How to Avoid the Worst Sector ETFs

Question: Why are there so many ETFs?

Answer: ETF providers tend to make lots of money on each ETF so they create more products to sell.

The large number of ETFs has little to do with serving your best interests. Below are three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the ETF and larger bid-ask spreads.

2. High Fees

ETFs 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 average or below average fees, invest only in ETFs with total annual costs below 0.48% which is the average total annual costs of the 237 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.27%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Invesco KBW High Dividend Yield Financial ETF (KBWD) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. Invesco provides one of the most expensive ETFs while Fidelity (FSTA, FNCL, FTEC) ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
KBWD	Invesco KBW High Dividend Yield Financial ETF	Financials	2.70%
HECO	EcoLogical Strategy ETF	Industrials	1.06%
UTES	ETFis Series Reaves Utilities ETF	Utilities	1.06%
FNG	AdvisorShares New Tech and Media ETF	Technology	0.94%
BOON	ETF Series NYSE Pickens Oil Response ETF	Energy	0.94%
Least Expensive			
SCHH	Schwab U.S. REIT ETF	Real Estate	0.08%
USRT	iShares Core U.S. REIT ETF	Real Estate	0.09%
FSTA	Fidelity MSCI Consumer Staples Index	Consumer Non-cyclicals	0.09%
FNCL	Fidelity MSCI Financials Index	Financials	0.09%
FTEC	Fidelity MSCI Information Technology Index	Technology	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings[1]. Fidelity MSCI Consumer Staples Index (FSTA) is the best ranked sector ETF in Figure 1. FSTA's Neutral Portfolio Management rating and 0.09% total annual cost earns it

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

a Very Attractive rating[2]. iShares Mortgage Real Estate ETF (REM) is the best ranked sector ETF overall. REM's Attractive Portfolio Management rating and 0.53% total annual cost also earns it a Very Attractive rating.

On the other hand, Schwab U.S. REIT ETF (SCHH) holds poor stocks and earns our Unattractive rating, yet has low total annual costs of 0.08%. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETFs holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad ETFs, but it is also the most important because an ETF's performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each sector with the worst holdings or portfolio management ratings.

Figure 2: Sector ETFs with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
XLB	State Street Materials Select Sector SPDR Fund	Basic Materials	Unattractive
FDIS	Fidelity MSCI Consumer Discretionary Index	Consumer Cyclicals	Unattractive
PSCC	Invesco S&P Small Cap Consumer Staples ETF	Consumer Non-cyclicals	Unattractive
OIH	VanEck Vectors Oil Services ETF	Energy	Unattractive
PSCF	Invesco S&P Small Cap Financials ETF	Financials	Unattractive
PTH	Invesco DWA Healthcare Momentum ETF	Healthcare	Unattractive
XTN	State Street SPDR S&P Transportation ETF	Industrials	Unattractive
EWRE	Invesco S&P 500 Equal Weight Real Estate ETF	Real Estate	Unattractive
XWEB	State Street SPDR S&P Internet ETF	Technology	Unattractive
FCOM	Fidelity MSCI Telecommunications Services Index	Telecom Services	Unattractive
PSCU	Invesco S&P Small Cap Utilities ETF	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

Invesco (PSCC, PSCF, PTH, EWRE, PSCU) and State Street (XLB, XTN, XWEB) appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

Invesco DWA Healthcare Momentum ETF (PTH) is the worst rated ETF in Figure 2. VanEck Vectors Oil Services ETF (OIH), Invesco S&P Small Cap Utilities ETF (PSCU), Fidelity MSCI Telecommunications Services Index (FCOM), and Invesco S&P 500 Equal Weight Real Estate ETF (EWRE) 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 ETFs are on our stock ratings of their holdings and the total annual costs of investing in the ETF.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF'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 ETFs HOLDINGs = PERFORMANCE OF ETF

[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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 Sam McBride receive no compensation to write about any specific stock, sector, 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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