How to Avoid the Worst Sector Mutual Funds

Picking from the multitude of sector mutual funds is a daunting task. In any given sector there may be as many as 231 different mutual funds, and there are at least 630 mutual funds across all sectors.

Why are there so many mutual funds? The answer is: because mutual fund providers are making lots of money selling them. The number of mutual funds has little to do with serving investors’ best interests. Below are three red flags investors can use to avoid the worst mutual funds:

1. Inadequate liquidity
2. High fees
3. Poor quality holdings

I address these red flags in order of difficulty. Advice on How to Find the Best Sector Mutual Funds is here. Details on the Best & Worst mutual funds in each sector are here.

How To Avoid Mutual Funds with Inadequate Liquidity

This is the easiest issue to avoid, and my advice is simple. Avoid all mutual funds with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the mutual fund and the underlying value of the securities it holds. In addition, low asset levels tend to mean lower volume in the mutual fund and large bid-ask spreads.

How To Avoid High Fees

Mutual funds should be cheap, but not all of them are. The first step is to know what is cheap and expensive.

To ensure you are paying at or below average fees, invest only in mutual funds with total annual costs below 1.97%, which is the average total annual costs of the 630 U.S. equity mutual funds I cover. Weighting the total annual costs by assets under management, the average total annual costs are lower at 1.31%. A lower weighted average is a good sign that investors are putting money in the cheaper mutual funds.

Figure 1 shows the most and least expensive sector mutual funds in the U.S. equity universe based on total annual costs. Rydex provides three of the most expensive funds while Vanguard’s are among the cheapest.

**Figure 1: 5 Least and Most Expensive Sector Mutual Funds**

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Name</th>
<th>Sector</th>
<th>Total Annual Cost</th>
<th>Overall Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>SFPAX</td>
<td>Saratoga Financial Services Portfolio</td>
<td>Financials</td>
<td>9.46%</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYELX</td>
<td>Rydex Series Electronics Fund</td>
<td>Information Technology</td>
<td>6.80%</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYTLX</td>
<td>Rydex Series Telecommunications Fund</td>
<td>Telecom Services</td>
<td>6.44%</td>
<td>1 Star</td>
</tr>
<tr>
<td>SBMBX</td>
<td>Saratoga Energy and Basic Materials Portfolio</td>
<td>Energy</td>
<td>6.24%</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYBMX</td>
<td>Rydex Series Basic Materials Fund</td>
<td>Materials</td>
<td>5.44%</td>
<td>1 Star</td>
</tr>
</tbody>
</table>

**Most Expensive**

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Name</th>
<th>Sector</th>
<th>Total Annual Cost</th>
<th>Overall Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>VGSNX</td>
<td>Vanguard REIT Index Fund</td>
<td>Financials</td>
<td>0.11%</td>
<td>2 Stars</td>
</tr>
<tr>
<td>VHCIX</td>
<td>Vanguard Health Care Index Fund</td>
<td>Health Care</td>
<td>0.16%</td>
<td>4 Stars</td>
</tr>
<tr>
<td>VITAX</td>
<td>Vanguard Information Technology Index Fund</td>
<td>Information Technology</td>
<td>0.17%</td>
<td>5 Stars</td>
</tr>
<tr>
<td>VINAX</td>
<td>Vanguard Industrials Index Fund</td>
<td>Industrials</td>
<td>0.17%</td>
<td>3 Stars</td>
</tr>
<tr>
<td>VCDAX</td>
<td>Vanguard Consumer Discretionary Index Fund</td>
<td>Consumer Discretionary</td>
<td>0.17%</td>
<td>3 Stars</td>
</tr>
</tbody>
</table>

**Least Expensive**

Sources: New Constructs, LLC and company filings

Important Disclosure Information is contained on the last page of this report. The recipient of this report is directed to read these disclosures.
Saratoga Financial Services Portfolio (SFPAX) and Rydex Series Electronics Fund (RYELX) are two of the most expensive U.S. equity mutual funds I cover. Vanguard REIT Index Fund (VGSNX) is the least expensive. However, investors need not pay high fees for good holdings. Vanguard Information Technology Index Fund (VITAX) is my highest-rated sector mutual fund and earns my Very Attractive rating. It also has low total annual costs of only 0.17%.

On the other hand, VGSNX holds poor stocks. No matter how cheap a mutual fund, if it holds bad stocks, its performance will be bad.

This result highlights why investors should not choose mutual funds based only on price. The quality of holdings matters more than price.

**How To Avoid mutual funds with the Worst Holdings**

This step is by far the hardest, but it is also the most important because a mutual fund’s performance is determined more by its holdings than by its costs. Figure 2 shows the mutual funds within each sector with the worst holdings or portfolio management ratings. The sectors are listed in descending order by overall rating as detailed in my 3Q Sector Ratings report.

