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DILIGENCE PAYS 7/22/19

Don't Pay for Overvalued "Growth" Stocks

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

We recently ranked each of the 12 investing styles according to our risk/reward ratings. Through this analysis, we identified one of the worst rated growth funds that charges investors above average fees for overvalued stocks.

Get the best fundamental research

Despite its 3 or 4-Star Morningstar rating (depending upon share class), Hartford Growth Opportunities Fund (HGOAX and more) is a mutual fund investors should avoid. Our research into the fund's holdings[1] reveals stocks with poor risk/reward compared to the benchmark. Throw in costly fees, and this fund lands in the Danger Zone.

Traditional Research Overrates this Fund

Per Figure 1, HGOAX, and six other share classes receive a 4-Star rating from Morningstar and HGORX and HGOCX receive a 3-Star rating. All eight classes receive a "Buy" rating from Zacks. When viewed through our Predictive Risk/Reward Fund Rating methodology, all share classes earn a Very Unattractive rating.

Figure 1: Hartford Growth Opportunities Fund Ratings

Ticker	Morningstar Rating	New Constructs Rating
HGOAX	4 Star	Very Unattractive
HGOVX	4 Star	Very Unattractive
HGOYX	4 Star	Very Unattractive
HGOIX	4 Star	Very Unattractive
HGOTX	4 Star	Very Unattractive
HGOSX	4 Star	Very Unattractive
HGORX	3 Star	Very Unattractive
HGOCX	3 Star	Very Unattractive

Sources: New Constructs, LLC, company, ETF and mutual fund filings, and Morningstar

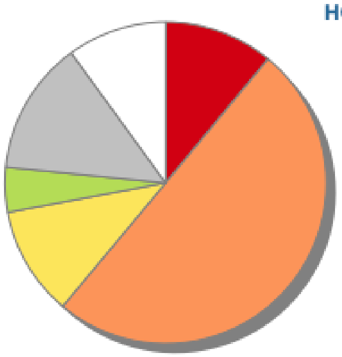
Holdings Research Reveals a Low-Quality Portfolio

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 assess holdings quality, we leverage our Robo-Analyst technology[2] to drill down and analyze the individual stocks in every fund we cover.

[1] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.
[2] Harvard Business School features the powerful impact of our research automation technology in the case study New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

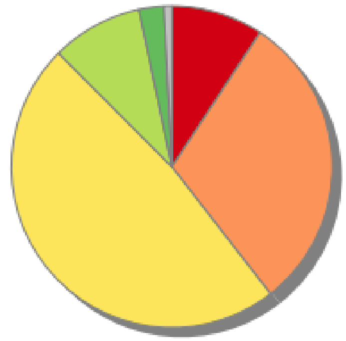
Figure 2: Hartford Growth Opportunities Fund Asset Allocation vs. Benchmark

Stock and Cash Rating Allocations vs Benchmark - iShares Trust: iShares Core S&P US Growth ETF (IUSG)



HGOAX Allocations		IUSG Allocations
11%	Very Unattractive	9%
50%	Unattractive	30%
11%	Neutral	48%
5%	Attractive	9%
0%	Very Attractive	2%
13%	Unrated	1%
10%	Cash	--

Holdings as of 05/31/19.
Ratings as of 07/15/2019.

