# **MUTUAL FUND RESEARCH**

6/11/15

# **Mutual Fund Ratings: The Best Approach**

We came across a MarketWatch.com <u>article recently</u> 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.

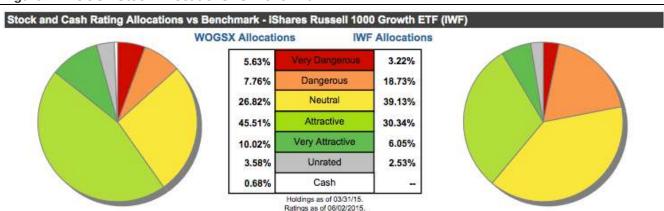


Figure 1: WOGSX Stock Allocations vs. Benchmark

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



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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, <u>past performance in no indicator of future success</u> so why should mutual fund research focus so heavily on past performance? In addition, <u>less than 1% of managers actually deliver alpha</u> 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.



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## New Constructs® - Profile

### How New Constructs Creates Value for Clients

- 1. **Superior Recommendations** Our <u>stock picks</u> consistently outperform. See our track record in our <u>stock-picking accolades</u> and <u>Proof Is In Performance</u> reports.
- 2. **More Accurate Research** Our <u>patented Research Platform</u> for <u>reversing accounting</u> <u>distortions</u> and <u>discounted cash flow analysis</u> 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 <u>Barron's</u>, our expertise in analyzing SEC filings delivers <u>Hidden Gems and Red Flags</u> 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 <u>Corporate Disclosure Transgressions</u> 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 <u>presentation to the Senate Banking Committee</u>, 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.



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