How To Find the Best Sector ETFs

Finding the best ETFs is an increasingly difficult task in a world with so many to choose from. How can you pick with so many choices available?

Don't Trust ETF Labels

There are at least 38 different Financials ETFs and at least 178 ETFs across ten sectors. Do investors need 17+ choices on average per sector? How different can the ETFs be?

Those 38 Financials ETFs are very different. With anywhere from 24 to 573 holdings, many of these Financials ETFs have drastically different portfolios, creating drastically different investment implications.

The same is true for the ETFs in any other sector, as each offers a very different mix of good and bad stocks. Consumer Staples rank first for stock selection. Utilities ranks last. Details on the Best & Worst ETFs in each sector are here.

Paralysis By Analysis

We think the large number of Financials (or any other) sector ETFs hurts investors more than it helps because too many options can be paralyzing. It is simply not possible for the majority of investors to properly assess the quality of so many ETFs. Analyzing ETFs, done with the proper diligence, is far more difficult than analyzing stocks because it means analyzing all the stocks within each ETF. As stated above, that can be as many as 573 stocks, and sometimes even more, for one ETF.

Any investor focused on fulfilling fiduciary duties recognizes that analyzing the holdings of an ETF is critical to finding the best ETF. Figure 1 shows our top rated ETF for each sector.

Figure 1: The Best ETF in Each Sector

Ticker	Name	Sector	Assets ($mm)
PEZ	PowerShares DWA Consumer Cyclicals Momentum	Consumer Discretionary	$54
XLP	State Street Consumer Staples Select Sector SPDR	Consumer Staples	$9,380
PXJ	PowerShares Dynamic Oil & Gas Services	Energy	$39
IYG	iShares U.S. Financial Services	Financials	$587
IXJ	iShares Global Healthcare	Health Care	$1,718
JETS	ETF Series Solutions: U.S. Global Jets	Industrials	$44
PXQ	PowerShares Dynamic Networking Portfolio	Information Technology	$20
XLB	State Street Materials Select Sector SPDR	Materials	$2,661
IGN	iShares North American Tech-Multimedia Networking	Telecom Services	$49
FUTY	Fidelity MSCI Utilities Index	Utilities	$284

Sources: New Constructs, LLC and company filings

Amongst the ETFs in Figure 1, State Street Consumer Staples Select Sector SPDR (XLP) ranks first overall, PowerShares Dynamic Networking Portfolio (PXQ) ranks second, and ETF Series Solutions: U.S. Global Jets (JETS) ranks third. Fidelity MSCI Utilities Index (FUTY) ranks last.

How to Avoid "The Danger Within"

Why do you need to know the holdings of ETFs before you buy?

You need to be sure you do not buy an ETF that might blow up. Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. No matter how cheap, if it holds bad stocks, the ETF's performance will be bad. Don't just take my word for it, see what Barron's says on this matter.

PERFORMANCE OF FUND'S HOLDINGS = PERFORMANCE OF FUND

If Only Investors Could Find Funds Rated by Their Holdings

Our ETF ratings leverage our stock coverage. We rate ETFs based on the aggregated ratings of the stocks each ETF holds.

State Street Consumer Staples Select Sector SPDR (XLP) is not only the top-rated Consumer Staples ETF, but it also the overall best sector ETF out of the 178 sector ETFs that we cover.

The worst ETF in Figure 1 is Fidelity MSCI Utilities Index (FUTY), which gets a Dangerous rating. One would think ETF providers could do better for this sector.

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

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