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 2.04%, which is the average total annual costs of the 619 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.26%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows Saratoga Financial Services Portfolio (SFPAX) is the most expensive sector mutual fund and Fidelity SAI Real Estate Index Fund (FESIX) is the least expensive. Saratoga (SFPAX, SBMBX, SFPCX, SEPCX, SHPAX) provides five of the most expensive mutual funds while Fidelity (FESIX, FSRNX, FSRVX) mutual funds are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
SFPAX	Saratoga Financial Services Portfolio	Financials	6.84%
SBMBX	Saratoga Energy and Basic Material Portfolio	Energy	6.81%
SFPCX	Saratoga Financial Services Portfolio	Financials	5.58%
SEPCX	Saratoga Energy and Basic Materials Portfolio	Energy	5.35%
SHPAX	Saratoga Health & Biotechnology Portfolio	Healthcare	4.90%
	Least Expensive		
FESIX	Fidelity SAI Real Estate Index Fund	Real Estate	0.09%
FSRNX	Fidelity Real Estate Index Fund	Real Estate	0.09%
FSRVX	Fidelity Real Estate Index Fund	Real Estate	0.12%
VHCIX	Vanguard Health Care Index Fund	Healthcare	0.12%
VCSAX	Vanguard Consumer Staples Index Fund	Consumer Non-cyclicals	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Vanguard Consumer Staples Index Fund (VCSAX) is the best ranked sector mutual fund in Figure 1. VCSAX's Neutral Portfolio Management rating and 0.12% total annual cost earn it a Very Attractive rating. Fidelity Consumer Finance Portfolio (FSVLX) is the best ranked sector mutual fund overall. FSVIX's Neutral Portfolio Management rating and 1.14% total annual cost also earn it a Very Attractive rating.

On the other hand, Fidelity Real Estate Index Fund (FSRNX) holds poor stocks and receives our Unattractive rating, yet has low total annual costs of 0.09%. 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
FMFEX	Fidelity Advisor Materials Fund	Basic Materials	Unattractive
FSCPX	Fidelity Consumer Discretionary Portfolio	Consumer Cyclicals	Unattractive
PGLOX	T. Rowe Price Global Consumer Fund	Consumer Non-cyclicals	Unattractive
VGELX	Vanguard Energy Fund	Energy	Unattractive
ADFSX	Alpine Financial Services Fund	Financials	Unattractive
PHLQX	Prudential Jennison Health Sciences Fund	Healthcare	Unattractive
VINAX	Vanguard Industrials Index	Industrials	Unattractive
FPREX	Forward Funds Salient Real Estate Fund	Real Estate	Very Unattractive
PGTIX	T. Rowe Price Global Technology Fund	Technology	Unattractive
VTCAX	Vanguard Telecommunication Services Fund	Telecom Services	Unattractive
PRUZX	Prudential Jennison Utility Fund	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

Vanguard (VGELX, VINAX, VTCAX) appears more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Forward Funds Salient Real Estate Fund (FPREX) is the worst rated mutual fund in Figure 2. Fidelity Advisor Materials Fund (FMFEX) and Vanguard Specialized Energy Fund (VGELX) also earn a Very Unattractive 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[1] 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,

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

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 Kyle Guske II receive no compensation to write about any specific stock, sector, or theme.

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1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
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

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