



## Don't Buy the Worst Rated Fund in our Coverage Universe

Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#).

The Small Cap Growth style is the worst rated investment style per our [4Q19 Style Ratings for ETFs and Mutual Funds](#) report. Given the low rating of the overall style, it makes sense there would be some particularly bad Small Cap Growth mutual funds in our coverage universe. Our [Predictive Risk/Reward Fund](#) ratings, based on the proprietary stock research featured in recent [Harvard Business School and MIT Sloan research](#), reveal a fund that stands out as the worst of the worst.

Get the best fundamental research

Despite its 3 Star Morningstar rating, Dunham Small Cap Growth Fund (DADGX and other share classes) is the worst rated fund in our 8,050+ ETF and mutual fund coverage universe. DADGX is in the [Danger Zone](#).

### Backwards Looking Research Overrates this Fund

Per Figure 1, DADGX, DCDGX, and DNDGX earn the 3-Star rating from Morningstar. However, our [Predictive Risk/Reward Fund Rating](#) methodology shows them as Very Unattractive.

**Figure 1: Dunham Small Cap Growth Fund Ratings**

| Ticker | Morningstar Rating | New Constructs Rating |
|--------|--------------------|-----------------------|
| DADGX  | 3 Star             | Very Unattractive     |
| DCDGX  | 3 Star             | Very Unattractive     |
| DNDGX  | 3 Star             | Very Unattractive     |

Sources: New Constructs, LLC, company, ETF and mutual fund filings, and [Morningstar](#)

DADGX allocates significant capital to companies with low profitability and high profit growth expectations baked into their stock prices, which makes its portfolio unusually risky. Investors that rely solely on past performance may not see the true risk of investing in this fund.

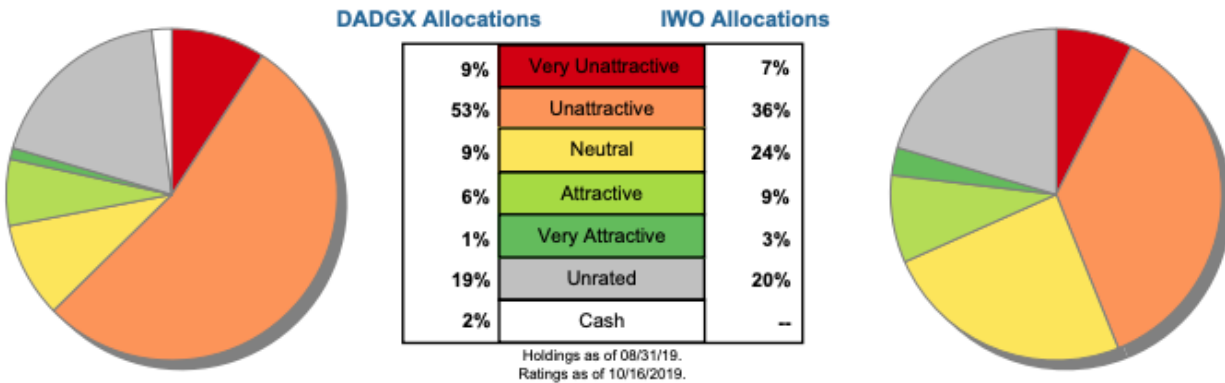
### Holdings Research Reveals a Low-Quality Portfolio Versus the Benchmark

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 assess holdings quality, we leverage our [Robo-Analyst technology](#)<sup>1</sup> and “novel dataset” featured in the Harvard Business School and MIT Sloan paper, [Core Earnings: New Data and Evidence](#), to drill down and analyze the individual stocks in every fund we cover.

<sup>1</sup> 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: DADGX Allocates Capital to More Low-Quality Holdings



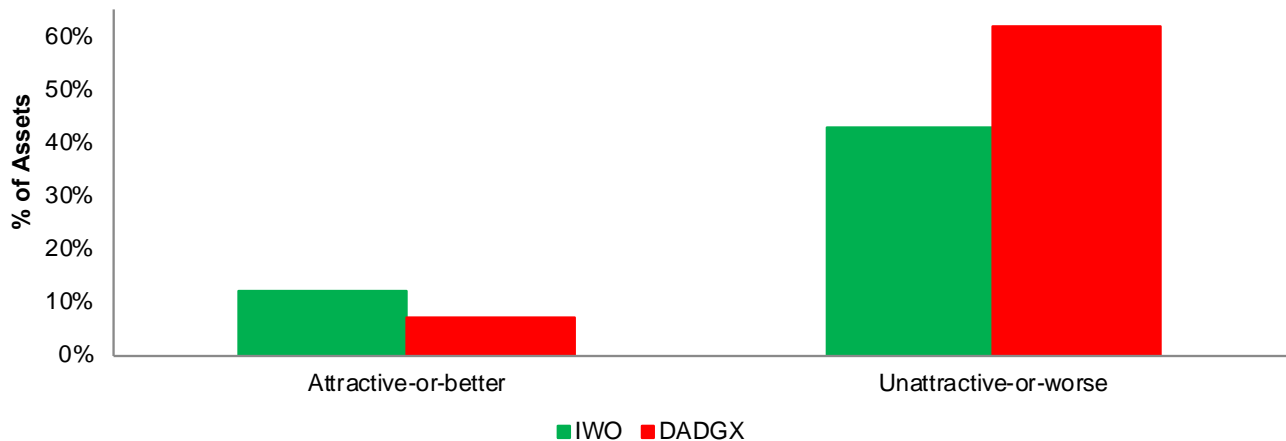
Sources: New Constructs, LLC and company, ETF and mutual fund filings

