



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.

Get the best fundamental research

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 720 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.25%, which highlights how investors tend to put their [money in mutual funds with low fees](#).

Figure 1 shows Rydex Telecommunications Fund (RYTLX) is the most expensive sector mutual fund and Fidelity Real Estate Index Fund (FSRNX) is the least expensive. Rydex provides three of the most expensive mutual funds while Vanguard ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
RYTLX	Rydex Telecommunications Fund	Telecom Services	8.39%
RYCSX	Rydex Telecommunications Fund	Telecom Services	7.38%
SBMBX	Saratoga Energy and Basic Materials Portfolio	Energy	6.92%
SFPAX	Saratoga Financial Services Portfolio	Financials	6.78%
RYMAX	Rydex Telecommunications Fund	Telecom Services	6.48%
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 a Very Attractive rating.² Fidelity Select Banking Portfolio (FSRBX) is the best ranked sector mutual fund overall. FSRBX's Attractive Portfolio Management rating and 0.95% total annual cost also earns it a Very Attractive rating.

On the other hand, Fidelity Real Estate Index Fund (FSRX) 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
FIJFX	Fidelity Advisor Materials Fund	Basic Materials	Unattractive
FGKMX	Fidelity Advisor Communication Services Fund	Consumer Cyclical	Unattractive
FSHOX	Fidelity Construction and Housing Portfolio	Consumer Non-cyclical	Unattractive
IENRX	Ivy Energy Fund	Energy	Unattractive
FSPCX	Fidelity Insurance Portfolio	Financials	Unattractive
PHLQX	Prudential PGIM Jennison Health Sciences Fund	Healthcare	Unattractive
PGWTX	Putnam Focused Equity Fund	Industrials	Unattractive
OREIX	Invesco Oppenheimer Real Estate Fund	Real Estate	Very Unattractive
ADNIX	American Beacon ARK Transformational Innovation	Technology	Unattractive
FIJGX	Fidelity Advisor Telecommunications Fund	Telecom Services	Unattractive
PRUQX	Prudential PGIM Jennison Utility Fund	Utilities	Very Unattractive

Sources: New Constructs, LLC and company filings

Fidelity and Prudential appear more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Ivy Energy Fund (IENRX) is the worst rated mutual fund in Figure 2. Fidelity Advisor Materials Fund (FIJFX), Prudential PGIM Jennison Utility Fund (PRUQX), American Beacon ARK Transformational Innovation Fund (ADNIX), Prudential PGIM Jennison Health Sciences Fund (PHLQX), and Invesco Oppenheimer Real Estate Fund (OREIX) 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 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 [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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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.



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