversified Emg Mkts	1.02	3.38
American Funds Invt Comp of America	AICFX	Silver	Large Blend	0.67	6.29
American Funds Grth Fund of America	GFAFX	Bronze	Large Growth	0.71	6.87
American Funds SMALLCAP World	SCWFX	Bronze	World Stock	1.07	5.58
American Funds Devel Wrld Grth & Inc	DWGFEX	Bronze	Diversified Emg Mkts	1.26	—
American Funds' Allocation Medalists					
American Funds American Balanced	BALFX	Silver	Alloc—50 to 70% Eqty	0.65	6.46
American Funds Inc Fund of America	IFAFX	Silver	Alloc—70 to 85% Eqty	0.65	5.48
American Funds Global Balanced	GBLEX	Silver	World Allocation	0.91	—
American Funds Capital Income Builder	CIBFX	Silver	World Allocation	0.65	4.05
American Funds' Bond Medalists					
American Funds Ltd Term Tax-Exempt Bnd	LTXFX	Bronze	Muni National Short	0.67	2.90
American Funds Tax-Exempt Bond	AFTFX	Bronze	Muni National Interm	0.67	3.69
American High-Income Municipal Bond	ABHFX	Bronze	High Yield Muni	0.74	4.07
American Funds Tax-Exempt CA	TECFX	Bronze	Muni California Interm	0.73	3.87

The American Funds' medalists are listed by their no-load F1 share classes. The expense ratios are for the most recent fiscal year, and the annualized 10-year returns are through November 2016.

The multimanager system facilitates transitions out of management as well. The system allows for the grooming of one or more undisclosed managers to replace managers who are expected to retire soon. It can also help a fund overcome the unexpected loss of a manager. That happened in July 2015 when **American Funds Growth Fund of America** GFAFX suffered the untimely death of its then longest-tenured manager, James Rothenberg. As Rothenberg had been nearing retirement, he managed one of the portfolio's smaller sleeves. While that still added up to at least \$5 billion, it was less than 4% of the fund's assets at the time.

Competitive Long-Term Results for Equity and Allocation Funds

The multimanager system has helped generate competitive long-term results for American Funds'

equity and allocation funds, as well as several of its municipal funds.

Nineteen of the firm's 22 medalists had a track record of at least a decade through November 2016, and 14 of them finished in their respective peer groups' top third or better in that period. Only American Funds Growth Fund of America had a bottom-half showing during that span. That fund's 6.5% annualized 10-year gain, however, fell only 11 basis points shy of its category's top half.

Some of the firm's top performers are especially strong. Take **American Funds New Perspective** NPFEX, whose management team won the Morningstar International-Stock Fund Manager of the Year award for 2015. From April 2001, shortly after the F1 share class' mid-March inception, through November 2016, the fund's 10-year rolling returns beat its current and former benchmarks in all 69 rolling periods.

Investment Culture: Strengths & Weaknesses

The firm's robust investment culture helps instill confidence for the future. Indeed, looking at various metrics Morningstar compares across management firms, such as fees, compensation, and manager investment, Capital Group, the parent of American Funds, looks to be a good steward.

Capital Group isn't perfect, however. Its fixed-income lineup isn't nearly as strong as its equity lineup. The huge asset bases the firm manages, while easier to handle because of the multimanager system, nonetheless bear monitoring for signs of strained capacity. And the firm could be more transparent by disclosing actual start dates for managers once they're named publicly. That would help investors understand just who is at the helm during rough patches.

Issues like manager disclosure notwithstanding, Capital Group remains one of the industry's best stewards. Increased access to the firm's retail lineup is a welcome development. ■■■

Contact Alec Lucas alec.lucas@morningstar.com