How To Avoid the Worst Style Mutual Funds

Question: Why are there so many mutual funds?

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

The large number of mutual funds has little to do with serving investors' best interests. Below are three red flags investors can use to avoid the worst mutual funds:

1. Inadequate Liquidity

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

2. High Fees

Mutual funds 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 mutual funds with total annual costs below 1.92%, which is the average total annual cost of the 5514 U.S. equity style mutual funds we cover.

Figure 1 shows the most and least expensive style mutual funds. Rydex provides four of the most expensive mutual funds while Vanguard mutual funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
Most Expensive			
RYAKX	Rydex Series Russell 2000 1.5x Strategy Fund	All Cap Blend	8.50%
RYCMX	Rydex Series Russell 2000 1.5x Strategy Fund	All Cap Blend	7.49%
RYAHX	Rydex Series Mid-Cap 1.5x Strategy Fund	All Cap Blend	6.81%
RYMKX	Rydex Series Russell 2000 1.5x Strategy Fund	All Cap Blend	6.59%
NWDHX	Nationwide Bailard Cognitive Value Fund	Small Cap Value	6.39%
Least Expensive			
VSMPX	Vanguard Total Stock Market Index Fund	All Cap Blend	0.03%
VIIIX	Vanguard Institutional Index Fund	Large Cap Blend	0.03%
FXAIX	Fidelity Concord Spartan 500 Index Fund	Large Cap Blend	0.03%
VITPX	Vanguard Institutional Total Stock Market Fund	All Cap Blend	0.03%
FFSMX	Fidelity Concord Spartan Total Market Fund	All Cap Blend	0.04%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Calvert Large Cap Portfolio (CMIIX) earns our Very Attractive rating and has low total annual costs of only 1.04%.

On the other hand, Fidelity Salem Street Spartan Mid Cap Index Fund (FSMDX) earns our Neutral rating because it holds poor stocks. No matter how cheap a mutual fund, if it holds bad stocks, its performance will be bad. The quality of a mutual fund's holdings matters more than its price.

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

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad mutual funds, but it is also the most important because a mutual fund's performance is determined more by its holdings than its costs. Figure 2 shows the mutual funds within each style with the worst holdings or portfolio management ratings.

Figure 2: Style Mutual Funds with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
CHOEX	Chou America Opportunity Fund	All Cap Blend	Very Dangerous
MMCGX	Morgan Stanley Institutional Mid Cap Growth	All Cap Growth	Dangerous
PMVYX	Putnam Investment Multi-Cap Value Fund	All Cap Value	Dangerous
LEOIX	Lazard Enhanced Opportunities Portfolio	Large Cap Blend	Very Dangerous
TGCEX	TCW Select Equities Fund	Large Cap Growth	Dangerous
CDVDX	Starboard Investment Cavalier Dividend Income	Large Cap Value	Dangerous
HDPCX	Professionally Managed Hodges Pure Contrarian	Mid Cap Blend	Very Dangerous
WIMGX	Westcore MIDCO Growth Fund	Mid Cap Growth	Dangerous
GOODX	Professionally Managed GoodHaven Fund	Mid Cap Value	Dangerous
ATIIX	AIM Investment Invesco Select Companies Fund	Small Cap Blend	Very Dangerous
WSCRX	Wells Fargo Advantage Small Company Growth	Small Cap Growth	Very Dangerous
ARVIX	Aston/River Road Independent Value Fund	Small Cap Value	Very Dangerous

Sources: New Constructs, LLC and company filings

Professionally Managed Portfolios appears more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

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

The Danger Within

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

PERFORMANCE OF MUTUAL FUND's HOLDINGs = PERFORMANCE OF MUTUAL FUND

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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