



## Sector Rankings For ETFs & Mutual Funds

At the beginning of the fourth quarter of 2014, only the Industrials and Consumer Staples sectors earn an Attractive-or-better rating. My sector ratings are based on the aggregation of my [fund ratings](#) for every ETF and mutual fund in each sector.

Investors looking for sector funds that hold quality stocks should look no further than the Consumer Staples and Industrials sectors. These sectors house numerous Attractive-or-better rated funds. Figures 6 and 7 provide details. The primary driver behind an Attractive fund rating is good [portfolio management](#), or good stock picking, with low [Total Annual Costs](#).

Note that the Attractive-or-better Predictive ratings do not always correlate with Attractive-or-better Total Annual Costs. This fact underscores that (1) [cheap funds can dupe investors](#) and (2) investors should invest only in funds with good stocks and low fees.

See Figures 4 through 13 for a detailed breakdown of ratings distributions by sector. See my [ETF & mutual fund screener](#) for rankings, ratings and reports on 7000+ mutual funds and 400+ ETFs. My fund rating methodology is detailed [here](#).

All of my reports on the best & worst ETFs and mutual funds in every sector and investment style are available [here](#).

**Figure 1: Ratings For All Sectors**

Sector	Predictive Rating	Portfolio Management Rating	Total Annual Costs Rating
Financials	Dangerous	Dangerous	Attractive
Utilities	Dangerous	Dangerous	Neutral
Energy	Dangerous	Dangerous	Neutral
Health Care	Neutral	Dangerous	Attractive
Materials	Neutral	Dangerous	Attractive
Telecom	Neutral	Dangerous	Attractive
Cons Disc	Neutral	Dangerous	Very Attractive
Info Tech	Neutral	Neutral	Neutral
Industrials	Attractive	Neutral	Attractive
Cons Staples	Very Attractive	Neutral	Attractive

Source: New Constructs, LLC and company filings

To earn an Attractive-or-better Predictive Rating, an ETF or mutual fund must have high-quality holdings and low costs. Only the top 30% of all ETFs and mutual funds earn our Attractive-or-better ratings.

State Street SPDR Consumer Staples Select Sector Fund ETF (XLP) is my top rated Consumer Staples fund. It gets my Very Attractive rating by allocating over 30% of its value to Attractive-or-better-rated stocks.

Wal-Mart (WMT) is, [and has been](#), one of my favorite stocks held by XLP. A lackluster 2014 has presented investors with a great opportunity in WMT. Over the past decade, Wal-Mart has grown after-tax profits ([NOPAT](#)) by a steady 7% compounded annually. The company earns a consistently high return on invested capital ([ROIC](#)) around 12% and has generated positive and increasing [economic earnings](#) in every year of my model, which tracks back to 1998. With over \$14 billion in free cash flow ([FCF](#)) in 2014 Wal-Mart has many options to generate profit growth, including its recent introduction of checking accounts and deeper foray into healthcare offerings. At its current price of ~\$77/share, WMT has a price to economic book value ([PEBV](#)) ratio of 0.9. This ratio implies the market expects Wal-Mart's NOPAT to