Per Figure 2, Dunham Small Cap Growth Fund’s asset allocation poses greater downside risk and holds less upside potential than its benchmark, the iShares Russell 2000 Growth ETF (IWO).

DADGX allocates just 7% of its portfolio to Attractive-or-better rated stocks compared to 12% for IWO. On the flip side, DADGX’s exposure to Unattractive-or-worse rated stocks is much higher, at 62%, than IWO, at 43%. See Figure 3.

Figure 3: DADGX vs. IWO – Attractive & Unattractive Asset Allocation

### DADGX Allocates to Worse-Rated Stocks



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

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

#### Poor Stock Selection Process

The sub-advisor for Dunham Small Cap Growth Fund, Pier Capital, notes its investment approach allows it to “invest in companies where Wall Street is underestimating growth and avoid investing in those where they are overestimating growth.”

However, when we look at DADGX’s holdings, we find that it allocates to stocks with significantly higher expectations for future profit growth than its benchmark and the market as a whole.

Figure 4 contains our detailed rating for DADGX, which includes each of the criteria we use to rate all funds under coverage. 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: Dunham Small Cap Growth Fund Rating Breakdown**

| Risk/Reward Rating <sup>?</sup> | Portfolio Management <sup>?</sup>     |                   |                        |                           |                                 |                     | Total Annual Costs <sup>?</sup> |
|---------------------------------|---------------------------------------|-------------------|------------------------|---------------------------|---------------------------------|---------------------|---------------------------------|
|                                 | Quality of Earnings                   |                   | Valuation              |                           |                                 | Asset Allocation    |                                 |
|                                 | Economic vs Reported EPS <sup>?</sup> | ROIC <sup>?</sup> | FCF Yield <sup>?</sup> | Price to EBV <sup>?</sup> | Market-Implied GAP <sup>?</sup> | Cash % <sup>?</sup> |                                 |
| 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%                           |
| <b>Actual Values</b>            |                                       |                   |                        |                           |                                 |                     |                                 |
| DADGX                           | Neutral EE                            | -2%               | -3%                    | 6.9                       | 76 yrs                          | 2%                  | 5.7%                            |
| <b>Benchmarks <sup>?</sup></b>  |                                       |                   |                        |                           |                                 |                     |                                 |
| Style ETF (IWO)                 | Positive EE                           | 6%                | -1%                    | 3.6                       | 48 yrs                          | -                   | 0.3%                            |
| S&P 500 ETF (SPY)               | Positive EE                           | 18%               | 2%                     | 2.8                       | 35 yrs                          | -                   | 0.1%                            |
| Small Cap ETF (IWM)             | Positive EE                           | 5%                | -1%                    | 3.3                       | 37 yrs                          | -                   | 0.2%                            |

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

As Figure 4 shows, DADGX’s holdings are inferior to its benchmark, IWO, in all five of criteria that make up our holdings analysis. Specifically:

- DADGX’s return on invested capital (ROIC) is -2% and well below the 6% earned by IWO and 18% by the S&P 500 (SPY).
- DADGX’s free cash flow yield of -3% is worse than the -1% of IWO and 2% of SPY.
- The price to economic book value (PEBV) ratio for DADGX is 6.9, which is significantly greater than the 3.6 for IWO holdings and the 2.8 of SPY holdings.
- Our [discounted cash flow analysis](#) reveals an average market implied growth appreciation period (GAP) of 76 years for DADGX’s holdings compared to 48 years for IWO and 35 years for SPY.

The stocks held by DADGX generate inferior cash flows compared to IWO, yet the market expects stocks held by DADGX to grow profits by nearly double that of IWO stocks. Lower historical profits and higher expectations for future profits do not make a good combination.

