# 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 2.10%, which is the average total annual costs of the 618 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.98%, 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 Fund (FSRNX) is the least expensive. Rydex (RYREX, RYCRX, RYHRX) provides three of the most expensive mutual funds while Fidelity (FSRNX, FESIX, FSRVX) ETFs 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 | 8.37% |
| RYCRX | Rydex Real Estate Fund | Financials | 7.35% |
| SFPAX | Saratoga Advantage Financial Services | Financials | 7.24% |
| SBMBX | Saratoga Advantage Energy & Basic Materials | Energy | 7.12% |
| RYHRX | Rydex Real Estate Fund | Financials | 6.47% |
| **Least Expensive** | | | |
| FSRNX | Fidelity Real Estate Index Fund | Financials | 0.09% |
| FESIX | Fidelity SAI Real Estate Index Fund | Financials | 0.10% |
| FSRVX | Fidelity Real Estate Index Fund | Financials | 0.11% |
| VUIAX | Vanguard Utilities Index Fund | Utilities | 0.12% |
| VITAX | Vanguard Information Technology Index Fund | Information Technology | 0.12% |

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Vanguard Consumer Staples Index Fund (VCSAX) earns our Very Attractive rating and has low total annual costs of only 0.12%.

On the other hand, Vanguard Energy Index Fund (VENAX) holds poor stocks and receives our Very Unattractive 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 |
|---|---|---|---|
| ICCCX | ICON Consumer Discretionary Fund | Consumer Discretionary | Unattractive |
| ICLEX | ICON Consumer Staples Fund | Consumer Staples | Unattractive |
| FSENX | Fidelity Select Energy Portfolio | Energy | Unattractive |
| DREYX | Davis Real Estate Fund | Financials | Unattractive |
| PHLQX | Prudential Jennison Health Sciences Fund | Health Care | Unattractive |
| PGILX | Putnam Global Industrials Fund | Industrials | Unattractive |
| JAMFX | Jacob Internet Fund | Information Technology | Unattractive |
| VMIAX | Vanguard Materials Index Fund | Materials | Unattractive |
| VTCAX | Vanguard Telecommunication Services Index Fund | Telecom Services | Unattractive |
| FIUIX | Fidelity Telecom & Utilities Fund | Utilities | Unattractive |

Sources: New Constructs, LLC and company filings

ICON (ICCCX, ICLEX), Fidelity (FSENX, FIUIX) and Vanguard (VMIAX, VTCAX) appear more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Prudential Jennison Health Sciences Fund (PHLQX) is the worst rated mutual fund in Figure 2. Fidelity Select Energy Portfolio (FSENX) also earns a Very Unattractive predictive overall rating, which means not only does it hold poor stocks, it charges 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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*Disclosure: David Trainer, Kyle Guske II, and Kenneth James receive no compensation to write about any specific stock, sector, or theme.*

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

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