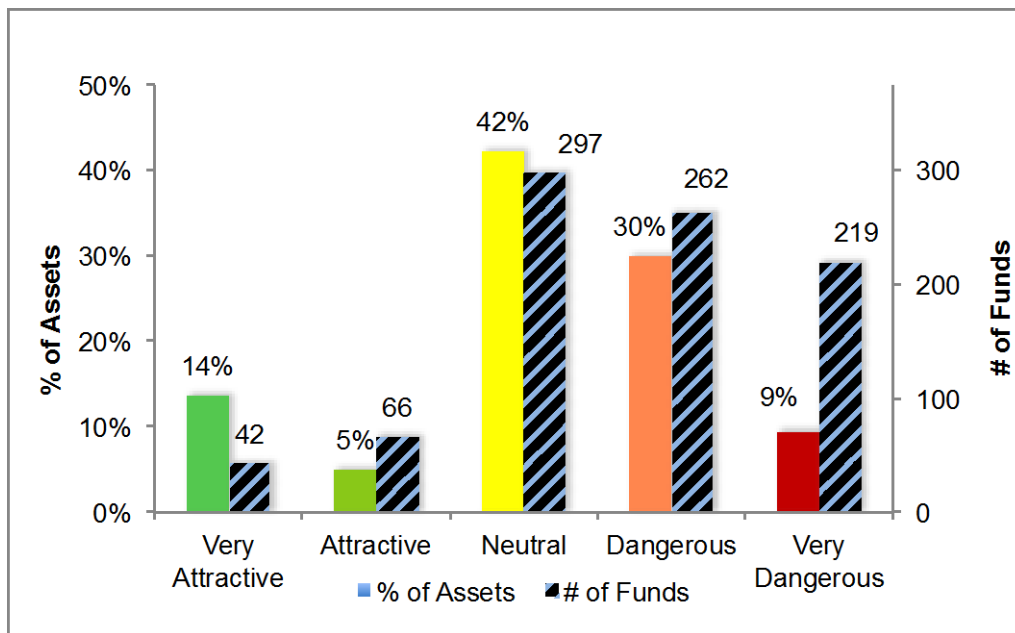
permanently decline by 10% for the remaining life of the company. Its not often that investors get a chance to buy a high quality company at such a discount. Heading into the holiday shopping season, WMT should be on everyone's list.

Hennessy Small Cap Financial Fund (HSFNX) is my worst-rated Financials fund. It gets my Very Dangerous rating by allocating over 55% of its value to Dangerous-or-worse-rated stocks, and to make matters worse, charges investors Total Annual Costs of 2.19%.

Radian Group (RDN) is one of my least favorite stocks held by HSFNX and gets my Dangerous rating. As with most financial institutions, RDN was hit hard back in 2008 and investors hoping for a turnaround may be waiting a while longer. In 2013 Radian earned a NOPAT of -\$193 million. This is the sixth time in seven years that Radian has earned an operating loss. Similarly, Radian generated an ROIC of -18% in 2013, which places it in the bottom quintile of all companies I cover. In addition to Radian's poor profitability, its core business remains in question with numerous new regulations and laws being proposed for the mortgage industry. Couple these factors with Radian's highly optimistic valuation and it is tough to be bullish. To justify its current price of ~\$14/share, RDN has to immediately achieve positive pre-tax margins of 5% (average before 2007), [and grow revenue by 16% compounded annually for the next 38 years](#). Repeated losses, an industry with an uncertain regulatory future, and an alarmingly high valuation make RDN a stock to avoid.

Figure 2 shows the distribution of our Predictive Ratings for all sector ETFs and mutual funds.

**Figure 2: Distribution of ETFs & Mutual Funds (Assets and Count) by Predictive Rating**



Source: New Constructs, LLC and company filings

Figure 3 offers additional details on the quality of the sector funds. Note that the average Total Annual Cost of Very Dangerous funds is over seven times that of Very Attractive funds.



**Figure 3: Predictive Rating Distribution Stats**

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of ETFs & Funds	42	66	297	262	219
% of ETFs & Funds	5%	7%	34%	30%	25%
% of TNA	14%	5%	42%	30%	9%
Avg TAC	0.29%	0.78%	0.74%	0.98%	2.11%

