Stock Picking Grades for ETFs and Mutual Funds: Information Technology Sector

This report shows how well Information Technology 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 collective market cap. Next, it juxtaposes the Portfolio Management 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 89 out of the 660 stocks (over 31% of the market value) in Information Technology ETFs and mutual funds get an Attractive-or-better rating.

The main takeaway from Figure 1 is that despite nearly a third of the market cap of the Information Technology sector consisting of Attractive-or-better rated stocks, ETF providers and mutual fund managers are allocating to the worst stocks in the sector.

Zero out 27 ETFs allocate enough to quality stocks to earn an Attractive-or-better Portfolio Management Rating. Mutual fund managers have not fared much better. Zero out of 147 mutual funds allocate enough of their assets to quality stocks to earn an Attractive-or better Portfolio Management Rating. ETF providers and mutual fund managers need to do a better job to justify their fees.

On a positive note, ETF investors have chosen wisely with over 89% of total net assets (TNA) in ETFs with a Neutral Portfolio Management Rating. This means that very little money is being invested in ETFs allocating to Dangerous-or-worse stocks. Mutual fund investors provide a contrasting picture with over 68% of TNA invested in funds with a Dangerous-or-worse Portfolio Management rating. Mutual fund investors need to perform due diligence when choosing a fund.

It is encouraging to see such a large percentage of total net assets allocated to ETFs with a Neutral Portfolio Management Rating, but as mentioned above, investors are disproportionately allocated to the worst mutual funds in the Information Technology sector.

Figure 1: Information Tech Sector: Comparing Quality of Stock Picking to Quality of Stocks Available

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of Stocks	25	64	205	307	59
% of Sector	11%	20%	47%	17%	4%
# of ETFs	0	0	19	8	0
% of ETFs	0%	0%	70%	30%	0%
% of TNA	0%	0%	89%	11%	0%
# of MFs	0	0	81	66	0
% of MFs	0%	0%	55%	45%	0%
% of TNA	0%	0%	32%	68%	0%

Sources: New Constructs, LLC and company filings

First Trust NASDAQ Technology Dividend Index ETF (TDIV) has the highest Portfolio Management Rating of all Information Technology ETFs and earns my Neutral Portfolio Management Rating. Columbia Seligman Global Technology Fund (SHGTX) has the highest Portfolio Management Rating of all Information Technology mutual funds and earns my Neutral Portfolio Management Rating.

PowerShares S&P SmallCap Information Technology Portfolio ETF (PSCT) has the lowest Portfolio Management Rating of all Information Technology ETFs and earns my Dangerous Portfolio Management Rating. T Rowe Price Global Technology Fund (PRGTX) has the lowest Portfolio Management Rating of all Information Technology mutual funds and earns my Dangerous Portfolio Management Rating.

Qualcomm (QCOM) is one of my favorite stocks held by TDIV and earns my Very Attractive rating. Over the past decade, Qualcomm has grown after-tax profits (NOPAT) by 23% compounded annually. Qualcomm has also increased its return on invested capital (ROIC) over this time from 19% in 2003 to 51% in 2013. The company has generated positive and increasing economic earnings every year since 2003. Despite this impressive and sustained profit growth, Qualcomm's is undervalued. At its current price of ~$72/share, QCOM has a price to economic book value (PEBV) ratio of 1.2. This ratio implies the market expects Qualcomm to grow its NOPAT by only 20% over the remaining life of the firm. Looking at the past decade, Qualcomm has often grown NOPAT by more than this in just one year. Market expectations are overly pessimistic and investors should take note.

Amazon (AMZN) is one of my least favorite stocks held PRGTX and earns my Very Dangerous rating. Amazon is also on our Most Dangerous stocks list for October. Since 2009, Amazon's NOPAT has declined by 12% compounded annually while its ROIC has fallen from 38% to just 4% in 2013. Many Amazon bulls disregard true profits and focus on Amazon's reported $5.5 billion cash flow in 2013. However, as I've highlighted before, this cash flow is an illusion, and Amazon's high capital efficiency days are behind it. Accounting methods for depreciation, stock-based compensation, capital leases, and off-balance sheet debt all offer loopholes that Amazon has exploited to inflate its cash flow numbers. In reality Amazon has seen billions in negative free cash flow for the past three years. To justify its current share price of ~$306/share, AMZN would need to increase its pre-tax margins to 5% and grow revenue by 20% compounded annually for the next 10 years. Expectations this high completely disregard that since 2011, Amazon's NOPAT margins have declined and its revenue growth is slowing. Investors should steer clear of Amazon before the market sees through the company's accounting tricks.

Many ETF providers and mutual fund managers do a poor job identifying quality stocks. Their funds allocate heavily to overvalued stocks like Amazon and don't hold high quality stocks such as Qualcomm. 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 Information Technology 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.

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 to, 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.