New Constructs®
Diligence | Independence | Performance

How Much Quality Is There In The "High Quality" ETF?

During bull markets, investors love to chase risky momentum stocks with questionable fundamentals in pursuit of big returns. When volatility increases and markets decline, on the other hand, investors get spooked and start putting more of their money in investments that are perceived as safer and "higher quality".

With the significant drop in the market to start 2016, we can be sure that many investors are looking to shift their portfolios towards higher quality stocks. The challenge is how to define "high-quality" because it is not as straightforward as one might think.

ETF investors may view the PowerShares S&P 500 High Quality Portfolio (SPHQ) as an appealing option. After all, the words "high quality" are right there in the name. Over the past six months, SPHQ has seen net inflows of $144 million, nearly triple the cash coming in to the similarly sized S&P 500 Growth ETF (SPYG).

However, investors that truly want to invest in quality stocks need to dig a little deeper. While SPHQ does a better-than-average job of selecting stocks with strong fundamentals, its flawed methodology means investors are getting exposure to some companies with significant weakness in their underlying business.

Accounting Earnings Are Unreliable

SPHQ tracks the S&P 500 High Quality Rankings Index, which, according to its website, "includes companies rated A- or above based on per-share earnings and dividend payout records for the past 10 years."

As we've written about many times before, reported earnings and dividends are not reliable indicators of the underlying quality of a business. High dividend paying stocks can end up being dividend traps, and flawed accounting rules mean that EPS growth has almost no correlation with value creation.

Identifying fundamentally sound companies requires more work than just looking at EPS and dividends. SPHQ's overly simplistic methods allow for some distinctly low quality businesses to find their way into this ETF.

Low Quality Businesses In A High Quality ETF

The ultimate marker of a high quality business is earning a return on invested capital (ROIC) above its weighted average cost of capital (WACC). These excess returns drive economic earnings, a far truer measure of profits for equity investors.

Figure 1 shows the nine companies in SPHQ that fail this very basic test, having earned negative economic earnings in each of the past five years.

Figure 1: SPHQ Stocks With Low-Quality Businesses

Name	Ticker	ROIC	Economic Earnings 2015 ($mm)	Overall Rating
General Electric	GE	7.1%	($2,314)	Dangerous
American Electric Power	AEP	3.7%	($1,118)	Dangerous
Entergy Corp	ETR	3.8%	($981)	Neutral
Xcel Energy	XEL	3.4%	($500)	Dangerous
NextEra Energy	NEE	4.7%	($398)	Dangerous
Welltower	HCN	3.9%	($263)	Dangerous
DTE Energy	DTE	4.3%	($220)	Dangerous
Kimco Realty	KIM	4.2%	($200)	Very Dangerous
Mckesson Corp	MCK	6.4%	($123)	Neutral

Sources: New Constructs, LLC and company filings.

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

General Electric (GE) stands out at the top of Figure 1. The industrial conglomerate has not turned an economic profit since 2006, and its balance sheet is not as strong as it first appears either. $3.5 billion in off-balance sheet debt due to operating leases add to the company's liabilities.

GE has a reputation as a stable business, and the massive sale of GE Capital provides cash to continue serving its 3.2% dividend for many years because the rest of the business is not making money. The firm's dismal economic earnings prove the underlying business is not nearly as strong as it once was, and the stock's 8% drop so far this year shows it's far from safe in a bad market.

Utilities make up a good portion of Figure 1, unsurprising for a sector that consistently is near the bottom of our sector ratings. Xcel Energy (XEL) is one of the worst, as it has failed to earn an ROIC above 4% going all the way back to 2002.

Even worse, the company has only recorded positive free cash flow once in the past decade. It funds its dividend through taking on more long-term debt, which has ballooned from $7 billion to $17 billion in the past decade. Over $2 billion of that debt is hidden off the balance sheet.

Accounting earnings would suggest that XEL is improving, with EPS improving by 6% in the last fiscal year. However, that improvement is almost entirely due to changes in non-operating pension costs, due in part to the company increasing its expected return on plan assets. When we strip out these non-operating items, we see that the company's true after-tax operating profit (NOPAT) declined by 3%.

Investors in SPHQ might be surprised to learn that they hold a stake in a company with such a poor track record of destroying shareholder value.

Economic Earnings Matter Most In A Tough Market

When markets get shaky, it's not the companies with EPS growth that weather the storm, it's those that deliver solid economic earnings. Just look at the crash of 2008. The only stocks that delivered solid returns to investors while the market crashed were those that earned a high ROIC. That is the pattern investors should follow for long-term success in the market.

SPHQ is better than a lot of other ETFs out there, and over 75% of its holdings earn out Neutral-or-better rating. Still, its "high-quality" moniker, combined with the lack of diligence involved in selecting its holdings, may mislead some investors.

Surviving a market crash is hard. You can't just trust an ETF's label and hope your investments will be safe. It takes real diligence and discipline to reveal the true quality of a company's earnings and measure the strength of its underlying business.

We will be the first to tell you that good fundamental research is rare, time-consuming, and expensive. As a result, by the time many investors realize they need fundamental research, it's too late. Their portfolios have been crushed.

We think the recent decline in liquidity is going to lead the market to recognize the true, long-term fundamentals of lots of stocks, a trend that began in 2015 and led to significant outperformance by our Most Dangerous Stocks newsletter as well as many of our Danger Zone picks in 2015. Less liquidity means more natural price discovery, something many experts have warned has been missing for too long. Those same experts have noted that when natural price discovery came back, it could do so with a vengeance. Markets could be volatile for a while. Be prepared.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, 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 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

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.