



## A Very Unattractive Fund in the Real Estate Sector

Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#).

The [Real Estate sector](#) earned an Unattractive rating in our [1Q18 Sector Ratings for ETFs and Mutual Funds](#). This ranking marks the second consecutive quarter the Real Estate sector has ranked tenth, (out of 11) since splitting Real Estate and Financials stocks into two distinct sectors in 4Q17.

Due to the large number of Unattractive-or-worse rated options, investors must be careful when choosing a Real Estate fund.

Virtus Duff & Phelps Real Estate Securities Fund (PHRAX, PHRCX, PHRIX, VRREX) is one of the Real Estate funds investors should avoid. The fund's poor holdings and high fees diminish the likelihood that the funds will outperform moving forward. Virtus Duff & Phelps Real Estate Securities Fund is in the [Danger Zone](#) this week.

### Traditional Fund Research Misses the Flaws in This Fund

Our machine learning and AI [Robo-Analyst technology](#) helps investors navigate this high-risk sector by sifting through the holdings of all 214 Real Estate ETFs and mutual funds. This diligence allows us to identify potentially dangerous funds that traditional [backward-looking fund research](#) may overlook.

Per Figure 1, PHRIX receives a 4 Star rating from Morningstar and the remaining classes receive a 3 Star rating. All four classes earn an Unattractive-or-worse rating using our [Predictive Risk/Reward Fund Rating](#) methodology. This rating methodology takes into account both costs and the individual holdings of each mutual fund, or the drivers of future fund performance.

**Figure 1: Virtus Duff & Phelps Real Estate Securities Fund Ratings**

Ticker	Morningstar Rating	New Constructs Rating
PHRIX	4 Star	Unattractive
VRREX	3 Star	Unattractive
PHRCX	3 Star	Very Unattractive
PHRAX	3 Star	Very Unattractive

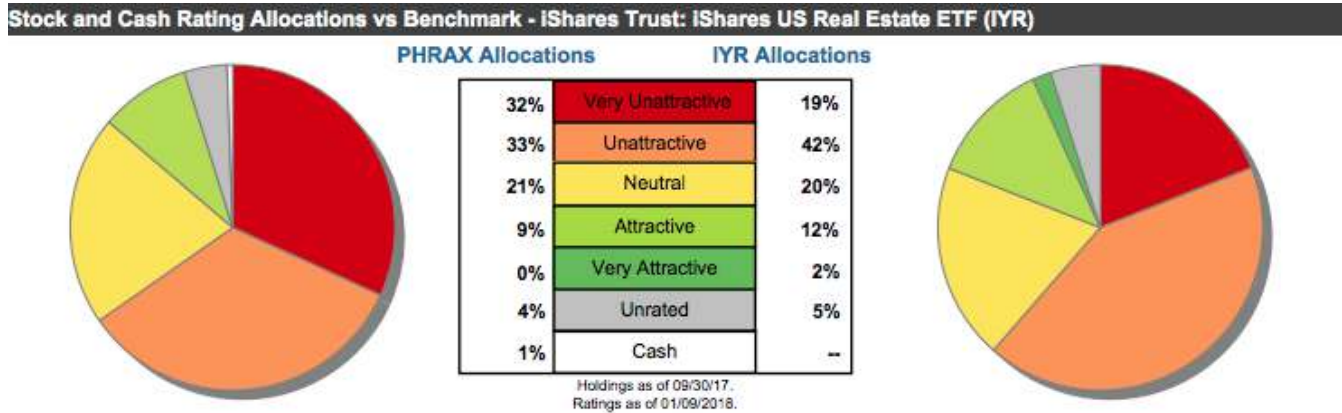
Sources: New Constructs, LLC and company filings

### Holdings Quality Analysis Reveals Poor Allocation vs. Benchmark

The only justification for a mutual fund to charge higher fees than its passively-managed ETF benchmark is "active" management that leads to out-performance. A fund is most likely to outperform if it has higher quality holdings than its benchmark. To make this determination on holdings quality, we leverage our Robo-Analyst technology to drill down to the individual stock level of every fund.



