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 0.48%, which is the average total annual costs of the 177 sector ETFs we cover. The weighted average is lower at 0.26%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows PowerShares KBW High Dividend Yield Financial Portfolio (KBWD) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. ETF Series Trust (UTES, BBP) provides two of the most expensive ETFs while Fidelity (FNCL, FSTA, FTEC, FHLC) ETFs are among the cheapest.

Figure 1: 5 Least and Most Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
KBWD	PowerShares KBW High Dividend Yield Financial Portfolio	Financials	3.50%
HECO	Strategy Shares EcoLogical ETF	Industrials	1.06%
UTES	ETF Series Trust Reaves Utilities ETF	Utilities	1.06%
BBP	ETF Series Trust BioShares Biotechnology Products	Health Care	0.94%
PSR	PowerShares Active U.S. Real Estate Fund	Financials	0.89%
Least Expensive			
SCHH	Schwab US REIT ETF	Financials	0.08%
FNCL	Fidelity MSCI Financials Index	Financials	0.09%
FSTA	Fidelity MSCI Consumer Staples Index	Consumer Staples	0.09%
FTEC	Fidelity MSCI Information Technology Index	Technology	0.09%
FHLC	Fidelity MSCI Health Care Index	Health Care	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Fidelity MSCI Financials Index (FNCL) earns our Very Attractive rating and has low total annual costs of only 0.09%.

On the other hand, Fidelity MSCI Energy Index ETF (FENY) holds poor stocks and earns our Very Dangerous rating, yet has low total annual costs of 0.09%. 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
XLY	State Street SPDR Consumer Discretionary	Consumer Discretionary	Dangerous
PSCC	PowerShares S&P Small Cap Consumer Staples	Consumer Staples	Neutral
PSCE	PowerShares S&P Small Cap Energy	Energy	Dangerous
FREL	Fidelity MSCI Real Estate Index	Financials	Dangerous
BBP	BioShares Biotechnology Products	Health Care	Dangerous
ARKQ	ARK Trust Industrial Innovation ETF	Industrials	Dangerous
ARKK	ARK Trust Innovation ETF	Information Technology	Dangerous
XME	State Street SPDR Metals & Mining	Materials	Dangerous
IYZ	iShares U.S. Telecom ETF	Telecom Services	Dangerous
PSCU	PowerShares S&P Small Cap Utilities	Utilities	Dangerous

Sources: New Constructs, LLC and company filings

PowerShares (PSCC, PSCE, PSCU) appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

PowerShares Small Cap Energy (PSCE) is the worst rated ETF in Figure 2. BioShares Biotechnology Products (BBP), ARK Innovation ETF (ARKK), iShares U.S. Telecom ETF (IYZ) and State Street SPDR Metals & Mining (XME) 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

Analyzing each holding within funds is no small task. Our Robo-Analyst technology enables us to perform this diligence with scale and provide the research needed to fulfill the fiduciary duty of care. More of the biggest names in the financial industry (see At BlackRock, Machines Are Rising Over Managers to Pick Stocks) are now embracing technology to leverage machines in the investment research process. Technology may be the only solution to the dual mandate for research: cut costs and fulfill the fiduciary duty of care. Investors, clients, advisors and analysts deserve the latest in technology to get the diligence required to make prudent investment decisions.

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Disclosure: David Trainer and Kenneth James receive no compensation to write about any specific stock, sector, or theme.

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2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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