\* Avg TAC = Weighted Average Total Annual Costs

Source: New Constructs, LLC and company filings

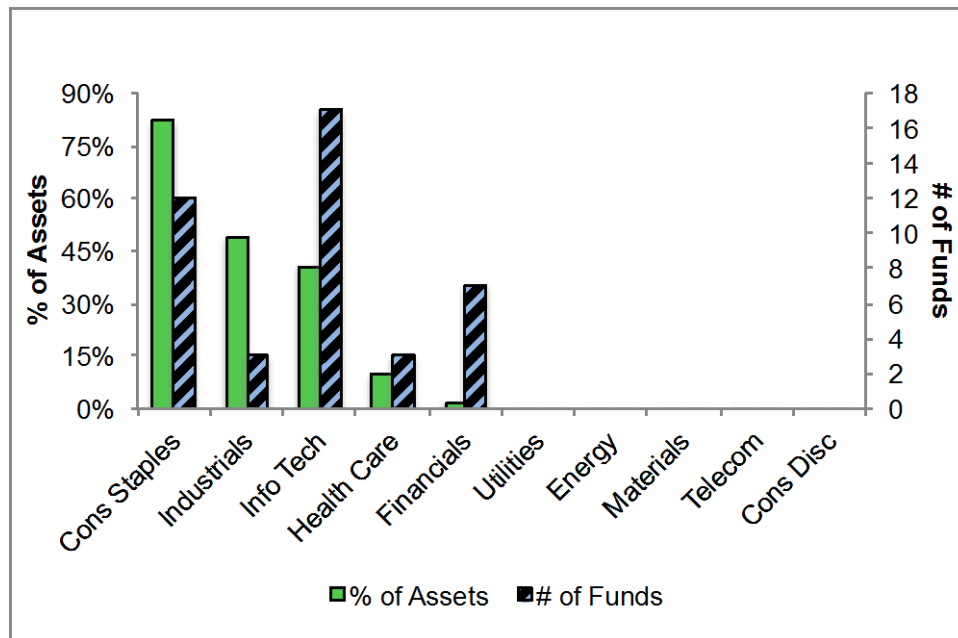
This table shows that only the best of the best funds get our Very Attractive Rating: they must hold good stocks AND have low costs. Investors deserve to have the best of both and we are here to give it to them.

**Ratings by Sector**

Figure 4 presents a mapping of Very Attractive funds by sector. The chart shows the number of Very Attractive funds in each sector and the percentage of assets in each sector allocated to funds that are rated Very Attractive.

As can be seen, five sectors contain funds that receive my Very Attractive rating. It should come as no surprise that the top rated sector, Consumer Staples, holds over 80% of assets in Very Attractive funds.

**Figure 4: Very Attractive ETFs & Mutual Funds by Sector**



Source: New Constructs, LLC and company filings



Figure 5 presents the data charted in Figure 4.

**Figure 5: Very Attractive ETFs & Mutual Funds by Sector**

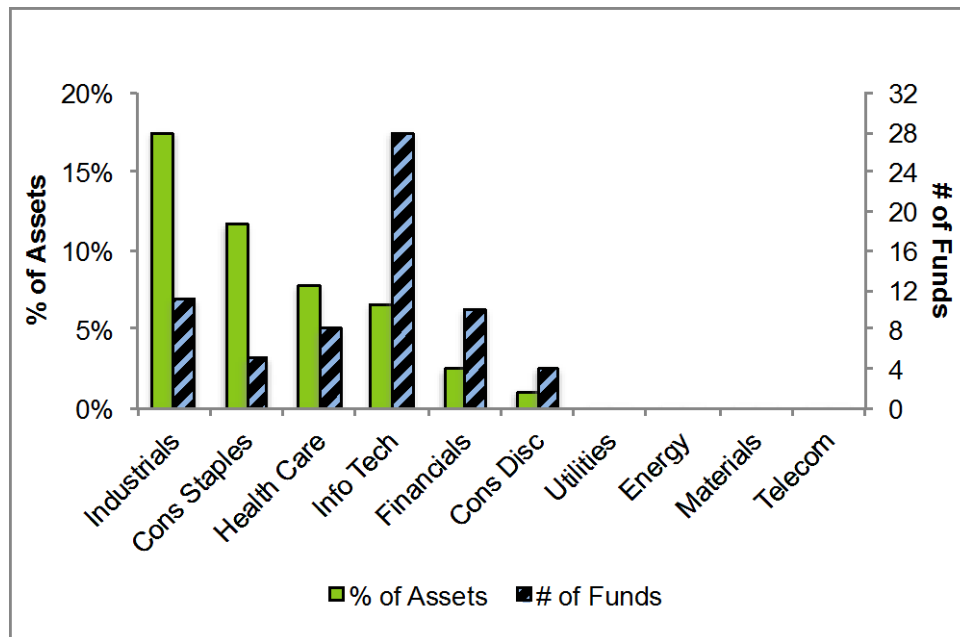
Sector	% of Sector Assets	# of Very Attractive Funds	% of Very Attractive Funds in Sector
Cons Staples	82%	12	48%
Industrials	49%	3	7%
Info Tech	41%	17	10%
Health Care	10%	3	3%
Financials	1%	7	2%
Cons Disc	0%	0	0%
Telecom	0%	0	0%
Energy	0%	0	0%
Utilities	0%	0	0%
Materials	0%	0	0%

Source: New Constructs, LLC and company filings

Figure 6 presents a mapping of Attractive funds by sector. The chart shows the number of Attractive funds in each sector and the percentage of assets allocated to Attractive-rated funds in each sector.

