How to Avoid the Worst Sector 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 your best interests. Below are three red flags you can use to avoid the worst mutual funds:

1. Inadequate Liquidity

This issue is the easiest 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 2.24%, which is the average total annual costs of the 687 sector mutual funds we cover. The weighted average is lower at 1.99%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows Rydex Real Estate Fund (RYREX) is the most expensive sector mutual fund and Fidelity Real Estate Index Fund (FSRNX) is the least expensive. Rydex (RYREX, RYCRX, RYHRX) provides three of the most expensive mutual funds while Vanguard (VCDAX, VUIAX, VITAX) mutual funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
RYREX	Rydex Real Estate Fund	Financials	8.33%
RYCRX	Rydex Real Estate Fund	Financials	7.30%
SFPAX	Saratoga Financial Services Portfolio	Financials	7.24%
SBMBX	Saratoga Energy & Basic Materials Portfolio	Energy	7.12%
RYHRX	Rydex Real Estate Fund	Financials	6.42%
	Least Expensive		
FSRNX	Fidelity Real Estate Index Fund	Financials	0.09%
FESIX	Fidelity SAI Real Estate Fund	Financials	0.10%
VCDAX	Vanguard Consumer Discretionary Index	Consumer Discretionary	0.11%
VUIAX	Vanguard Utilities Index	Utilities	0.12%
VITAX	Vanguard Technology Index	Technology	0.12%

Sources: New Constructs, LLC and company filings

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

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On the other hand, Vanguard Energy Index Fund (VENAX) holds poor stocks and receives our Very Dangerous rating yet has low total annual costs of 0.14%. 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 sector with the worst holdings or portfolio management ratings.

Figure 2: Sector Mutual Funds with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
FSCPX	Fidelity Select Consumer Discretionary	Consumer Discretionary	Dangerous
FSAVX	Fidelity Select Automotive Portfolio	Consumer Staples	Dangerous
FSESX	Fidelity Select Energy Service Portfolio	Energy	Dangerous
BREIX	Baron Real Estate Fund	Financials	Dangerous
PHLQX	Prudential Jennison Health Sciences Fund	Health Care	Dangerous
ICTRX	ICON Industrials Fund	Industrials	Dangerous
PGTIX	T. Rowe Price Global Technology Fund	Information Technology	Dangerous
RYBIX	Rydex Basic Materials Fund	Materials	Dangerous
VTCAX	Vanguard Telecom Services Index Fund	Telecom Services	Dangerous
PUTYX	Putnam Global Utilities Fund	Utilities	Dangerous

Sources: New Constructs, LLC and company filings

Fidelity (FSCPX, FSAVX, FSESX) funds appear more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

T. Rowe Price Global Technology Fund (PGTIX) is the worst rated mutual fund in Figure 2. Prudential Jennison Health Sciences Fund (PHLQX), Baron Real Estate Fund (BREIX) and Fidelity Select Energy Service Portfolio (FSESX) 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

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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4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

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