**Figure 2: Virtus Duff & Phelps Real Estate Securities Fund (PHRAX) Asset Allocation**



Sources: New Constructs, LLC and company filings

Per Figure 2, Virtus Duff & Phelps Real Estate Securities Fund allocates only 9% of its assets to Attractive-or-better rated stocks compared to 14% for the benchmark, iShares U.S. Real Estate ETF (IYR). In addition, exposure to Very Unattractive rated stocks is much higher for PHRAX (32% of assets) than for IYR (19% of assets).

Furthermore, five of the mutual fund's top 10 holdings receive an Unattractive-or-worse rating and make up 22% of its portfolio. In total, nine of the top 10 receive a Neutral-or-worse rating and make up 37% of the portfolio.

Given the unfavorable distribution of Attractive vs. Very Unattractive allocations relative to the benchmark, Virtus Duff & Phelps Real Estate Securities Fund appears poorly positioned to capture upside potential while minimizing downside risk.

**Details on PHRAX's Allocation to Low Quality Real Estate Stocks**

In Figure 3, the details behind our [predictive Risk/Reward Fund rating](#) for PHRAX show how its portfolio management is poor. The criteria we use to rate the Portfolio Management of funds are the same as for our [Stock Ratings](#), because the performance of a fund's holdings equals the performance of a fund.

**Figure 3: Virtus Duff & Phelps Real Estate Securities Fund (PHRAX) Rating Breakdown**

**Virtus Opp Trust: Virtus Duff & Phelps Real Estate Securities Fd (PHRAX)** Closing Price: \$25.77 (Jan 09, 2018)  
Sector: Real Estate

Risk/Reward Rating ?	Portfolio Management ?						Total Annual Costs ?
	Quality of Earnings		Valuation			Asset Allocation	
	Econ vs Reported EPS ?	ROIC ?	FCF Yield ?	Price to EBV ?	GAP ?	Cash % ?	
Very Unattractive	Misleading Trend	Bottom Quintile	<-5%	>3.5 or <-1	>50	>20%	>4%
Unattractive	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50	8%<20%	2%<4%
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20	2.5%<8%	1%<2%
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10	1%<2.5%	0.5%<1%
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	0<3	<1%	<0.5%
<b>Actual Values</b>							
PHRAX	Neutral EE	5%	-5%	6.8	41 yrs	<1%	3.8%
<b>Benchmarks ?</b>							
Sector ETF (IYR)	Positive EE	6%	-0%	4.3	33 yrs	-	0.5%
S&P 500 ETF (SPY)	Positive EE	18%	2%	3.3	37 yrs	-	0.1%
Small Cap ETF (IWM)	Positive EE	5%	-1%	3.1	44 yrs	-	0.2%

Sources: New Constructs, LLC and company filings

The return on invested capital ([ROIC](#)) for PHRAX's holdings is a bottom-quintile 5%, which is lower than the benchmark's 6% ROIC and well below the S&P 500 (18%). The -5% free cash flow ([FCF](#)) yield of PHRAX's holdings is lower than IYR (0%) and the S&P 500 (2%).

The price to economic book value ([PEBV](#)) ratio for IYR is 4.3. Meanwhile, the PEBV ratio for PHRAX is 6.8. This ratio means the market expects PHRAX profits to grow by over 600% while expecting much less growth out of the benchmark's holdings.

Lastly, our discounted cash flow analysis of fund holdings reveals a market implied growth appreciation period ([GAP](#)) of 41 years for PHRAX compared to 33 years for IYR and 37 years for the S&P 500. In other words, companies held by PHRAX have to grow [economic earnings](#) for eight years longer than those in the benchmark and four years long than those in the S&P to justify their current stock prices. This expectation seems even more unlikely given that PHRAX's holdings are not more profitable than IYR or the S&P 500, as measured by ROIC.

Ultimately, the high profit growth expectations baked into the valuations of stocks held by PHRAX lowers the upside potential and makes outperformance less likely.

### Excessive Fees Make the Fund More Risky

At 3.81%, PHRAX's total annual costs ([TAC](#)) are higher than 95% of Real Estate sector funds and all funds under coverage. For comparison, the average TAC of all Real Estate mutual funds under coverage is 1.88%, the weighted average is 0.97%, and the benchmark ETF (IYR) has total annual costs of 0.49%. Per Figure 4, Virtus Duff & Phelps Real Estate Securities Fund's expense ratios understate the true costs of investing in this fund. Our TAC metric accounts for more than just expense ratios. We take into account the impact of front-end loads, back-end loads, redemption fees, and transaction costs.