Take note of the difference between assets and number of funds in the Information Technology sector. This sector contains 28 Attractive funds, but these funds hold only 7% of sector assets.

**Figure 6: Attractive ETFs & Mutual Funds by Sector**



Source: New Constructs, LLC and company filings



Figure 7 presents the data charted in Figure 6.

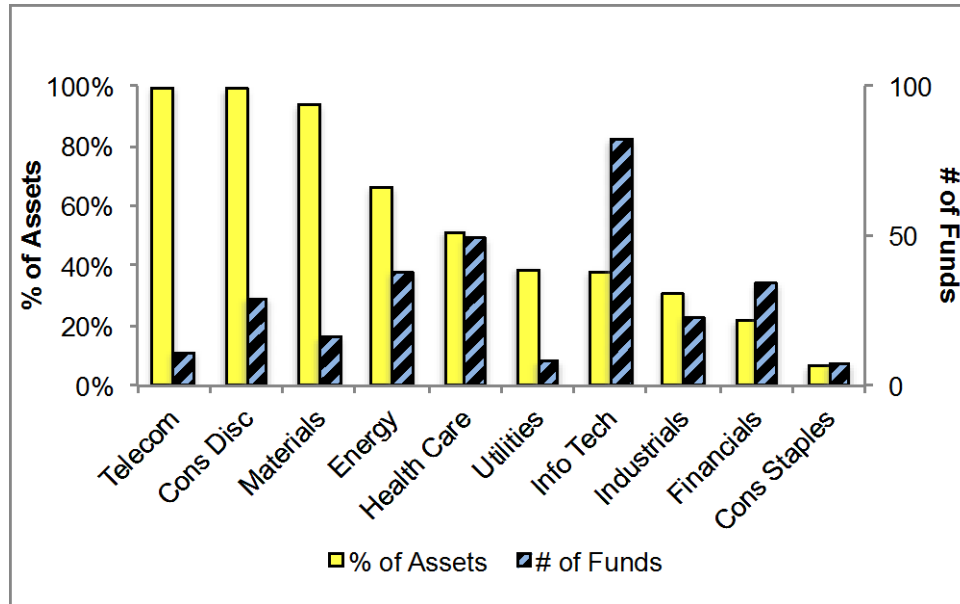
**Figure 7: Attractive ETFs & Mutual Funds by Sector**

Sector	% of Sector Assets	# of Attractive Funds	% of Attractive Funds in Sector
Industrials	17%	11	26%
Cons Staples	12%	5	20%
Health Care	8%	8	7%
Info Tech	7%	28	16%
Financials	2%	10	3%
Cons Disc	1%	4	11%
Telecom	0%	0	0%
Energy	0%	0	0%
Utilities	0%	0	0%
Materials	0%	0	0%

Source: New Constructs, LLC and company filings

Figure 8 presents a mapping of Neutral funds by sector. The chart shows the number of Neutral funds in each sector and the percentage of assets allocated to Neutral-rated funds in each sector.

**Figure 8: Neutral ETFs & Mutual Funds by Sector**



Source: New Constructs, LLC and company filings



Figure 9 presents the data charted in Figure 8.

