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Cheap Funds Dupe Investors – 3Q15

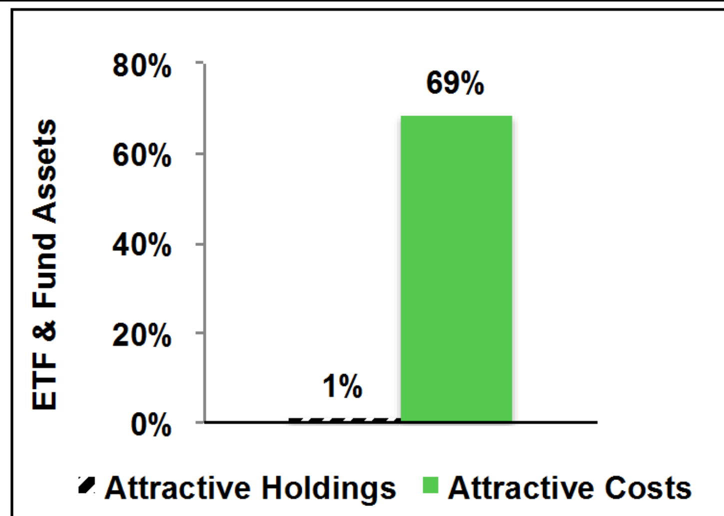
Fund holdings affect fund performance more than fees or past performance. A cheap fund is not necessarily a good fund. A fund that has done well in the past is not likely to do well in the future (e.g. 5-star kiss of death and active management has long history of underperformance). Yet, traditional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

Our research on holdings enables investors to find funds with high quality holdings - AND - low fees.

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, 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 69% 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

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 investors had more insight into the quality of funds' holdings, we think they would allocate a lot less money to funds with poor quality holdings. Many funds would cease to exist.

Investors deserve research on the quality of stocks held by ETFs and mutual funds.

Quality of holdings is the single most important factor in determining an ETF or mutual fund's future performance. No matter how low the costs, if the ETF or mutual fund holds bad stocks, performance will be poor. Costs are easy to find but research on the quality of holdings is almost non-existent.

Figure 2 shows investors are not putting enough money into ETFs and mutual funds with high-quality holdings. Only 87 of 7098 (1% of assets) of 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 investors 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	87	4164	2847
% of Assets	1%	76%	23%

Source: New Constructs, LLC and company filings

Figure 3 shows that investors successfully find low-cost funds. 69% of assets are held in ETFs and mutual funds that have Attractive-or-better rated total annual costs, our apples-to-apples measure of the all-in cost of investing in any given fund.

Out of the 7098 ETFs and mutual funds we cover, 1550 (69% of all assets) earn an Attractive-or-better total annual costs rating.

Clearly, ETF and mutual funds investors are smart shoppers when it comes to finding cheap investments. But cheap is not necessarily good.

State Street SPDR S&P Oil & Gas Exploration & Production (XOP) gets an overall predictive rating of Very Dangerous because no matter how low its fees (0.39%), we expect it to underperform because it holds too many Dangerous-or-worse rated stocks. Low fees cannot boost fund performance. Only good stocks can boost performance.

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

	Attractive-or-better	Neutral	Dangerous-or-worse
# of ETFs & Funds	1550	2903	2645
% of Assets	69%	16%	15%

Source: New Constructs, LLC and company filings

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 54% of ETF and mutual fund assets are allocated to funds with low costs and high-quality holdings according to our 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	2121	2846	2131
% of Assets	54%	32%	14%

Source: New Constructs, LLC and company filings

Investors deserve forward-looking ETF and mutual fund research that assesses both costs and quality of holdings. For example, Vanguard Dividend Appreciation Index Fund (VDADX) has both lows costs and quality holdings.

Why is the most popular fund rating system based on backward-looking past performance?

We do not know, but we 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 overcharge investors for poor portfolio management. How else could they get away with selling so many Dangerous-or-worse rated ETFs and mutual funds?

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. Investors also need to beware certain index label myths.

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

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

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.
Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

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

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