**DADGX Strays From its Stated Methodology**

Despite being a Small Cap Growth fund, DADGX holds nearly 40 stocks (out of ~106) with market caps well above the traditional \$2 billion small cap designation. Some of these stocks are clearly large cap stocks, such as ServiceNow (NOW: \$48 billion market cap), Atlassian Corporation (TEAM: \$30 billion market cap), and Spotify (SPOT: \$21 billion valuation). This style drift means investors expecting small cap exposure aren’t getting what they’re promised.

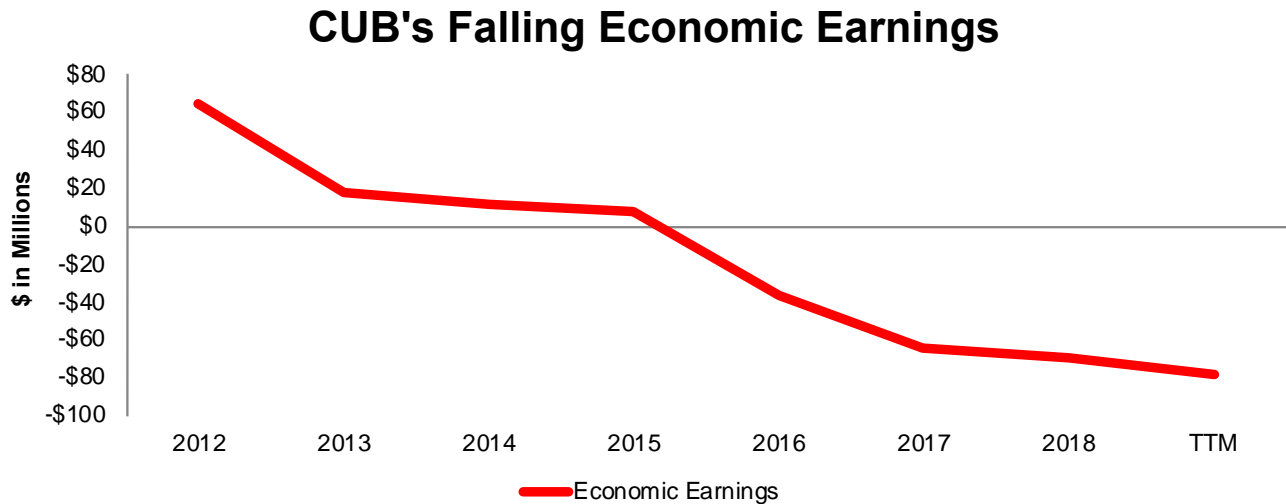
**Methodology Leads to Bad Stock Picks**

Apart from allocating to numerous large and mid cap stocks, DADGX also allocates to some of the most overvalued small cap stocks. DADGX’s holdings include many previous Danger Zone picks and stocks with notable flaws in their business model that we’ve singled out, including [Installed Building Products](#) (IBP), [ServiceNow](#) (NOW), [Zendesk](#) (ZEN), [LivePerson](#) (LPSN), [Spotify](#) (SPOT), [The RealReal](#) (REAL), [PROS Holdings](#) (PRO), [Chewy Inc.](#) (CHWY), [8x8 Inc.](#) (EHGT), and [Avalara](#) (AVLR).

Cubic Corporation (CUB: \$73/share) is one of the worst of DADGX’s holdings. Since 2012, CUB’s [economic earnings](#) have fallen from \$65 million to -\$78 million TTM.



Figure 5: CUB's Economic Earnings Decline Since 2012



Sources: New Constructs, LLC and company filings

Economic earnings account for non-operating expenses and income, such as the \$33 million (3% of TTM revenue) gain on sale [disclosed](#) in CUB's 3Q 10-Q. Only by adjusting for these non-operating items can we calculate the true operating profits of the business.

Economic earnings also account for changes to the balance sheet, and include items such as operating leases hidden ([not for long](#)) off the balance sheet. CUB's invested capital has more than doubled since 2012 despite its revenue remaining flat. Growth in invested capital without subsequent revenue growth drove CUB's [invested capital turns](#) (a measure of balance sheet efficiency) down from 2.6 in 2012 to 0.9 TTM.

Falling invested capital turns, combined with declining NOPAT margins (down from 7% in 2012 to 2% TTM) [drove](#) CUB's ROIC from a once impressive 18% in 2012 to a bottom quintile 2% TTM.

### CUB is Significantly Overvalued

Despite the deterioration in the true profits of the company, shares have increased ~80% since early 2012 and are drastically overvalued. We use our [reverse DCF model](#) to quantify the growth in cash flows CUB must achieve to justify its valuation.

To justify its current price of \$73/share, CUB must immediately achieve 7% NOPAT margins (the highest the company ever achieved in 2012 – compared to 2% TTM) and also grow NOPAT by 18% compounded annually for the next 17 years. [See the math behind this reverse DCF scenario](#). This expectation seems rather optimistic given that CUB's NOPAT has fallen by 25% compounded annually since 2012.