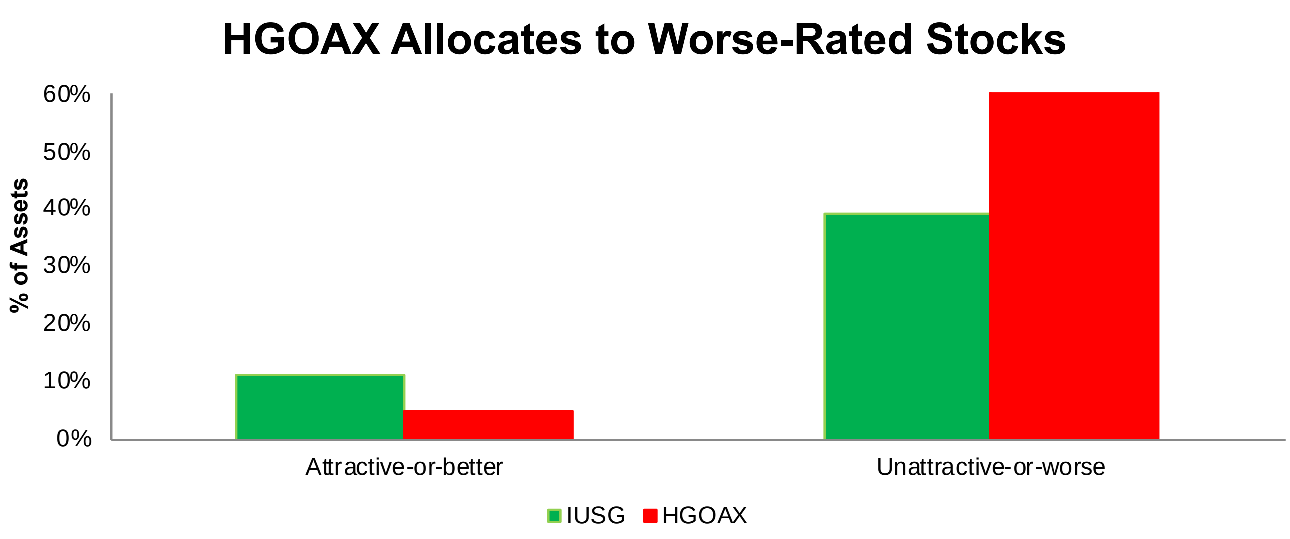


Sources: New Constructs, LLC and company, ETF and mutual fund filings

Per Figure 2, Hartford Growth Opportunities Fund's asset allocation poses greater downside risk and holds less upside potential than its benchmark, the iShares Core S&P U.S. Growth ETF (IUSG).

HGOAX allocates only 5% of its portfolio to Attractive-or-better rated stocks compared to 11% for IUSG. On the flip side, HGOAX's exposure to Unattractive-or-worse rated stocks is much higher, at 61%, than IUSG, at 39%. See Figure 3.

Figure 3: HGOAX vs. IUSG – Attractive & Unattractive Asset Allocation



Sources: New Constructs, LLC and company, ETF and mutual fund filings

Nine of the mutual fund's top 10 holdings receive an Unattractive-or-worse rating. These nine stocks make up 29% of its portfolio.

Given the unfavorable allocation of Very Attractive vs. Very Unattractive stocks relative to the benchmark, Hartford Growth Opportunities Fund appears poorly positioned to generate the outperformance required to justify its fees.

Poor Stock Selection Process

When selecting investments, the managers of HGOAX note their process is differentiated through flexibility, discipline, and active management.

- Flexibility refers to the fund's willingness to look for growth across companies of all sizes, regardless of geography or sector.

- Discipline refers to the fund's "focus on not only upside potential, but also loss potential to manage risk".
- Active management refers to the fund's high "active share", which is the percentage of stock holdings that differ from the benchmark.

In a video explaining the fund's investment process, the manager states they look for stocks with "accelerating tangible operating momentum" or ATOM. Companies with ATOM have "accelerating growth and improving margins that will lead to better than expected earnings growth."

We've shown before that earnings growth has little correlation with creating shareholder value, which makes it a poor metric to identify quality investments. As a result, HGOAX allocates to stocks less profitable and more expensive than its benchmark and the S&P 500 (SPY).

Figure 4 contains our detailed rating for HGOAX, 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 4: Hartford Growth Opportunities Fund Rating Breakdown

Hartford Mutual Funds II, Inc: Hartford Growth Opportunities Fund (HGOAX)

Closing Price: $42.77 (Jul 15, 2019)
Total Net Assets: $5.2 Billion
Style: All Cap Growth

	Portfolio Management							
	Quality of Earnings		Valuation			Asset Allocation		
Risk/Reward Rating	Economic vs Reported EPS	ROIC	FCF Yield	Price to EBV	Market-Implied 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								
HGOAX	**Neutral EE**	**10%**	**-3%**	**10.3**	**77 yrs**	**10%**		**3.6%**
Benchmarks								
Style ETF (IUSG)	Positive EE	18%	1%	4.2	57 yrs	-		0.0%
S&P 500 ETF (SPY)	Neutral EE	18%	1%	3.1	41 yrs	-		0.1%
Small Cap ETF (IWM)	Positive EE	6%	-1%	3.2	38 yrs	-		0.2%

Sources: New Constructs, LLC and company, ETF and mutual fund filings

As Figure 4 shows, HGOAX's holdings are inferior to IUSG in all five of the criteria that make up our holdings analysis. Specifically:

- HGOAX's return on invested capital (ROIC) is 10%, which is below the 18% earned by ISUG and SPY.
- HGOAX's free cash flow yield of -3% is worse than the 1% of IUSG and SPY.
- The price-to-economic book value (PEBV) ratio for HGOAX is 10.3 compared to 4.2 for IUSG holdings and 3.1 for SPY holdings.
- Our discounted cash flow analysis reveals an average market-implied growth appreciation period (GAP) of 77 years for HGOAX holdings compared to 57 years for IUSG and 41 years for SPY.

