Stock Picking Grades for ETFs and Mutual Funds: Consumer Staples Sector

This report shows how well Consumer Staples ETFs and mutual fund managers pick stocks. We juxtapose our Portfolio Management rating on funds, which grades managers based on the quality of the stocks they choose, with the number of good stocks available in the sector. This analysis shows whether or not ETF providers and mutual fund managers deserve their fees.

For example, if a fund has a poor Portfolio Management rating in a sector where there are lots of good stocks, that fund does not deserve the fees it charges, and investors are much better off putting money in a passively-managed fund or investing directly in the sector's good stocks. On the other hand, if a fund has a good Portfolio Management rating in a sector where there are lots of bad stocks, then investors should put money in that fund assuming the fund's costs are competitive.

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. We think investors can gain an advantage with our forward-looking fund ratings since past performance is not a reliable predictor of future returns.

Figure 1 shows that 34 out of the 204 stocks (over 27% of the market value) in the Consumer Staples sector that get an Attractive-or-better rating.

The main takeaway from Figure 1 is that over 70% of ETFs (7 out of 10) allocate enough to quality stocks to earn an Attractive-or-better rating. ETF providers in the Consumer Staples sector are earning their fees. Mutual fund managers are demonstrating similar skill with over 67% of mutual funds (10 out of 15) allocating enough assets to quality stocks to earn an Attractive-or-better rating for their funds.

It appears investors are doing their homework in this sector as well since over 98% of total net assets (TNA) in is Attractive-or-better rated ETFs. Similarly, 79% of TNA in mutual funds is invested in funds that earn an Attractive-or-better rating.

It is encouraging to see such a large percentage of total net assets allocated to Attractive-or-better rated funds. Investors do a good job of recognizing the best funds in the Consumer Staples sector.

Figure 1: Consumer Staples Sector: Comparing Quality of Stock Picking To Quality Of Stocks Available

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of Stocks	8	26	84	70	16
% of Sector	7%	20%	57%	14%	1%
# of ETFs	6	1	3	0	0
% of ETFs	60%	10%	30%	0%	0%
% of TNA	85%	12%	2%	0%	0%
# of MFs	4	6	3	2	0
% of MFs	27%	40%	20%	13%	0%
% of TNA	13%	66%	21%	0%	0%

Sources: New Constructs, LLC and company filings

State Street SPDR Consumer Staples Select Sector Fund ETF (XLP) has the highest portfolio management rating of all Consumer Staples ETFs and earns my Attractive Portfolio Management rating. Vanguard Consumer Staples Index Fund (VCSAX) has the highest portfolio management rating of all Consumer Staples mutual funds and earns my Neutral Portfolio Management rating.

PowerShares S&P Small Cap Consumer Staples Portfolio ETF (PSCC) has the lowest rating of all Consumer Staples ETFs and earns my Dangerous Portfolio Management rating. Fidelity Select Construction and Housing

Portfolio (FSHOX) has the lowest Portfolio Management rating of all Consumer Staples mutual funds and earns my Dangerous Portfolio Management rating.

Kimberly-Clark Corp. (KMB) is one of my favorite companies held by Consumer Staples ETFs and mutual funds and earns my Attractive rating. Over the past decade, Kimberly Clark has grown after tax profits (NOPAT) by a consistent 5% compounded annually since 1998. KMB earned a 13% return on invested capital (ROIC) in 2013, which continues the company's trend of double-digit ROICs that goes back to 1998. Topping it off, Kimberly Clark has generated positive economic earnings for each of the last 16 years. At its current price of ~$107/share, KMB has a price to economic book value (PEBV) ratio of 1.1 This ratio implies the market expects Kimberly-Clark to grow NOPAT by only 10% for the remaining life of the company. We do not see KMB as one of the popular "get rich quick" stocks. However, the company has proven its ability to consistently grow NOPAT while maintaining a high ROIC and should easily surpass the low expectations reflected in its market value.

Alico Inc. (ALCO) is one of my least favorite stocks held by Consumer Staples ETFs and mutual funds and earns my Very Dangerous rating. Since 2011, ALCO's NOPAT has fallen by 7% compounded annually. Alico's ROIC also fell to 4% in 2013, which puts it in the bottom quintile of all companies I cover. The company has earned negative economic earnings in eight of the last nine years. These negative trends in profitability appear to be continuing in 2014. ALCO reported a decline in year over year revenues in 3Q14. Another problem with Alico is its lofty valuation. To justify its current price of ~$37/share, ALCO must grow NOPAT by 15% compounded annually for the next 24 years. Given the company's recently declining NOPAT as well as its poor results so far in 2014, the expectations baked into Alico's current stock price seem overly optimistic.

Many ETFs and mutual fund managers do a poor job identifying quality stocks. They allocate heavily to overvalued stocks like Alico and don't hold high quality stocks such as Kimberly-Clark. 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 Staples 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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