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 average or below average fees, invest only in mutual funds with total annual costs below 1.93%, which is the average total annual cost of the 6089 U.S. equity Style mutual funds we cover. The weighted average is lower at 1.26%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows that Calvert U.S. Large Cap Growth Responsible Index (CGJYX) is the most expensive style mutual fund and Vanguard Total Stock Market Index (VSMPX) is the least expensive. American Growth Fund (AMREX, AMRHX, and AMRAX) provides three of the most expensive mutual funds while Vanguard mutual fund (VSMPX, VIIIX, and VITPX) are among the cheapest.

Figure 1: 5 Least and Most Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
Most Expensive			
CGJYX	Calvert U.S. Large Cap Growth Responsible Index	Large Cap Growth	11.78%
AMREX	American Growth Fund Series Two	All Cap Growth	10.47%
AMRHX	American Growth Fund Series Two	All Cap Growth	9.01%
RYAKX	Rydex Russell 2000 1.5x Strategy	All Cap Blend	8.50%
AMRAX	American Growth Fund Series Two	All Cap Blend	8.48%
Least Expensive			
VSMPX	Vanguard Total Stock Market Index	All Cap Blend	0.03%
VIIIX	Vanguard Institutional Index	Large Cap Blend	0.03%
FXAIX	Fidelity Spartan 500 Index	Large Cap Blend	0.03%
VITPX	Vanguard Institutional Total Stock Market	All Cap Blend	0.04%
FFSMX	Fidelity Spartan Total Market Index	All Cap Blend	0.04%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Smead Value Fund (SVFYX) earns our Very Attractive rating and has low total annual costs of only 0.97%.

On the other hand, Vanguard Extended Market Index Fund (VEMPX) holds poor stocks yet has low total annual costs of 0.08%. 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.

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
COREX	Avondale Core Investment Fund	All Cap Blend	Very Dangerous
KAUFX	Federated Kaufmann Fund	All Cap Growth	Very Dangerous
SMVZX	RidgeWorth Mid-Cap Value	All Cap Value	Dangerous
MFOMX	BNY Mellon Focused Equity Opportunities	Large Cap Blend	Dangerous
CCWRX	Columbia Select Large Cap Growth	Large Cap Growth	Dangerous
SIMFX	Sims Total Return Fund	Large Cap Value	Very Dangerous
HDPCX	Hodges Pure Contrarian Fund	Mid Cap Blend	Dangerous
TGDNX	TCW Growth Equities Fund	Mid Cap Growth	Dangerous
DEFIX	Tocqueville Trust Delafield Fund	Mid Cap Value	Dangerous
RYRHX	Rydex Russell 2000 Fund	Small Cap Blend	Very Dangerous
PUMYX	PACE Small/Medium Growth Equity Investments	Small Cap Growth	Very Dangerous
ARSBX	Aristotle Small Cap Equity	Small Cap Value	Dangerous

Sources: New Constructs, LLC and company filings

No one provider appears more often than any other providers in Figure 2.

Sims Total Return Fund (SIMFX) is the worst rated mutual fund in Figure 2. Seven other mutual funds (HDPCX, COREX, RYRHX, TDGNX, PUMYX, DEFIX, and KAUFX) also earn a Very Dangerous predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs too.

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

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.

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