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 1.9%, which is the average total annual cost of the 6,225 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 ETFs with low fees.

Figure 1 shows Aberdeen US Mid Cap Equity Fund (GUEAX) is the most expensive style mutual fund and Vanguard Total Stock Market Index Fund (VSTSX) is the least expensive. American Growth Mutual Funds (AMREX, AMRHX, AMRAX) provide three of the most expensive mutual funds while Fidelity (FFSMX, FSKAX, FXAIX) mutual funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
Most Expensive			
GUEAX	Aberdeen US Mid Cap Equity Fund	Mid Cap Blend	16.63%
CGJYX	Calvert US Large Cap Growth Responsible IDX	All 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%
AMRAX	American Growth Fund Series One	All Cap Blend	8.48%
Least Expensive			
VSTSX	Vanguard Total Stock Market Index Fund	All Cap Blend	0.02%
FFSMX	Fidelity Total Market Index Fund	All Cap Blend	0.02%
FSKAX	Fidelity Total Market Index Fund	All Cap Blend	0.02%
FXAIX	Fidelity 500 Index Fund	Large Cap Blend	0.03%
VSMPX	Vanguard Total Stock Market Index Fund	All Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Nuveen Concentrated Core Fund (NCARX) earns our Very Attractive rating and has low total annual costs of only 0.99%.

On the other hand, Vanguard Capital Value Fund (VCVLX) holds poor stocks and receives our Very Dangerous rating, yet has low total annual costs of 0.74%. 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
STMIX	Steinberg Select Fund	All Cap Growth	Dangerous
AMDVX	American Mid Cap Value Fund	All Cap Value	Dangerous
MFOMX	BNY Melon Focused Equity Opportunities Fund	Large Cap Blend	Dangerous
PCLCX	PACE Large Co Growth Equity Investments	Large Cap Growth	Dangerous
GHTIX	Good Harbor Tactical Equity Income Fund	Large Cap Value	Dangerous
LLSCX	Longleaf Partners Small-Cap Fund	Mid Cap Blend	Dangerous
MDOIX	Dynamic Opportunities Series	Mid Cap Growth	Dangerous
HWMIX	Hotchkins & Wiley Mid-Cap Value Fund	Mid Cap Value	Dangerous
RYRHX	Rydex Russell 2000 Fund	Small Cap Blend	Very Dangerous
PCSGX	PACE Small/Medium Growth Equity Investments	Small Cap Growth	Very Dangerous
ICMZX	Intrepid Endurance Fund	Small Cap Value	Very Dangerous

Sources: New Constructs, LLC and company filings

PACE (PCLCX and PCSGX) appears more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Hotchkins & Wiley Mid Cap Value Fund (HWMIX) is the worst rated mutual fund in Figure 2. Eight other mutual funds (COREX, HWMIX, ICMZX, LLSCX, MDOIX, PCLCX, RYRHX, and STMIX) 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 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

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Disclosure: David Trainer and Kyle Martone 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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