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ETF RESEARCH
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How To Avoid the Worst Style 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 issue 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 at or below average fees, invest only in ETFs with total annual costs below 0.49%, which is the average total annual cost of the 293 U.S. equity Style ETFs we cover. The weighted average is lower at 0.16%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows ETF Series Solutions AlphaClone ETF (ALFA) is the most expensive style ETF and Schwab US Large-Cap ETF (SCHX) is the least expensive. ETFS Trust (ZSML, ZLRG) provides two of the most expensive ETFs while Schwab (SCHX, SCHB, SCHG) ETFs are among the cheapest.

Figure 1: 5 Least and Most Expensive Style ETFs

Ticker	Name	Style	Total Annual Cost
Most Expensive			
ALFA	ETF Series Solutions AlphaClone ETF	All Cap Blend	2.47%
ZSML	ETFS Zacks Earnings Small Cap Fund	Mid Cap Blend	1.54%
FWDD	AdvisorShares Madrona Domestic ETF	All Cap Blend	1.39%
ZLRG	ETFS Zacks Earnings Large Cap Fund	All Cap Blend	1.38%
FLAG	WeatherStorm Forensic Accounting	All Cap Value	1.28%
Least Expensive			
SCHX	Schwab U.S. Large Cap ETF	Large Cap Blend	0.03%
SCHB	Schwab U.S. Broad Market ETF	All Cap Blend	0.03%
ITOT	iShares Core S&P Total Market ETF	All Cap Blend	0.03%
IVV	iShares Core S&P 500 ETF	Large Cap Blend	0.04%
SCHG	Schwab U.S. Large Cap Growth ETF	Large Cap Growth	0.04%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Schwab U.S. Large Cap ETF (SCHX) earns our Very Attractive rating and has low total annual costs of only 0.03%.

On the other hand, Vanguard Russell 2000 Value Index Fund (VTWV) holds poor stocks and earns our Dangerous rating, yet has low total annual costs of 0.22%. 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.

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

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoid bad ETFs, but it is also the most important because an ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst holdings or portfolio management ratings.

Figure 2: Style ETFs with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
LTL	ProShares Ultra Telecommunications	All Cap Blend	Dangerous
FPX	First Trust Equity Opportunities	All Cap Growth	Dangerous
RPV	Guggenheim S&P 500 Pure Value	All Cap Value	Neutral
EQAL	PowerShares Russell 1000 Equal Weight	Large Cap Blend	Dangerous
MTUM	iShares Edge MSCI USA Momentum Factor	Large Cap Growth	Neutral
VOOV	Vanguard S&P 500 Value Index	Large Cap Value	Neutral
RYJ	Guggenheim Raymond James SB-1 Equity	Mid Cap Blend	Dangerous
DWAQ	PowerShares DWA NASDAQ Momentum	Mid Cap Growth	Dangerous
PXMV	PowerShares Russell Midcap Pure Value	Mid Cap Value	Dangerous
EQWS	PowerShares Russell 2000 Equal Weight	Small Cap Blend	Dangerous
PXSG	PowerShares Russell 2000 Pure Growth	Small Cap Growth	Dangerous
RZV	Guggenheim S&P Small Cap 600 Pure Value	Small Cap Value	Dangerous

Sources: New Constructs, LLC and company filings

PowerShares (EQAL, DWAQ, PXMV, EQWS, PXSG) appears more often than any other provider in Figure 2, which means that they offer the most ETFs with the worst holdings.

ProShares Ultra Telecommunications (LTL) is the worst rated ETF in Figure 2. Guggenheim S&P Small Cap 600 Pure Value (RZV), PowerShares Russell 2000 Equal Weight (EQWS), PowerShares Russell 2000 Pure Growth (PXSG), and Guggenheim Raymond James SB-1 Equity (RYJ) earn a Dangerous predictive overall rating, which means not only do they hold poor stocks, they also 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

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Disclosure: David Trainer, Kyle Guske II, 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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