**Figure 4: Virtus Duff & Phelps Real Estate Securities Fund's Cost Comparison**

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
PHRAX	3.81%	1.38%	<b>2.43%</b>
PHRCX	2.44%	2.13%	<b>0.31%</b>
PHRIX	1.30%	1.13%	<b>0.17%</b>
VRREX	1.11%	0.96%	<b>0.15%</b>

Sources: New Constructs, LLC and company filings

To justify its higher fees, each class of the fund must outperform its benchmark by the following over three years:

1. PHRAX must outperform by an average of 3.31% annually.
2. PHRCX must outperform by an average of 1.94% annually.
3. PHRIX must outperform by an average of 0.81% annually.
4. VRREX must outperform by an average of 0.62% annually.

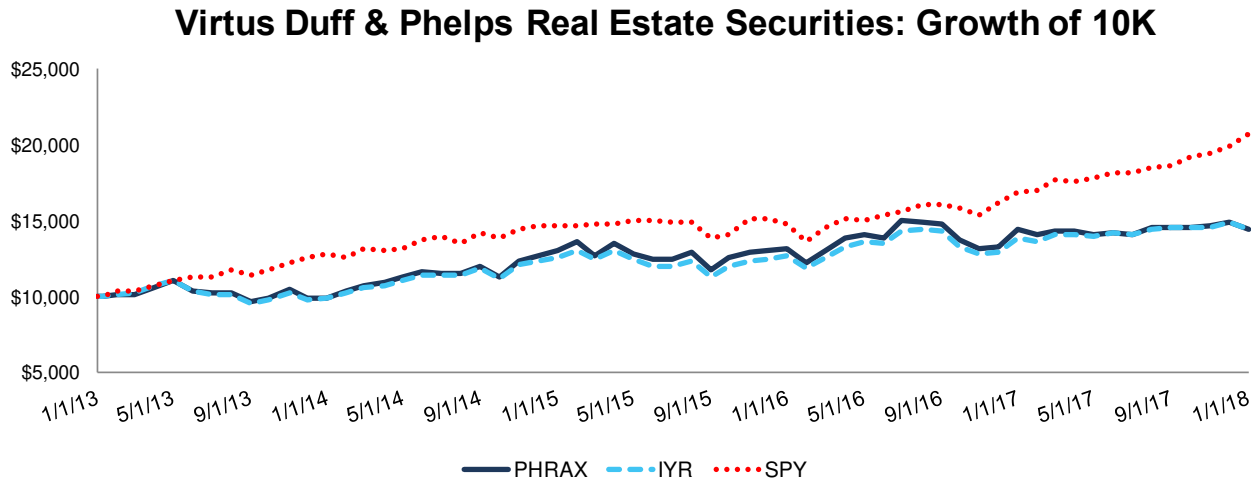
An in-depth analysis of PHRAX's TAC is on [page 2 here](#).

### Underperformance Looks Likely to Continue

Over the past year, PHRAX underperformed IYR and SPY in terms of growth in 10k invested. This underperformance is not a new trend either. Over the past 10 years, PHRAX has performed in line with its benchmark and underperformed the overall market (S&P 500), thereby failing to earn its high fees. Given that 32% of assets are allocated to stocks with Very Unattractive ratings (65% to Unattractive-or-worse ratings), the recent price underperformance looks likely to continue.



**Figure 5: Virtus Duff & Phelps Real Estate Securities Fund vs. IYR & SPY**



Sources: New Constructs, LLC and company filings.

**The Importance of Holdings Based Fund Analysis**

Our [ETF & mutual fund ratings](#) provide forward looking diligence by analyzing the risk/reward of the holdings of every fund. This unique approach to mutual fund analysis shows that investors must be careful when investing in funds. Rather than putting money into PHRAX, investors would be better suited with one of the Real Estate funds that receive an Attractive-or-better rating.

Each quarter we rank the 11 sectors in our [Sector Ratings for ETF & Mutual Funds](#) and the 12 investment styles in our [Style Ratings For ETFs & Mutual Funds](#) report. This analysis allows us to find funds that investors using [traditional fund research](#) may view as quality investments while deeper analysis reveals otherwise, such as Virtus Duff & Phelps Real Estate Securities Fund.

*This article originally published on [January 16, 2018](#).*

*Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.*

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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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