ETF & Mutual Fund Rankings: Health Care Sector

The Health Care sector ranks ninth out of the 10 sectors as detailed in our 4Q15 Sector Ratings for ETFs and Mutual Funds report. Last quarter, the Health Care sector ranked fifth. It gets our Dangerous rating, which is based on aggregation of ratings of 23 ETFs and 61 mutual funds in the Health Care sector as of October 6, 2015. See a recap of our 3Q15 Sector Ratings here.

Figures 1 and 2 show the five best and worst-rated ETFs and mutual funds in the sector. Not all Health Care sector ETFs and mutual funds are created the same. The number of holdings varies widely (from 24 to 353). This variation creates drastically different investment implications and, therefore, ratings.

Investors should not buy any Health Care ETFs or mutual funds because none get an Attractive-or-better rating. If you must have exposure to this sector, you should buy a basket of Attractive-or-better rated stocks and avoid paying undeserved fund fees. Active management has a long history of not paying off.

Figure 1: ETFs with the Best & Worst Ratings – Top 5

	Allocation of ETF Holdings			
Ticker	Attractive-or-better Stocks	Neutral Stocks	Dangerous-or-worse Stocks	Predictive Rating
Best ETFs				
IXJ	11%	44%	21%	Neutral
XLV	12%	56%	23%	Neutral
BBH	16%	25%	40%	Neutral
IHF	22%	48%	23%	Neutral
IYH	11%	55%	24%	Neutral
Worst ETFs				
IHE	1%	41%	42%	Very Dangerous
FBT	7%	23%	57%	Very Dangerous
PBE	8%	20%	62%	Very Dangerous
PTH	9%	15%	56%	Very Dangerous
BBP	2%	9%	69%	Very Dangerous

* Best ETFs exclude ETFs with TNAs less than $100 million for inadequate liquidity.

Sources: New Constructs, LLC and company filings

Figure 2: Mutual Funds with the Best & Worst Ratings – Top 5

	Allocation of Mutual Fund Holdings			
Ticker	**Attractive-or-better Stocks**	**Neutral Stocks**	**Dangerous-or-worse Stocks**	**Predictive Rating**
Best Mutual Funds				
FSHCX	19%	49%	27%	**Neutral**
VHCIX	10%	51%	24%	**Neutral**
HGHYX	13%	21%	33%	**Neutral**
HGHIX	13%	21%	33%	**Neutral**
HGHTX	13%	21%	33%	**Neutral**
Worst Mutual Funds				
DLHAX	11%	27%	32%	**Very Dangerous**
RYOAX	8%	20%	48%	**Very Dangerous**
RYCFX	8%	20%	48%	**Very Dangerous**
ICHAX	3%	45%	35%	**Very Dangerous**
RYBOX	8%	20%	48%	**Very Dangerous**

* Best mutual funds exclude funds with TNAs less than $100 million for inadequate liquidity.

Sources: New Constructs, LLC and company filings

Live Oak Health Sciences Fund (LOGSX) and Saratoga Advantage Trust: Health & Biotechnology Portfolio (SBHIX) are excluded from Figure 2 because their total net assets (TNA) are below $100 million and do not meet our liquidity minimums.

iShares S&P Global Healthcare Index Fund ETF (IXJ) is the top-rated Health Care ETF and Fidelity Select Medical Delivery Portfolio (FSHCX) is the top-rated Health Care mutual fund. Both earn a Neutral rating.

BioShares Biotechnology Products (BBP) is the worst-rated Health Care ETF and Rydex Series Biotechnology Fund (RYBOX) is the worst-rated Health Care mutual fund. Both earn a Very Dangerous rating.

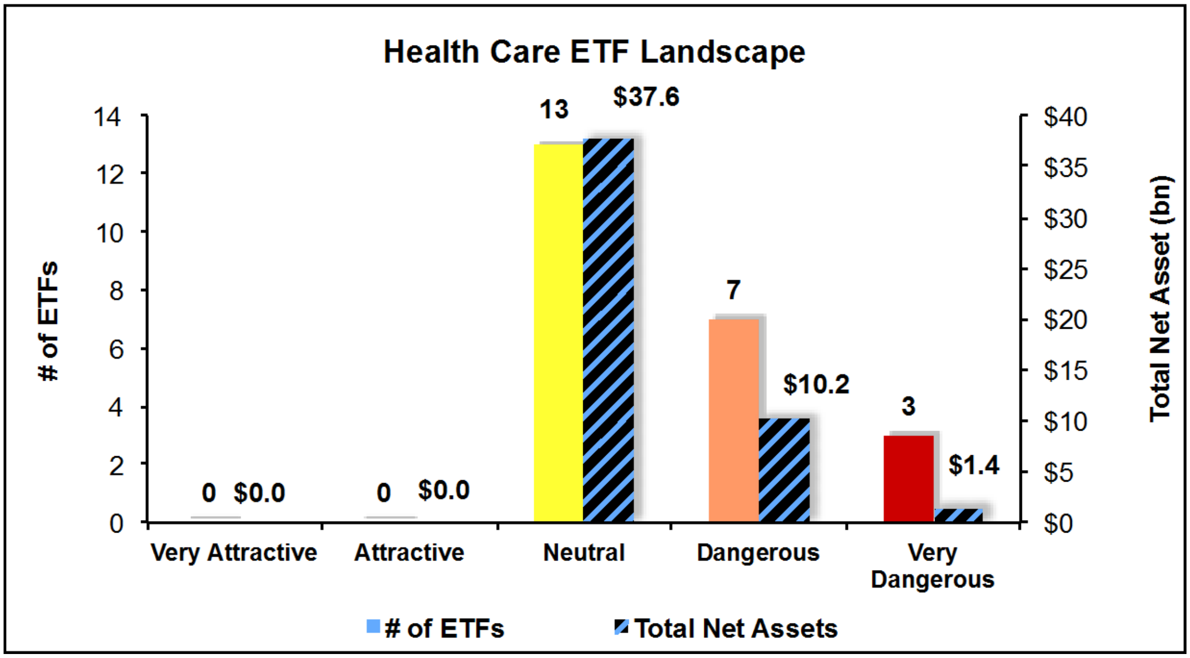
338 stocks of the 3000+ we cover are classified as Health Care stocks.

