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 1.83%, which is the average total annual cost of the 5,907 style mutual funds we cover. The weighted average is lower at 1.43%, which highlights how investors tend to put their money in funds with low fees.

Figure 1 shows Catalyst Funds Buyback Strategy (BUYAX) is the most expensive style mutual fund and Fidelity SAI US Large Cap Index Fund (FLCPX) is the least expensive. Catalyst Funds (BUYAX, BUYCX) and Advisors Preferred (QACAX, QACFX) provide four of the most expensive mutual funds while Fidelity (FLCPX, FFSMX, FSKAX) mutual funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
	Most Expensive		
BUYAX	Catalyst Funds Buyback Strategy	All Cap Blend	8.10%
QACAX	Advisors Preferred Quantified All Cap Equity	Mid Cap Blend	7.20%
BUYCX	Catalyst Funds Buyback Strategy	All Cap Blend	6.68%
PAMVX	Pacific Advisors Mid Cap Value Fund	Mid Cap Blend	6.55%
QACFX	Advisors Preferred Quantified All Cap Equity	Mid Cap Blend	6.51%
	Least Expensive		
FLCPX	Fidelity SAI US Large Cap Index Fund	Large Cap Blend	0.02%
VFFSX	Vanguard S&P 500 Index Fund	Large Cap Blend	0.02%
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%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Fidelity SAI US Large Cap Index Fund (FLCPX) earns our Very Attractive rating and has low total annual costs of only 0.02%.

On the other hand, Vanguard Small Cap Growth Index Fund (VSGIX) holds poor stocks and earns our Dangerous rating, yet has low total annual costs of 0.21%. 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
LHVIX	Linde Hansen Contrarian Value Fund	All Cap Blend	Dangerous
ZVGIX	Zevenbergen Genea Fund	All Cap Growth	Dangerous
RFVIX	RiverPark Focused Value Fund	All Cap Value	Dangerous
AMWIX	ALPS/WMC Research Value Fund	Large Cap Blend	Dangerous
PLAYX	PACE Large Co Growth Equity Investments	Large Cap Growth	Dangerous
NRIGX	Integrity Energized Dividend Fund	Large Cap Value	Dangerous
CRIMX	CRM Mid Cap Value Fund	Mid Cap Blend	Dangerous
JIMSX	John Hancock Mid Cap Stock Fund	Mid Cap Growth	Dangerous
GOODX	The GoodHaven Fund	Mid Cap Value	Very Dangerous
UISCX	USAA Small Cap Stock Fund	Small Cap Blend	Very Dangerous
FMPFX	Nuveen Small Cap Growth Opportunities	Small Cap Growth	Dangerous
SCMVX	Schneider Small Cap Value Fund	Small Cap Value	Dangerous

Sources: New Constructs, LLC and company filings

No one provider appears more often than any other in Figure 2.

CRM Mid Cap Value Fund (CRIMX) is the worst rated mutual fund in Figure 2. Linde Hansen Contrarian Value (LHVIX), Zevenbergen Genea Fund (ZVGIX), RiverPark Focused Value Fund (RFVIX), PACE Large Co Growth Equity Investments (PLAYX), Integrity Energized Dividend Fund (NRIGX), John Hancock Mid Cap Stock Fund (JIMSX), GoodHaven Fund (GOODX), USAA Small Cap Stock Fund (UISCX), Nuveen Small Cap Growth Opportunities (FMPFX) and Schneider Small Cap Value Fund (SCMVX) 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.

This article originally published on May 5, 2017.

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

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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.

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