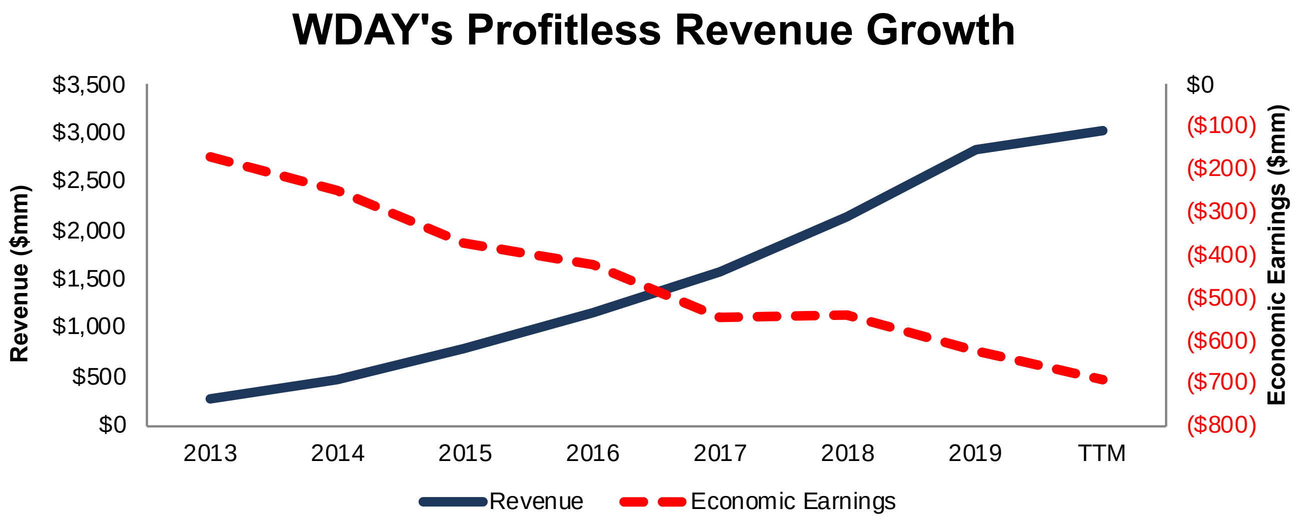
Altogether, this analysis reveals that the companies held by HGOAX earn inferior cash flows (as measured by ROIC) but are valued at a premium (as measured by FCF yield, PEBV, and GAP) when compared to the benchmark and general market (S&P 500).

How Using the Wrong Metrics Leads to Bad Stocks

Workday Inc. (WDAY: $214/share) is one of HGOAX's holdings that perfectly illustrates why relying on metrics such as earnings can lead to bad stock picks. Since 2013, WDAY's economic earnings, or in this case losses, have more than quadrupled, despite impressive top line growth.

WDAY's revenue has grown 48% compounded annually since 2013 while economic earnings, the true cash flows of the business, have fallen 24% compounded annually, to -$691 million over the trailing twelve months, per Figure 5. Over this time, WDAY's ROIC has fallen from -14% to -23%.

Figure 5: WDAY's Economic Earnings Fall Despite Revenue Growth



Sources: New Constructs, LLC and company filings

To calculate economic earnings, we must first remove non-operating expenses and income, such as the $57 million (8% of 2019 economic earnings) gain from equity investments found on page 73 of WDAY's 2019 10-K. Only by adjusting for these items can we calculate the true operating profits of the business.

Economic earnings also account for changes to the balance sheet, and include items hidden (not for long) off the balance sheet, such as $310 million (10% of reported net assets) in off-balance sheet operating leases.