HCA Holdings (HCA: $79/share) is one of our favorite stocks held by Health Care ETFs and mutual funds and is on October's Most Attractive Stocks list. It earns our Very Attractive rating. Since 2012, HCA has grown after-tax profit (NOPAT) by 5% compounded annually. HCA earns an impressive top-quintile return on invested capital (ROIC) of 15%. This high profitability has allowed HCA to become the largest hospital operator in the world. However, HCA shares are priced as if the company will see a significant decline in profits going forward. At its current price of $79/share, HCA has a price to economic book value (PEBV) ratio of 0.8. This ratio implies that the market expects HCA's NOPAT to permanently decline by 20%, in spite of the profit growth achieved the past four years. If HCA can grow NOPAT by just 5% compounded annually over the next five years, the stock is worth $123/share today – a 56% upside.

Athenahealth (ATHN: $139/share) is one of our least favorite stocks held by Health Care ETFs and mutual funds and was put in the Danger Zone in April 2015. Since 2011, athenahealth's NOPAT has declined by 43% compounded annually. Over the same timeframe, ROIC has fallen from 14% to a bottom quintile 0%. The biggest issue at athenahealth remains its inability to grow the business and rein in costs. However, as we've seen with other Danger Zone companies, investors have overlooked athenahealth's problems by focusing on revenue growth, which has left ATHN overvalued. To justify its current price of $139/share, athenahealth must grow NOPAT 37% compounded annually for the next 23 years. This expectation seems rather optimistic given the sustained profit decline since 2011.

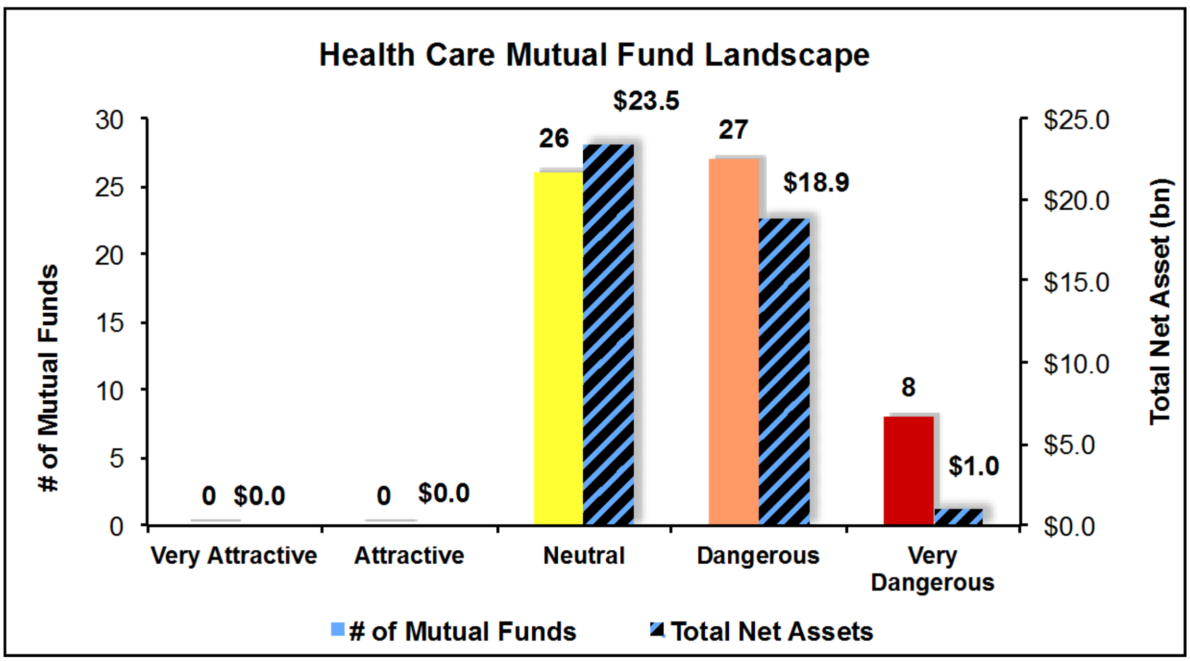
Figures 3 and 4 show the rating landscape of all Health Care ETFs and mutual funds.

Figure 3: Separating the Best ETFs From the Worst ETFs



Sources: New Constructs, LLC and company filings

Figure 4: Separating the Best Mutual Funds From the Worst Mutual Funds



Sources: New Constructs, LLC and company filings

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

New Constructs® – Profile

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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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