A Very Unattractive Fund That Morningstar Gives 4 Stars

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

Meridian Contrarian Fund (MFCAX, MFCCX, MFCIX, MVALX) is an All Cap Blend funds investors should avoid. The fund's poor holdings[1] and high fees diminish the likelihood that the fund will outperform moving forward. Meridian Contrarian Fund (MFCAX) is in the Danger Zone this week.

Traditional Fund Research Misses this Fund's Flaws

Per Figure 1, MFCAX receives a 4-Star rating from Morningstar and the remaining classes receive a 3 or 4-Star rating as well. When viewed through our Predictive Risk/Reward Fund Rating methodology, all four classes earn an Unattractive-or-worse rating, with MFCAX earning a Very Unattractive rating.

Figure 1: Meridian Contrarian Fund Ratings

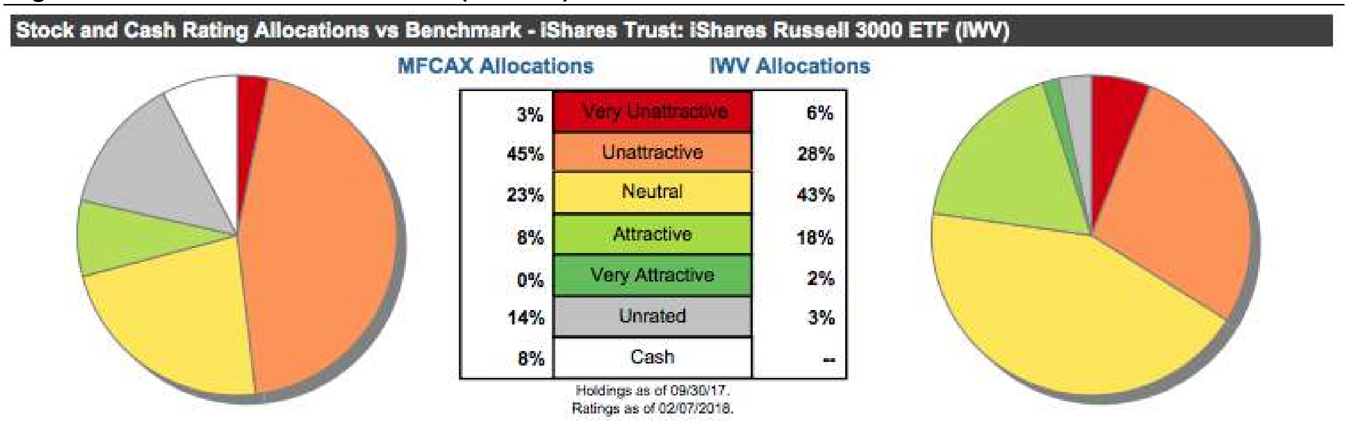
Ticker	Morningstar Rating	New Constructs Rating
MFCAX	4 Star	Very Unattractive
MFCCX	3 Star	Unattractive
MFCIX	4 Star	Unattractive
MVALX	4 Star	Unattractive

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 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 and analyze the individual stocks in every fund we cover.

Figure 2: Meridian Contrarian Fund (MFCAX) Asset Allocation



Sources: New Constructs, LLC and company filings

Per Figure 2, Meridian Contrarian Fund's asset allocation increases downside risk compared to its benchmark, iShares Russell 3000 (IWV). MFCAX allocates only 8% of its portfolio to Attractive-or-better rated stocks compared to 20% for IWV. Exposure to Very Unattractive rated stocks is much higher for MFCAX (48% of

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

portfolio) than for IWV (34% of portfolio). Overall, MFCAX allocates 31% of its portfolio to stocks with a Neutral-or-better rating while IWV allocates 63% of its portfolio to Neutral-or-better rated stocks.

Seven of the mutual fund's top 10 holdings receive an Unattractive rating and make up 21% of its portfolio. One of the top 10 holdings is previous Danger Zone pick Verint Systems (VRNT). In total, nine of the top 10 receive a Neutral-or-worse rating and make up 27% of MFCAX's portfolio.

Given the unfavorable distribution of Attractive vs. Very Unattractive allocations relative to the benchmark, Meridian Contrarian Fund appears poorly positioned to generate the outperformance required to justify its fees.

MFCAX Allocates to Overvalued Stocks

Figure 3 contains our detailed rating for MFCAX, which includes each of the criteria we use to rate all funds under coverage and shows the fund's poor portfolio management. These criteria are the same for our Stock Rating Methodology, because the performance of a fund's holdings equals the performance of a fund after fees.

