Stock Picking Grades for Telecom Services Sector Fund Managers

This report shows how well Telecom Services 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 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 21 out of the 138 stocks (over 22% of the market value) in Telecom Services ETFs and mutual funds get an Attractive-or-better rating.

The main takeaway from Figure 1 is that ETF providers and mutual fund managers actually have a few quality stocks to choose from. Unfortunately, Telecom ETFs and mutual fund managers have done a poor job picking stocks and have allocated too heavily to the worst stocks in the sector.

Zero out of 6 ETFs allocate enough to quality stocks to earn an Attractive-or-better Portfolio Management Rating. Mutual fund managers have not fared much better as 0 out of 13 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.

While investors have relatively little choice when it comes to the quality of Telecom sector ETFs, it is still concerning to see 90% of investor assets in Telecom ETFs invested in the five ETFs with Dangerous-or-worse Portfolio Management Ratings. Investors are allocating to the worst ETFs in the sector. The landscape is even worse for mutual fund investors due to the fact that there are no mutual funds that even receive a Neutral Portfolio Management rating. Consequently, 100% of investor assets are allocated to mutual funds with Dangerous-or-worse Portfolio Management Ratings.

Investors in this sector would be better served buying a basket of Attractive-or-better rated stocks rather than paying fees to funds with poor holdings.

Figure 1: Telecom Services Sector: Comparing Quality of Stock Picking to Quality of Stocks Available

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of Stocks	5	16	27	73	17
% of Sector	1%	21%	29%	36%	14%
# of ETFs	0	0	1	5	0
% of ETFs	0%	0%	17%	83%	0%
% of TNA	0%	0%	10%	90%	0%
# of MFs	0	0	0	13	0
% of MFs	0%	0%	0%	100%	0%
% of TNA	0%	0%	0%	100%	0%

Sources: New Constructs, LLC and company filings

PowerShares Dynamic Media ETF (PBS) has the highest Portfolio Management Rating of all Telecom Services ETFs and earns my Neutral Portfolio Management Rating. PFS Wireless Fund (WIREX) has the highest Portfolio Management Rating of all Telecom Services mutual funds and earns my Dangerous Portfolio Management Rating.

Fidelity MSCI Telecom Services ETF (FCOM) has the lowest Portfolio Management Rating of all Telecom Services ETFs and earns my Dangerous Portfolio Management Rating. Vanguard Telecommunication Services Index Fund (VTCAX) has the lowest Portfolio Management Rating of all Telecom Services mutual funds and earns my Dangerous Portfolio Management Rating.

Verizon (VZ) is one of my favorite stocks held by WIREX and gets my Attractive rating. Over the past five years, Verizon has grown after-tax profit (NOPAT) by 10% compounded annually. Over the same timeframe, Verizon has increased its return on invested capital (ROIC) from 6% in 2008 to 9% in 2013. Verizon's stock price has not caught up with the company's fundamentals, which creates a good opportunity to buy a quality company at a great price. At its current price of ~$48/share, VZ has a price to economic book value (PEBV) ratio of 1.1. This ratio implies that the market expects Verizon to grow NOPAT by only 10% from current levels for the remaining life of the company. The expectation is rather low given that Verizon has grown NOPAT by 10% a year for half a decade. Investors should look into VZ while it remains this cheap.

TW Telecom (TWTC) is one of my least favorite stocks held by FCOM and earns my Dangerous rating. Since 2010, TW's NOPAT has declined by 1% compounded annually while its ROIC has fallen from 6% to 5%. TW has generated positive economic earnings in only one of the past 16 years. The company's free cash flow (FCF) also steeply declined to -$132 million in 2013. Despite the fundamental issues noted above, TW's stock is pricing formidable profit growth. To justify its current price of ~$37/share, TW must grow NOPAT by 15% compounded annually for the next 22 years. Given TW's inability to grow NOPAT at all over the last four years, it seems unrealistic to expect the company to sustain double-digit NOPAT growth for over two decades.

Many ETF providers and mutual fund managers do a poor job identifying quality stocks. Their funds allocate heavily to overvalued stocks like TW Telecom and don't hold high quality stocks such as Verizon. 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 Telecom Services 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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