How Well Do Consumer Discretionary ETFs and Fund Managers Pick Stocks?

This report shows how well Consumer Discretionary ETFs and mutual fund managers pick stocks. We focus on how much managers allocate to the best stocks compared to how many good stocks are available in the sector.

Figure 1 shows how many good stocks, according to our nationally-recognized ratings, are in the sector and their market cap. Next, it juxtaposes the ratings of the ETFs and mutual funds in the sector. Our forward-looking ratings for ETFs and Mutual Fund are based primarily on our ratings on each fund's holdings. We think investors can gain an advantage with our research since past performance is not a reliable predictor of future returns.

Figure 1 shows that 69 out of the 433 stocks (over 17% of the market value) in Consumer Discretionary ETFs and mutual funds get an Attractive-or-better rating.

However only 13% of ETFs allocate enough to quality stocks to earn an Attractive-or-better rating. Mutual fund managers have not fared much better. Only 10% of mutual funds allocate enough of their assets to quality stocks to earn an Attractive-or better rating. ETF providers and mutual fund managers need to do a better job to justify their fees.

While there are quality funds available, unfortunately 99% of investor assets in Consumer Discretionary ETFs are invested in Neutral-or-worse ETFs. Investors are allocating to the worst ETFs in the sector. The picture is not much better for mutual fund investors as only 2% of investor assets are allocated to Attractive-or-better rated mutual funds.

Investors need to tread carefully when considering ETFs and mutual funds in the Consumer Discretionary sector, as it contains numerous Neutral-or-worse rated funds. Only 2 out of 16 ETFs and 2 out of 21 mutual funds in the Consumer Discretionary sector allocate enough value to Attractive-or-better-rated stocks to earn an Attractive-or-better rating.

Figure 1: Consumer Discretionary Sector Landscape For ETFs, Mutual Funds & Stocks

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of Stocks	14	55	158	173	33
% of Sector	3%	14%	47%	31%	5%
# of ETFs	0	2	14	0	0
% of ETFs	0%	13%	88%	0%	0%
% of TNA	0%	1%	99%	0%	0%
# of MFs	0	2	15	3	1
% of MFs	0%	10%	71%	14%	5%
% of TNA	0%	2%	98%	0%	0%

Sources: New Constructs, LLC and company filings

As mentioned above, investors are disproportionately allocated to the worst ETFs and mutual funds in the Consumer Discretionary sector. Investors in this sector need to perform better due diligence on the holdings of their ETFs and mutual funds.

Guggenheim S&P Equal Weight Consumer Discretionary ETF (RCD) has the highest portfolio management rating of all Consumer Discretionary ETFs and earns my Attractive rating. ICON Consumer Discretionary Fund (ICCAX) has the highest Portfolio Management rating of all Consumer Discretionary mutual funds and earns my Neutral rating. Despite its high Portfolio Management rating, ICCAX's high Total Annual Costs earn it my Very Dangerous overall rating.

Fidelity MSCI Consumer Discretionary ETF (FDIS) has the lowest Portfolio Management rating of all Consumer Discretionary ETFs and earns my Dangerous rating. Vanguard Consumer Discretionary Index Fund (VCDAX) has the lowest Portfolio Management rating of all Consumer Discretionary mutual funds and earns my Dangerous rating.

Hasbro Inc. (HAS) is one of my favorite companies held by RCD and earns my Attractive rating. Over the past 12 years, Hasbro has grown after-tax profits (NOPAT) by 12% compounded annually. The company generates a consistently high return on invested capital (ROIC) and achieved an ROIC of 14% in 2013. Hasbro has also earned positive economic earnings in nine of the past 10 years. Despite Hasbro's strong fundamentals, investors have become weary of this toy-maker. At it current price of ~$55/share, Hasbro has a price to economic book value (PEBV) ratio of 1.2. This ratio implies that the market expects Hasbro to grow NOPAT by only 20% over the remaining life of the business. This expectation seems a bit pessimistic given Hasbro has grown NOPAT by double digits compounded annually for over a decade and recently secured the rights to make toys under the Disney Princess brands as well as the hit movie Frozen.

Orbitz Worldwide, Inc. (OWW) is one of my least favorite companies held by Consumer Discretionary ETFs and mutual funds and earns my Very Dangerous rating. Orbitz has not grown NOPAT since 2008. The company currently earns an ROIC of 5%, which places it in the bottom quintile of all companies I cover. Orbitz has also not generated positive economic earnings since going public in 2007. To justify its current price of ~$8/share, Orbitz must grow NOPAT by 7% compounded annually for the next 18 years. While OWW achieved this level of profit growth in 2013, that year appears to be more of a blip on the radar after numerous years of NOPAT declines. OWW has been given a high-growth premium without the high growth track-record, and investors should steer clear.

Many ETFs and mutual funds managers do a poor job identifying quality stocks. They allocate heavily to overvalued stocks like Orbitz and don't hold high quality stocks such as Hasbro. These funds are not worth owning at any cost.

The emphasis that traditional research places on low costs is a positive for investors, but low fees alone do not drive performance. Only good holdings can. Don't fall prey to the index label myths. Even "passive" investors should be analyzing the holdings of their funds.

Our Best & Worst ETFs and Mutual Funds for the Consumer Discretionary Sector report reveals our predictive ratings on the best and worst funds in the sector.

Kyle Guske II contributed to this report.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, or theme.

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