How To Avoid the Worst Style ETFs

Question: Why are there so many ETFs?

Answer: ETF providers tend to make lots of money on each ETF so they create more products to sell.

The large number of ETFs has little to do with serving your best interests. Below are three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest issue to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the ETF and larger bid-ask spreads.

2. High Fees

ETFs should be cheap, but not all of them are. The first step here is to know what is cheap and expensive.

To ensure you are paying at or below average fees, invest only in ETFs with total annual costs below 0.45%, which is the average total annual cost of the 281 U.S. equity style ETFs we cover.

Figure 1 shows the most and least expensive Style ETFs. AdvisorShares and ProShares each provide two of the most expensive ETFs while Schwab ETFs are among the cheapest.

Figure 1: 5 Least and Most Expensive Style ETFs

Ticker	Name	Style	Total Annual Cost
Most Expensive			
FWDD	AdvisorShares Madrona Forward Domestic ETF	All Cap Blend	1.39%
TTFS	AdvisorShares TrimTabs Float Shrink ETF	All Cap Blend	1.10%
FLAG	Forensic Accounting ETF	Large Cap Value	1.09%
DDM	ProShares Ultra Dow30 ETF	Large Cap Blend	1.06%
UDOW	ProShares UltraPro Dow30 ETF	Large Cap Blend	1.06%
Least Expensive			
SCHX	Schwab U.S. Large-Cap ETF	Large Cap Blend	0.04%
SCHB	Schwab U.S Broad Market ETF	All Cap Blend	0.04%
VOO	Vanguard S&P 500 ETF	Large Cap Blend	0.06%
VTI	Vanguard Total Stock Market ETF	All Cap Blend	0.06%
SCHD	Schwab U.S. Dividend Equity ETF	Large Cap Value	0.08%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. State Street SPDR Dow Jones Industrial Average ETF (DIA) earns our Very Attractive rating and has low total annual costs of only 0.19%.

On the other hand, Schwab U.S. Mid Cap ETF (SCHM), despite 0.09% total annual costs earns our Neutral rating because it holds poor stocks. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETFs holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoid bad ETFs, but it is also the most important because an ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst holdings or portfolio management ratings. Note there are no All Cap Growth or All Cap Value ETFs under coverage.

Figure 2: Style ETFs with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
RORO	State Street SPDR SSgA Risk Aware ETF	All Cap Blend	Dangerous
ARKK	Ark Innovation ETF	Large Cap Blend	Dangerous
RWG	Columbia RP Focused Large Cap Growth	Large Cap Growth	Dangerous
SPHD	PowerShares S&P 500 High Dividend	Large Cap Value	Dangerous
RSCO	State Street SPDR Russell Small Cap	Mid Cap Blend	Dangerous
VOT	Vanguard Mid-Cap Growth	Mid Cap Growth	Dangerous
PEY	PowerShares Dividend Achievers	Mid Cap Value	Dangerous
SMLV	State Street SPDR Russell 2000 Low Volatility	Small Cap Blend	Dangerous
VBK	Vanguard Small-Cap Growth	Small Cap Growth	Dangerous
SLYV	State Street SPDR S&P 600 Value	Small Cap Value	Dangerous

Sources: New Constructs, LLC and company filings

State Street appears more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

Our overall ratings on ETFs are based primarily on our stock ratings of their holdings.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF's performance is only as good as its holdings' performance. Barron's agrees.

PERFORMANCE OF ETFs HOLDINGs = PERFORMANCE OF ETF

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