**Figure 9: Neutral ETFs & Mutual Funds by Sector**

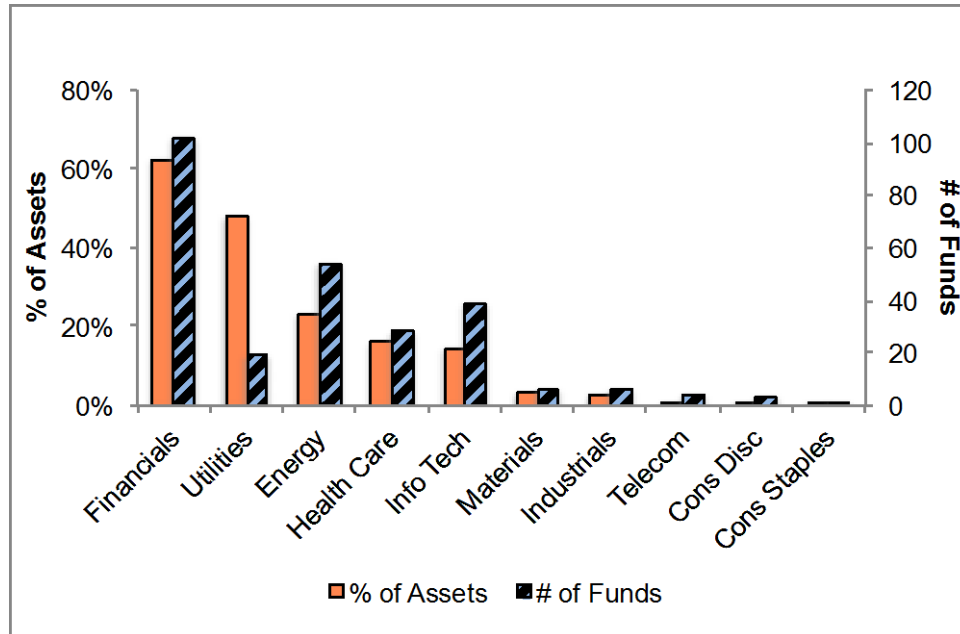
Sector	% of Sector Assets	# of Neutral Funds	% of Neutral Funds in Sector
Telecom	99%	11	58%
Cons Disc	99%	29	78%
Materials	94%	16	62%
Energy	66%	38	32%
Health Care	52%	49	42%
Utilities	39%	8	22%
Info Tech	38%	82	47%
Industrials	31%	23	53%
Financials	22%	34	12%
Cons Staples	6%	7	28%

Source: New Constructs, LLC and company filings

Figure 10 presents a mapping of Dangerous funds by fund sector. The chart shows the number of Dangerous funds in each sector and the percentage of assets allocated to Dangerous-rated funds in each sector.

The landscape of sector ETFs and mutual funds is littered with Dangerous funds. Investors in Utilities funds have put over 48% of their assets in Dangerous-rated funds.

**Figure 10: Dangerous ETFs & Mutual Funds by Sector**



Source: New Constructs, LLC and company filings



Figure 11 presents the data charted in Figure 10.

**Figure 11: Dangerous ETFs & Mutual Funds by Sector**

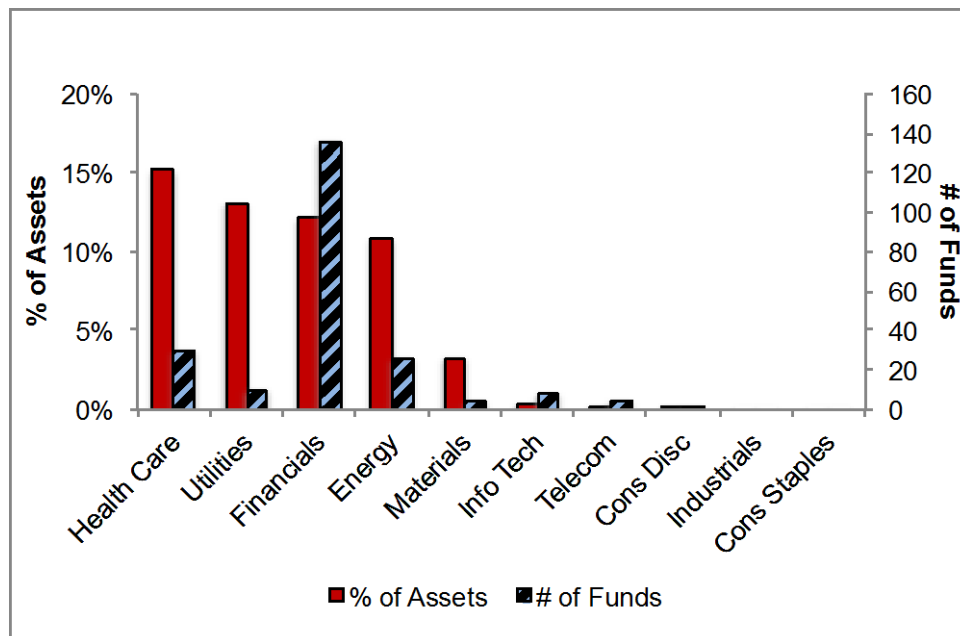
Sector	% of Sector Assets	# of Dangerous Funds	% of Dangerous Funds in Sector
Financials	62%	102	35%
Utilities	48%	19	51%
Energy	23%	54	46%
Health Care	16%	28	24%
Info Tech	14%	39	22%
Materials	3%	6	23%
Industrials	3%	6	14%
Telecom	0%	4	21%
Cons Disc	0%	3	8%
Cons Staples	0%	1	4%