Figure 3: Meridian Contrarian Fund (MFCAX) Rating Breakdown

Meridian Fund, Inc: Meridian Contrarian Fund (MFCAX) Closing Price: $41.28 (Feb 07, 2018) Style: All Cap Blend

	Portfolio Management						
	Quality of Earnings		Valuation			Asset Allocation	
Risk/Reward Rating	Econ vs Reported EPS	ROIC	FCF Yield	Price to EBV	GAP	Cash %	Total Annual Costs
Very Unattractive	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	>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%
Actual Values							
MFCAX	**Neutral EE**	**10%**	**0%**	**4.0**	**54 yrs**	**8%**	**3.9%**
Benchmarks							
Style ETF (IWV)	Positive EE	16%	2%	3.0	39 yrs	-	0.2%
S&P 500 ETF (SPY)	Positive EE	18%	2%	3.0	37 yrs	-	0.1%
Small Cap ETF (IWM)	Positive EE	5%	-1%	3.1	43 yrs	-	0.2%

Sources: New Constructs, LLC and company filings

The return on invested capital (ROIC) for MFCAX's holdings is 10%, which is below the 16% ROIC earned by companies held by IWV and the 18% earned by S&P 500 companies. Further, the 0% free cash flow (FCF) yield of MFCAX's holdings is below IWV and the S&P 500 (2%). These numbers are remarkable when one considers that "improving return on invested capital and free cash flow" is one of the stated criteria MFCAX uses when selecting stocks.

At the very least, one might expect the stocks held by a contrarian fund to be cheaper than the market, but that's not the case either. The price to economic book value (PEBV) ratio for IWV is 3.0, while the PEBV ratio for MFCAX is 4.0. The companies held by MFCAX earn inferior cash flows and are valued at a premium to those cash flows when compared to the benchmark.

Lastly, our discounted cash flow analysis of fund holdings reveals a market implied growth appreciation period (GAP) of 54 years for MFCAX compared to 39 years for IWV. In other words, MFCAX companies have to grow economic earnings for 15 years longer than companies held by IWV to justify their current stock prices. This expectation seems even more unlikely given that MFCAX's holdings are less profitable than IWV, as measured by ROIC.

Verint Systems (VRNT) is one of MFCAX's top holdings, earns an Unattractive rating, and was a Danger Zone pick in April 2017. Since publish VRNT is down 10% while the S&P 500 is up 12%. VRNT's after-tax profit (NOPAT) fell 33% compounded annually since 2014 while its ROIC fell from 10% in 2014 to 2% TTM. Despite the fundamental issues, VRNT is still up 25% over the past two years and shares remain overvalued.

To justify its current price of $39/share, VRNT must achieve 6% margins (vs 4% TTM) and grow NOPAT by 19% compounded annually for the next 11 years. This scenario seems unlikely given VRNT's inability to grow NOPAT since 2014. Even if we assume VRNT can achieve a 6% NOPAT margin and grow NOPAT by 15% compounded annually for the next decade, the stock is worth only $21/share today – a 46% downside.

Excessive Fees Make the Fund More Risky

At 3.91%, MFCAX's total annual costs (TAC) are higher than 96% of All Cap Blend style funds and all funds under coverage. For comparison, the average TAC of all All Cap Blend mutual funds under coverage is 1.81%, the weighted average is 0.51%, and the benchmark ETF (IWV) has total annual costs of 0.20%. Per Figure 4, Meridian Contrarian 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: Meridian Contrarian Fund's Cost Comparison

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
MFCAX	3.91%	1.41%	2.50%
MFCCX	2.60%	2.21%	0.39%
MFCIX	1.50%	1.24%	0.26%
MVALX	1.39%	1.15%	0.24%

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. MFCAX must outperform by an average of 3.69% annually.
2. MFCCX must outperform by an average of 2.38% annually.
3. MFCIX must outperform by an average of 1.27% annually.
4. MVALX must outperform by an average of 1.17% annually.

An in-depth analysis of MFCAX's TAC is on page 2 here.

Short-Term Outperformance Looks Unlikely to Continue

Over the past three years, MFCAX has not surpassed the 3.69% per year outperformance required to justify its higher fees, in terms of growth in $10K invested. Growth of $10K is not load adjusted, so, while it may seem on the surface as if MFCAX has outperformed net of fees, it has not once all costs are accounted for. For reference, MFCAX's load adds 2.19% to its total annual costs. MFCAX's performance looks worse when moving beyond the 3-year timeframe. Per Figure 5, MFCAX has underperformed (measured by growth of $10K) its benchmark over the past five and ten-year periods compounded annually.

Figure 5: MFCAX vs. IWV: Growth of 10K Over Time

	Growth of $10K Compounded Annually		
Ticker	3-Year	5-Year	10-Year
IWV	10.9%	14.0%	9.4%
MFCAX	11.3%	13.2%	8.9%

Sources: New Constructs, LLC and company filings.

Given that 48% of assets are allocated to stocks with Unattractive-or-worse ratings, MFCAX looks likely to underperform moving forward.

The Importance of Holdings Based Fund Analysis

The analysis above shows that while the All Cap Blend style receives an Attractive rating in our 1Q18 Style Ratings for ETFs & Mutual Funds report, it still contains risky funds. With so many ETFs and mutual funds in the style (855), picking the right one can be difficult. Smart fund investing means analyzing the holdings of each fund, which is impossible for the average investor to perform.

Our machine learning and AI Robo-Analyst technology helps investors navigate this investment style by sifting through the holdings of all 855 All Cap Blend ETFs and mutual funds. This diligence allows us to identify potentially dangerous funds that traditional backward-looking fund research may overlook.

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 Meridian Contrarian Fund. Rather than putting money into MFCAX, investors would be better suited with one of the 437 Attractive-or-better rated ETFs and mutual funds in the All Cap Blend style.

This article originally published on February 12, 2018.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

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

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.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.