



Mutual Fund Ratings: The Best Approach

We came across a MarketWatch.com [article recently](#) that posed the question “Why won’t your mutual fund tell you what it owns?” This article raises some very good questions, not only about mutual fund reporting, but also the manner in which investors should analyze mutual funds.

The article points out that investors too often overlook the most important driver of mutual fund performance: the holdings. It’s time to set the record straight on mutual fund ratings. It’s long overdue that investors receive mutual fund research that gets to the bottom of the true drivers of mutual fund performance.

Performance Driver #1: Quality of a Fund’s Holdings

The first and most important driver of mutual fund’s performance is the quality of its holdings. Backward-looking technical measures are helpful, but we think investors deserve more.

PERFORMANCE OF MUTUAL FUND’S HOLDINGS = PERFORMANCE OF MUTUAL FUND

This fundamental fact is why New Constructs rates nearly 7000 mutual funds, not by past performance or manager’s tenure, but by the ratings of their holdings. We aggregate our models on the fund’s holdings to provide the same earnings quality and valuation analysis of funds that we provide on the 3000+ individual stocks we cover.

For example, one of our highest rated Large Cap Growth funds, White Oak Select Growth Fund (WOGSX) allocates 56% of its assets to Attractive or better rated stocks and only 14% to Dangerous or worse rated stocks. This transparency allows investors to know exactly what they’re buying into when investing in a mutual fund.

Figure 1: WOGSX Stock Allocations vs. Benchmark



Sources: New Constructs, LLC and company filings

Performance Driver #2: Expense of a Fund

The next driver, and second aspect of our mutual fund ratings, is costs. Expense ratios often misrepresent the true costs of investing in a fund because they are only one, often the smallest, part of the costs investors incur. This misrepresentation is why New Constructs looks at [total annual costs](#), the true total cost of being in a particular fund over a 3-year holding period. Our research reveals that expense ratios can sometimes understate fund costs by as much as 5.75 percentage points as in the case of our most expensive mutual fund, Rydex Series Real Estate Fund (RYREX), which receives our Very Dangerous rating. RYREX’s 7.85% total annual costs are well above its stated expense ratio of 1.65%. In addition, RYREX’s total annual costs include over 4% in transaction costs, based on the fund’s 600% turnover.

A Better Rating System

After rating a fund’s holdings and determining its total annual costs, we assign a fund an overall rating from Very Dangerous to Very Attractive. The top ranked funds not only allocate to quality stocks, but also charge



competitive fees. On the other hand, the worst ranked funds not only allocate to bad stocks, but also overcharge investors in the process.

As we know, [past performance in no indicator of future success](#) so why should mutual fund research focus so heavily on past performance? In addition, [less than 1% of managers actually deliver alpha](#) so why should investors put a large focus on the manager of the fund? The answers to these questions are clear. Investors need to look past traditional fund research, and seek out ratings based upon the two main drivers of fund performance: fund holdings and fund expenses.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, 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 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.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.