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Danger Zone: Saratoga Advantage Trust: Financial Services Portfolio

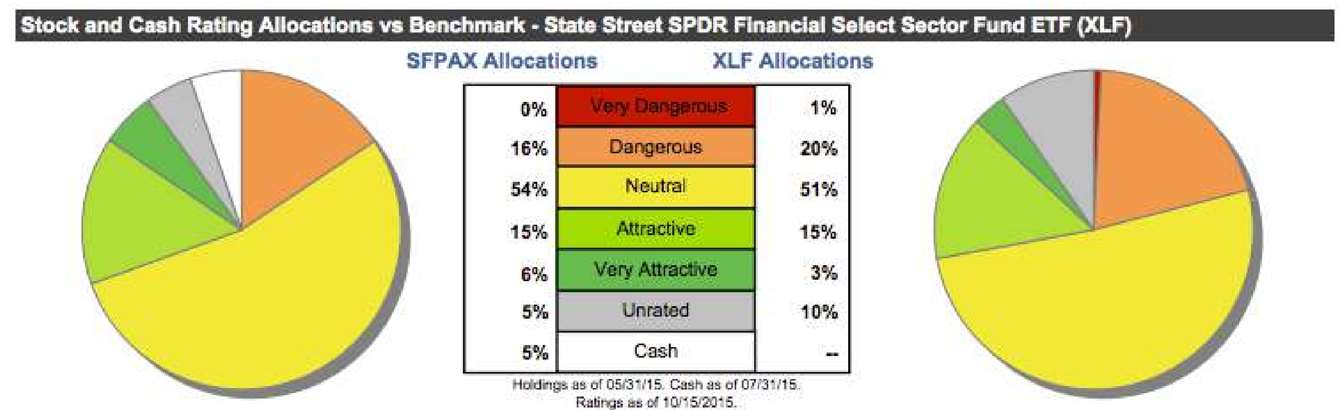
Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and MarketWatch.com.

The only justification for mutual funds to have higher fees than ETFs is "active" management that leads to out-performance. How can you outperform if you do not have meaningfully different holdings than your ETF benchmark? This week, Saratoga Advantage Trust: Financial Services Portfolio (SFPAX, SFPCX, SFPIX) funds are in the Danger Zone due to charging egregiously high fees while closet indexing.

Closet Indexing Makes Outperformance Unlikely

Saratoga Financials Services Portfolio's asset allocation nearly mirrors its benchmark and borders on closet indexing, which makes outperformance unlikely. Of Saratoga Financial Services Portfolio's top 10 holdings, nine are the same as XLF. Those nine stocks represent 40% of Saratoga's assets. Figure 1 has more details on the similarity of the portfolios. The take away is that they are very similar. How can one expect outperformance when you hold mostly the same stocks?

Figure 1: Saratoga Financial Services Portfolio Asset Allocation



Sources: New Constructs, LLC and company filings

The Most Expensive Fund Under Coverage

With total annual costs (TAC) of 7.27%, SFPAX is the most expensive fund out of the 834 sector ETFs and mutual funds under coverage. SFPCX (TAC of 5.70%) and SFPIX (TAC of 4.49%) also rank within the top 25 most expensive sector funds. Further details can be seen in Figure 2. For comparison, the benchmark State Street SPDR Financial Select Sector (XLF) charges total annual costs of 0.17%.

Figure 2: Saratoga Financial Services' Understated Costs

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
SFPAX	7.27%	4.30%	**2.97%**
SFPCX	5.70%	4.89%	**0.81%**
SFPIX	4.49%	3.89%	**0.60%**

Sources: New Constructs, LLC and company filings.

Over a 10-year holding period, the 2.97 percentage point difference between SFPAX's TAC and its reported expense ratio results in 34% less capital in investors' pockets.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

To justify its higher fees, the fund must outperform its benchmark by the following over three years:

1. SFPAX must outperform by 7.1% annually.
2. SFPCX must outperform by 5.52% annually.
3. SFPIX must outperform by 4.32% annually.

The Importance of Proper Due Diligence

One thing we've learned while analyzing tens of thousands of company filings over the past twenty years is never underestimate how wild or bad disclosures may be. As soon as you say, "there's no way a company would do that"…we find a company that has done that. The same is true for mutual funds. Who would imagine that a fund would copy an ETF and try to charge so much more? Fortunately, it appears few investors are falling for this trick, as the fund's AUM is under $5 million.

Without proper analysis of fund holdings, investors might be overpaying or disappointed with performance.

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

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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.

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