How To Avoid the Worst Sector 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 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 average or below average fees, invest only in ETFs with total annual costs below 0.49%, which is the average total annual costs of the 178 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.27%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 EcoLogical Strategy ETF (HECO) is the most expensive sector ETF and Vanguard Financials Index Fund (VFH) is the least expensive. PowerShares (PXQ and PEJ) provides two of the most expensive ETFs while Vanguard ETFs (VFH, VGT, and VDC) are among the cheapest.

Figure 1: 5 Least and Most Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
HECO	EcoLogical Strategy ETF	Industrials	1.06%
PXQ	PowerShares Dynamic Networking Portfolio	Information Technology	0.70%
PEJ	PowerShares Dynamic Leisure & Entertainment	Consumer Discretionary	0.70%
JETS	U.S. Global Jets	Industrials	0.66%
QTEC	First Trust NASDAQ-100 Technology Sector	Information Technology	0.66%
Least Expensive			
VFH	Vanguard Financials Index Fund	Financials	0.11%
VGT	Vanguard Information Technology Index Fund	Information Technology	0.11%
VDC	Vanguard Consumer Staples Index Fund	Consumer Staples	0.11%
FNCL	Fidelity MSCI Financials Index	Financials	0.13%
FTEC	Fidelity MSCI Information Technology Index	Information Technology	0.13%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. iShares U.S. Financial Services (IYG) earns our Very Attractive rating and has low total annual costs of only 0.48%.

On the other hand, Vanguard Utilities Index Fund (VPU) holds poor stocks yet has low total annual costs of 0.11%. 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 avoiding bad ETFs, but it is also the most important because an ETF's performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each sector with the worst holdings or portfolio management ratings.

Figure 2: Sector ETFs with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
XRT	SPDR S&P Retail ETF	Consumer Discretionary	Dangerous
PSCC	PowerShares S&P Small Cap Consumer Staples	Consumer Staples	Neutral
VDE	Vanguard Energy Index Fund	Energy	Dangerous
FTY	iShares Real Estate 50 ETF	Financials	Dangerous
BBP	BioShares Biotechnology Products Fund	Health Care	Dangerous
EVX	VanEck Vectors Environmental Services	Industrials	Dangerous
FDN	First Trust Dow Jones Internet Index Fund	Information Technology	Dangerous
XME	SPDR S&P Metals & Mining ETF	Materials	Dangerous
IYZ	iShares U.S. Telecommunications ETF	Telecom Services	Dangerous
VPU	Vanguard Utilities Index Fund	Utilities	Dangerous

Sources: New Constructs, LLC and company filings

Vanguard (VPU and VDE) and iShares (FTY and IYZ) appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

BioShares Biotechnology Products (BBP) is the worst rated ETF in Figure 2. First Trust Dow Jones Internet Index (FDN) also earn a Very Dangerous predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

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. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF ETFs HOLDINGs = PERFORMANCE OF ETF

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