New Constructs®
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BEST & WORST FUNDS
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Cheap Funds Dupe Investors – 4Q2014

Fund holdings affect fund performance more than fees or past performance. A cheap fund is not necessarily a good fund. A fund that has done well in the past is not likely to do well in the future (e.g. 5-star kiss of death and active management has long history of underperformance). Yet, traditional fund research focuses only on low fees and past performance. Our research on holdings enables you to find funds with high quality holdings - AND - low fees.

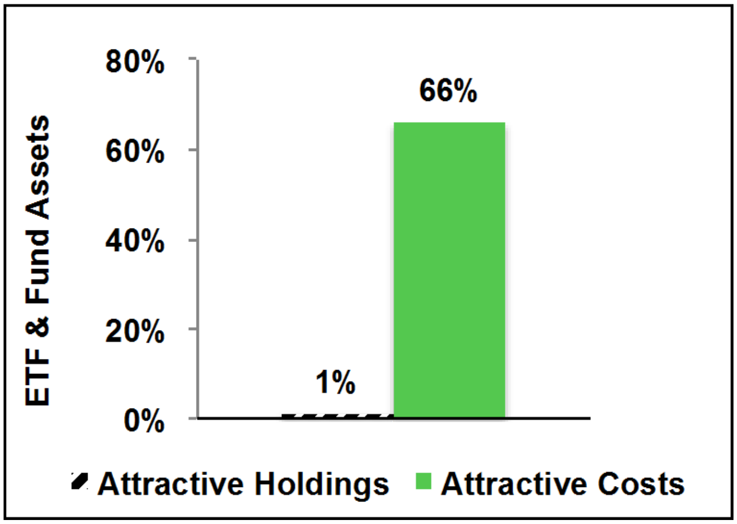
Finding Cheap Funds is Easy, but Finding Good Holdings is Not

Investors are good at picking cheap funds. We want them to be better at picking funds with good stocks. Both are required to maximize success.

We make this easy with our predictive fund ratings. A fund's predictive rating is based on its holdings and its total costs, and how it ranks when compared to the rest of the 7000+ ETFs and mutual funds we cover.

Figure 1 shows that 66% of fund assets are in ETFs and mutual funds with low costs but only 1% of assets are in ETFs and mutual funds with Attractive holdings. This discrepancy is astounding.

Figure 1: Allocation of Fund Assets By Holdings Quality and By Costs



Sources: New Constructs, LLC and company filings

Who is to Blame?

Two key shortcomings in the ETF and mutual fund industry cause this large discrepancy:

1. A lack of research into the quality of holdings.
    - Not enough research focuses on the quality of Portfolio Management of funds
2. A lack of high-quality holdings or good stocks.
    - With about twice as many funds as stocks in the market, there simply are not enough good stocks to fill all the funds.

These shortcomings are related. If you had more insight into the quality of funds' holdings, I think you would allocate a lot less money to funds with poor quality holdings. Many funds would cease to exist. However, research on the quality of holdings is almost non-existent.

How Bad is the Problem?

Figure 2 shows investors are not putting enough money into ETFs and mutual funds with high-quality holdings. Only 78 of 7674 (1% of assets) ETFs and mutual funds allocate a significant amount of value to quality holdings. 99% of assets are in funds that do not justify their costs and over charge you for poor portfolio management.

Figure 2: Distribution of ETFs & Mutual Funds (Count & Assets) By Portfolio Management Rating

	Attractive-or-better	Neutral	Dangerous-or-worse
# of ETFs & Funds	78	3899	3697
% of Assets	1%	66%	33%

Source: New Constructs, LLC and company filings

Figure 3 shows that Investors successfully find low-cost funds. 66% of assets are held in ETFs and mutual funds that have Attractive-or-better rated Total Annual Costs, my apples-to-apples measure of the all-in cost of investing in any given fund.

Figure 3: Distribution of ETFs & Mutual Funds (Count & Assets) By Total Annual Costs Ratings

	Attractive-or-better	Neutral	Dangerous-or-worse
# of ETFs & Funds	1515	3124	3035
% of Assets	66%	18%	16%

Source: New Constructs, LLC and company filings

Clearly, ETF and mutual funds investors are smart shoppers when it comes to finding cheap investments. But as we've discussed, cheap is not necessarily good. State Street SPDR S&P Biotech ETF (XBI) gets an overall predictive rating of Very Dangerous because no matter how low its fees (0.39%), I expect it to underperform because it holds too many Dangerous-or-worse rated stocks.

Investors should allocate their capital to funds with both high-quality holdings and low costs because those are the funds that offer investors the best performance potential.

But they do not. Not even close.

Figure 4 shows that 53% of ETF and mutual fund assets are allocated to funds with low costs and high-quality holdings according to my Predictive Fund Ratings, which are based on the quality of holdings and the all-in costs to investors.

Figure 4: Distribution of ETFs & Mutual Funds (Count & Assets) By Predictive Ratings

	Attractive-or-better	Neutral	Dangerous-or-worse
# of ETFs & Funds	2291	3091	2292
% of Assets	53%	34%	13%

Source: New Constructs, LLC and company filings

You deserve forward-looking ETF and mutual fund research that assesses both costs and quality of holdings. For example, Fidelity Spartan Total Market Index Fund (FFSMX) has both low costs and quality holdings.

Lack of Holdings Research Picks Investors Pocketbooks

Why is the most popular fund rating system based on backward-looking past performance? I do not know, but I do know that the lack of transparency into the quality of portfolio management provides cover for the ETF and mutual fund industry to continue to over charge you for poor portfolio management.

John Bogle is correct — investors should not pay high fees for active portfolio management. His index funds have provided investors with many low-cost alternatives to actively managed funds. However, by focusing entirely on costs, he overlooks the primary driver of fund performance: the stocks held by funds.

Research on the quality of portfolio management of funds empower empowers you to make better investment decisions. You should no longer pay for poor portfolio management.

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

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1. **Superior Recommendations** – Our stock picks consistently outperform. See our track record in our stock-picking accolades and Proof Is In Performance reports.
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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.

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