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 2.03%, which is the average total annual costs of the 666 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.66%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows Saratoga Energy and Basic Materials Portfolio (SBMBX) is the most expensive sector mutual fund and Fidelity Real Estate Index Fund (FSRNX) is the least expensive. Saratoga (SBMBX, SFPAX, SEPCX) provides three of the most expensive mutual funds while Vanguard (VFAIX, VINAX, VUIAX) ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
SBMBX	Saratoga Energy and Basic Materials Portfolio	Energy	6.92%
RYTLX	Rydex Series Telecommunications Fund	Telecom Services	6.88%
SFPAX	Saratoga Financial Services Portfolio	Financials	6.78%
RYCSX	Rydex Telecommunications Fund	Telecom Services	5.89%
SEPCX	Saratoga Energy and Basic Materials Portfolio	Energy	5.37%
Least Expensive			
FSRNX	Fidelity Real Estate Index Fund	Real Estate	0.09%
FESIX	Fidelity SAI Real Estate Index Fund	Real Estate	0.09%
VFAIX	Vanguard Financials Index Fund	Financials	0.12%
VINAX	Vanguard Industrials Index Fund	Industrials	0.12%
VUIAX	Vanguard Utilities Index Fund	Utilities	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Vanguard Financials Index Fund (VFAIX) is the best ranked sector mutual fund in Figure 1. VFAIX's Neutral Portfolio Management rating and 0.12% total annual cost earns it an Attractive rating.[2] Vanguard Consumer Staples Index Fund (VCSAX) is the best ranked sector mutual fund overall. VCSAX's Attractive Portfolio Management rating and 0.13% total annual cost earns 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
VMIAX	Vanguard Materials Index Fund	Basic Materials	Neutral
FGKMX	Fidelity Advisor Communication Services Fund	Consumer Cyclicals	Unattractive
FSHOX	Fidelity Construction and Housing Portfolio	Consumer Non-cyclicals	Unattractive
BENUX	Baron Energy and Resources Fund	Energy	Very Unattractive
LMRIX	1919 Financial Services Fund	Financials	Unattractive
PHLQX	Prudential Jennison Health Sciences Fund	Healthcare	Unattractive
RYPIX	Rydex Transportation Fund	Industrials	Unattractive
VRREX	Duff & Phelps Real Estate Securities Fund	Real Estate	Very Unattractive
ADNIX	American Beacon ARK Transformational Innovation	Technology	Unattractive
FIJGX	Fidelity Advisor Telecommunications Fund	Telecom Services	Very Unattractive
FIUIX	Fidelity Telecom & Utilities Fund	Utilities	Very Unattractive

Sources: New Constructs, LLC and company filings

Fidelity (FGKMX, FSHOX, FIJGX, FIUIX) appears more often than any other provider in Figure 2, which means that they offer the most mutual funds with the worst holdings.

American Beacon ARK Transformation Innovation Fund (ADNIX) is the worst rated mutual fund in Figure 2. Fidelity Advisor Telecommunications Fund (FIJGX), Baron Energy and Resources Fund (BENUX), Fidelity Telecom & Utilities Fund (FIUIX), Prudential Jennison Health Sciences Fund (PHLQX), and Duff & Phelps Real Estate Securities Fund 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 on our stock ratings of their holdings and the total annual costs of investing in the fund.

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.

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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 Sam McBride 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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