Source: New Constructs, LLC and company filings

Figure 12 presents a mapping of Very Dangerous funds by fund sector. The chart shows the number of Very Dangerous funds in each sector and the percentage of assets in each sector allocated to funds that are rated Very Dangerous.

The takeaway here deals with the Financials sector, in which almost half (47%) of the funds receive a Very Dangerous rating.

**Figure 12: Very Dangerous ETFs & Mutual Funds by Sector**



Source: New Constructs, LLC and company filings

Figure 13 presents the data charted in Figure 12.

**Figure 13: Very Dangerous ETFs & Mutual Funds by Sector**

Sector	% of Sector Assets	# of Very Dangerous Funds	% of Very Dangerous Funds in Sector
Health Care	15%	30	25%
Utilities	13%	10	27%
Financials	12%	136	47%
Energy	11%	26	22%
Materials	3%	4	15%
Info Tech	0%	8	5%
Telecom	0%	4	21%
Cons Disc	0%	1	3%
Industrials	0%	0	0%
Cons Staples	0%	0	0%

Source: New Constructs, LLC and company filings

*Kyle Guske II contributed to this report*

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



## Appendix: Predictive Fund Rating System

New Constructs' [Predictive fund Ratings](#) enable smarter investing by assessing the key drivers of future fund performance. We start by analyzing every funds' holdings based on New Constructs' stock ratings, which are regularly featured as among the [best by Barron's](#). Next, we measure and rank the all-in fund expenses. Finally, we rank the fund compared to all other funds to identify the best and worst funds in the market.

Intuitively, there are two drivers for future fund performance.

1. Stock-picking ([Portfolio Management Rating](#)) and
2. Fund expenses ([Total Annual Costs Rating](#))

Our Predictive Fund Rating is based on these drivers and the fund's ranking:

1. Top 10% = Very Attractive Rating
2. Next 20% = Attractive Rating
3. Next 40% = Neutral Rating
4. Next 20% = Dangerous Rating
5. Bottom 10% = Very Dangerous Rating

The figure below details the criteria that drive our Predictive Rating system for funds. The two drivers of our predictive ratings system are Portfolio Management and Total Annual Costs. The Portfolio Management ratings (detail [here](#)) is the same as our Stock Rating (detail [here](#)) except that we incorporate Asset Allocation (details [here](#)). The Total Annual Costs Ratings (details [here](#)) captures the all-in costs of being in a fund over a 3-year holding period, the average period for all mutual funds.

Predictive Rating	Portfolio Management Rating					Cash Allocation	Total Annual Costs
	Business Strength		Valuation				
	Quality of Earnings	Return on Invested Capital	FCF Yield	Price to Economic Book Value	Market-Implied Duration of Growth		
Very Dangerous	Misleading Trend	Bottom Quintile	< -5%	>3.5 or -1<0	> 50	> 20%	> 4 %
Dangerous	False Positive	4th Quintile	-5% < -1%	2.4<3.5 or <-1	20 < 50	8% < 20%	2% < 4%
Neutral	Neutral EE	3rd Quintile	-1% < 3%	1.6 < 2.4	10 < 20	2.5% < 8%	1% < 2%
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1 < 1.6	3 < 10	1% < 2.5%	0.5% < 1%
Very Attractive	Rising EE	Top Quintile	> 10%	0 < 1.1	0 < 3	<1%	< 0.5%

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### How New Constructs Creates Value for Clients

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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***

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