How To Avoid the Worst Sector ETFs

Question: Why are there so many ETFs?

Answer: ETF providers tend to make lots of money on each ETF so they create more products to sell.

The large number of ETFs has little to do with serving your best interests. Below are three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the ETF and larger bid-ask spreads.

2. High Fees

ETFs should be cheap, but not all of them are. The first step here is to know what is cheap and expensive.

To ensure you are paying at or below average fees, invest only in ETFs with total annual costs below 0.54%, which is the average total annual cost of the 187 U.S. equity Sector ETFs we cover.

Figure 1 shows the most and least expensive Sector ETFs. ProShares provides three of the most expensive ETFs while Vanguard ETFs are among the cheapest.

Figure 1: 5 Least and Most-Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
KBWD	PowerShares KBW High End Dividend Yield ETF	Financials	1.73%
DIG	ProShares Ultra Oil & Gas ETF	Energy	1.05%
GASL	Direxion Daily Natural Gas Related Bull 3x Shares ETF	Energy	1.05%
UYM	ProShares Ultra Basic Materials ETF	Materials	1.05%
UXI	ProShares Ultra Industrials ETF	Industrials	1.05%
	Least Expensive		
SCHH	Schwab U.S. REIT ETF	Financials	0.08%
VNQ	Vanguard REIT Sector ETF	Financials	0.11%
VDE	Vanguard Energy Sector ETF	Energy	0.13%
FENY	Fidelity MSCI Energy Index ETF	Energy	0.13%
FMAT	Fidelity MSCI Materials Index ETF	Materials	0.13%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. State Street SPDR Consumer Staples Select Sector ETF (XLP) earns our Very Attractive rating and has low total annual costs of only 0.17%.

On the other hand, Schwab U.S. REIT ETF (SCHH) holds poor stocks. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad ETFs, but it is also the most important because an ETF's performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each sector with the worst holdings or portfolio management ratings.

Figure 2: Sector ETFs with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
ITB	iShares Dow Jones U.S. Home Construction	Consumer Discretionary	Dangerous
PSCC	PowerShares S&P SmallCap Consumer Staples	Consumer Staples	Dangerous
GASL	Direxion Daily Natural Gas Related Bull 3x	Energy	Dangerous
ROOF	IndexIQ US Real Estate Small Cap	Financials	Dangerous
BBP	BioShares Biotechnology Products	Health Care	Dangerous
FIW	First Trust ISE Water	Industrials	Dangerous
ARKW	Ark Web x.0	Information Technology	Dangerous
SLX	Van Eck Market Vectors Steel	Materials	Dangerous
LTL	ProShares Ultra Telecommunications	Telecom Services	Dangerous
PSCU	PowerShares S&P SmallCap Utilities	Utilities	Dangerous

Sources: New Constructs, LLC and company filings

PowerShares appears more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

Our overall ratings on ETFs are based primarily on our stock ratings of their holdings.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF's performance is only as good as its holdings' performance.

PERFORMANCE OF ETF's HOLDINGS = PERFORMANCE OF ETF

Disclosure: David Trainer and Max Lee receive no compensation to write about any specific stock, sector, or theme.

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