**Figure 2: Sector Mutual Funds with the Worst Holdings**

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Name</th>
<th>Sector</th>
<th>Portfolio Management Rating</th>
<th>Overall Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSHOX</td>
<td>Fidelity Select Construction and Housing Portfolio</td>
<td>Consumer Staples</td>
<td>Dangerous</td>
<td>3 Stars</td>
</tr>
<tr>
<td>RYTSX</td>
<td>Rydex Series Transportation Fund</td>
<td>Industrials</td>
<td>Dangerous</td>
<td>2 Stars</td>
</tr>
<tr>
<td>RYELX</td>
<td>Rydex Series Electronics Fund</td>
<td>Information Technology</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYRTX</td>
<td>Rydex Series Retailing Fund</td>
<td>Consumer Discretionary</td>
<td>Neutral</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYTLX</td>
<td>Rydex Series Telecommunications Fund</td>
<td>Telecom Services</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYBOX</td>
<td>Rydex Series Biotechnology Fund</td>
<td>Health Care</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYBMX</td>
<td>Rydex Series Basic Materials Fund</td>
<td>Materials</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>SBMBX</td>
<td>Saratoga Energy and Basic Materials Portfolio</td>
<td>Energy</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYREX</td>
<td>Rydex Series Real Estate Fund</td>
<td>Financials</td>
<td>Dangerous</td>
<td>1 Star</td>
</tr>
<tr>
<td>RYUTX</td>
<td>Rydex Series Utilities Fund</td>
<td>Utilities</td>
<td>Very Dangerous</td>
<td>1 Star</td>
</tr>
</tbody>
</table>

Sources: New Constructs, LLC and company filings

My **overall ratings on mutual funds** are based primarily on my **stock ratings** of their holdings. My firm covers over 3000 stocks and is known for the due diligence done on each stock we cover.

Rydex Series appears more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings. Rydex Series Utilities Fund (RYTUX) has the worst holdings of all Utilities mutual funds. RYBOX, SBMBX, FSHOX, and RYRTL all have the worst holdings in their respective sectors.

Find the mutual funds with the worst overall ratings on my **mutual fund screener**. More analysis of the **best sector mutual funds is here**.

**The Danger Within**

Buying a mutual fund without analyzing its holdings is like buying a stock without analyzing its business and finances. As Barron’s says, investors should know the **Danger Within**. Put another way, research on mutual fund holdings is necessary due diligence because a mutual fund’s performance is only as good as its holdings’ performance.

**PERFORMANCE OF MUTUAL FUND’s HOLDINGS = PERFORMANCE OF MUTUAL FUND**
Best & Worst Stocks In these Mutual Funds

Valero Energy Corp (VLO) is one of my least favorite stocks held by SBMBX and earns my Very Dangerous rating. Since 2009, VLO's after tax profit (NOPAT) has declined by 9% compounded annually. Over the same timeframe, the company’s return on invested capital (ROIC) has fallen from 11% to 6% in 2013. The last time VLO generated positive economic earnings was 2009. Despite its declining profits and ROIC, VLO is valued as a profit-growing company. To justify its current price of ~$51/share, VLO must grow NOPAT by 8% compounded annually for the next 10 years. While this expectation isn't out of reach for some companies, the recent trend in profits makes these expectations for Valero’s future seem rather high. Investor should avoid VLO.

Ford Motor Company (F) is one of my favorite stocks held by VCDAX and earns my Attractive rating. F also lands on my Most Attractive list for August. Since 2007, F has grown NOPAT by an impressive 42% compounded annually. In addition, the company has increased its ROIC to 9% from 1% in 2007. With the release of 16 new models in the U.S. this year, including the best-selling F-150, Ford looks to continue this profit growth. However, the market has failed to see any profit growth potential in Ford. At its current price of ~$17/share, F has a price to economic book value (PEBV) ratio of just 1.0. This ratio implies that the market expects F’s NOPAT never to grow meaningfully from current levels. While F may not continue to grow profits as fast as it has these past few years, it should easily surpass the market’s low expectations. Investors should give F a serious look.

Kyle Guske II contributed to this article

Disclosure: David Trainer owns F. David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, or theme.
**New Constructs® – Profile**

**How New Constructs Creates Value for Clients**

1. **Superior Recommendations** – Our [stock picks](#) consistently outperform. See our track record in our [stock-picking accolades](#) and [Proof Is In Performance](#) reports.

2. **More Accurate Research** – Our patented Research Platform for [reversing accounting distortions](#) and [discounted cash flow analysis](#) leverages better data to deliver smarter research.

3. **Time Savings** – We check the fine print in thousands of corporate filings so you don't have to. 
   As reported by [Barron’s](#), our expertise in analyzing SEC filings delivers [Hidden Gems and Red Flags](#) that drive long-term stock-picking success.

4. **Transparency** – We are proud to share the results of our analysis of over 50,000 10Ks. See the [Corporate Disclosure Transgressions](#) report we provided the SEC. Our reports detail all data and assumptions. Company Models enable users to change them.

5. **Objectivity** – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our [presentation to the Senate Banking Committee](#), the SEC and many others in DC.

**Our Philosophy About Research**

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

**Additional Information**

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting, advisory and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).
DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs’ research recommendations may not coincide with the hedge fund’s holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents. This report is not directed at, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.