By adding these leases back to invested capital, we hold WDAY accountable for all capital invested in the business. These adjustments, when combined with a rising weighted average cost of capital (10.0% TTM, up from 8.4% in 2013), increase the capital charge and decrease economic earnings.

Despite the deterioration in the true profits of the company, shares remain significantly overvalued.

Overvaluation Gets Missed. To justify its current price of $214/share, WDAY must immediately achieve 10% NOPAT margins (compared to -16% TTM) and grow revenue by 23% compounded annually for the next 20 years. See the math behind this dynamic DCF scenario. In this scenario, WDAY would be generating over $164 billion in revenue, which is more than four times greater than Oracle's (one of its largest competitors) 2018 revenue of $40 billion. This scenario seems even more optimistic given that WDAY hasn't achieved positive NOPAT margins in any year of our model.

Even if we assume WDAY can achieve 10% NOPAT margins and grow revenue by an impressive 20% compounded annually for the next decade, the stock is worth only $47/share today – a 78% downside. See the math behind this dynamic DCF scenario.

Excessive Fees Make Outperformance Even More Difficult

At 3.62%, HGOAX's total annual costs (TAC) are higher than 95% of the 559 All Cap Growth style mutual funds under coverage. For comparison, the average TAC of all All Cap Growth mutual funds under coverage is 1.70%, the weighted average is 1.53%, and the benchmark ETF (IUSG) has total annual costs of 0.04%.

Per Figure 6, each class of Hartford Growth Opportunities Fund's expense ratios understate the true costs of investing in this fund and four classes charge above average TAC. Our TAC metric accounts for more than just expense ratios. We consider the impact of front-end loads, back-end loads, redemption fees, and transaction costs. For example, HGOAX's front-end load adds 2.09% to its total annual costs and its annual turnover ratio of 122% adds 0.26% to its total annual costs that aren't captured by the expense ratio.

Figure 6: Hartford Growth Opportunities Fund's Real Costs

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
HGOVX	1.08%	0.74%	**0.34%**
HGOYX	1.13%	0.79%	**0.34%**
HGOIX	1.18%	0.83%	**0.35%**
HGOTX	1.20%	0.85%	**0.35%**
HGOSX	1.54%	1.15%	**0.39%**
HGORX	1.89%	1.46%	**0.43%**
HGOCX	2.33%	1.85%	**0.48%**
HGOAX	3.62%	1.11%	**2.51%**

Sources: New Constructs, LLC and company, ETF and mutual fund filings

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

1. HGOAX must outperform by an average of 3.57% annually.
2. HGOCX must outperform by an average of 2.29% annually.
3. HGORX must outperform by an average of 1.84% annually.
4. HGOSX must outperform by an average of 1.49% annually.

An in-depth analysis of HGOAX's TAC is on page 2 of our mutual fund report.

Free Copy of our HGOAX report

HGOAX's Performance Can't Justify Its Fees

When we take into account its load, which adds 2.09% to its total annual costs, we see that while HGOAX has underperformed in recent years and failed to justify its fees.

HGOAX's 1-year and 3-year quarter-end average annual total return underperformed IUSG by nearly 600 basis points and 40 basis points respectively. Its 10-year quarter-end average annual total return outperformed IUSG by just 13 basis points. For reference, HGOAX must outperform its benchmark by 2.08% annually over 10 years to justify its fees.

Given that 61% of assets are allocated to stocks with Unattractive-or-worse ratings, HGOAX looks likely to underperform moving forward.

The Importance of Holdings-Based Fund Analysis

Smart fund (or ETF) investing means analyzing the holdings of each mutual fund, which in the past was nearly impossible for the average investor. Instead, investors were content to buy a fund based on past performance, but studies show such a strategy does not necessarily lead to outperformance. Only through holdings-based analysis can one determine if a fund's methodology is sound and actually allocates to high-quality stocks.

Holdings-based analysis is no longer impractical for the average investor. Through our partnerships with TD Ameritrade and Interactive Brokers, investors can access our research and enjoy the sophisticated fundamental research that Wall Street insiders use. Our machine learning and Robo-Analyst technology helps investors navigate the fund landscape by analyzing the holdings of 7,500+ ETFs and mutual funds under coverage to avoid what Barron's refers to as "the danger within." This diligence allows us to cut through the noise and identify potentially dangerous funds that traditional backward-looking fund research may overlook, such as HGOAX.

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

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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