Even if we assume CUB can achieve 5% NOPAT margins, and grow NOPAT by 23% compounded annually for the next decade, the stock is worth only \$37/share today – a 49% downside. [See the math behind this reverse DCF scenario](#).

### Excessive Fees Make Outperformance Even More Difficult

At 5.71%, DADGX's total annual costs ([TAC](#)) are the highest out of the 536 Small Cap Growth mutual funds under coverage. In fact, only 29 out of 8,057 funds under coverage charge higher TAC than DADGX. For comparison, the average TAC of all Small Cap Growth mutual funds under coverage is 1.98%, the weighted average is 1.16%, and the benchmark ETF (IWO) has total annual costs of 0.26%.

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, DADGX's front-end load adds 2.19% to its total annual costs and its annual turnover ratio of 190% adds 0.99% to its total annual costs – neither of which are captured by the expense ratio. Figure 6 shows our breakdown of DADGX's total annual costs, which is [available](#) for all of the 8,000+ mutual funds under coverage.



**Figure 6: Dunham Small Cap Growth Fund Total Annual Costs Breakdown**

| Total Annual Costs Breakdown |              |              |
|------------------------------|--------------|--------------|
| All Cost Types               | DADGX        | IWO          |
| Front-End Load               | 2.19%        | --           |
| Expense Ratio                | 2.52%        | 0.26%        |
| Back-End Load                | 0.00%        | --           |
| Redemption Fee               | 0.00%        | --           |
| Transaction Costs            | 0.99%        | --           |
| <b>Total Annual Costs</b>    | <b>5.71%</b> | <b>0.26%</b> |

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. DADGX must outperform by an average of 5.43% annually.
2. DCDGX must outperform by an average of 4.05% annually.
3. DNDGX must outperform by an average of 2.88% annually.

An in-depth analysis of DADGX and its TAC is available in our standard mutual fund report.

Free Copy of our DADGX report

**DADGX’s Performance Can’t Justify Its Fees**

When we take into account its load, which adds 2.19% to its total annual costs, we see that DADGX has underperformed in recent years and failed to justify its fees.

DADGX’s 1-year [quarter-end average annual total return](#) underperformed IWO by over 600 basis points. Its 3-year quarter-end average annual total return bested IWO by 103 basis points, which is nowhere near enough to justify its fees, as noted above. Its 5 and 10-year quarter-end average annual total return each underperformed by 4 and 108 basis points respectively

Given that 62% of assets are allocated to stocks with Unattractive-or-worse ratings, DADGX 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. Failure to do so is a failure to perform proper due diligence. Simply buying a mutual fund or ETF based on past performance [does not necessarily lead](#) to outperformance. Only through holdings-based analysis can one determine if a fund’s methodology leads managers to pick high-quality or low-quality stocks.

However, most investors don’t realize they can access sophisticated fundamental research using data that [corrects market inefficiencies and generates alpha](#). Our [Robo-Analyst technology](#) analyzes the holdings of all 556 ETFs and mutual funds in the Small Cap Growth style and 8,000+ ETFs and mutual funds under coverage to avoid [“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 DADGX.

2 This [paper](#) compares our analytics on a mega cap company to other major providers.



### **Better Rated Small Cap Growth Funds**

There are no Small Cap Growth mutual funds that earn an Attractive-or-better rating, which helps explain why it ranks last of the 12 investment styles in our [4Q19 Style Ratings for ETFs and Mutual Funds](#) report. Investors looking for exposure to Small Cap Growth stocks should build their own portfolio of Attractive-or-better Small Cap Growth stocks instead of paying someone else to do it poorly.

*This article originally published on [October 21, 2019](#).*

*Disclosure: David Trainer, Kyle Guske II, and Sam McBride 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.*



## ***Footnotes adjustments matter. We are the ONLY source.***

---

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

**[HBS & MIT Sloan research](#) reveals that:**

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies ([featured by Harvard Business School](#)), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, [Core Earnings: New Data and Evidence](#), shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This [paper](#) compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Quotes from HBS & MIT Sloan professors on our research:

### **Get better research:**

*“...the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications.”* – page 19

### **Pick better stocks:**

*“Trading strategies that exploit cross-sectional differences in firms’ transitory earnings produce abnormal returns of 7-to-10% per year.”* – Abstract

### **Avoid losses from using other firms’ data:**

*“...many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat...”* – page 13

### **Build better models:**

*“Core Earnings [calculated using New Constructs’ novel dataset] provides predictive power for various measures of one-year-ahead performance...that is incremental to their current-period counterparts.”* – page 3-4

### **Exploit market inefficiencies:**

*“These results suggest that the adjustments made by analysts to better capture core earnings are incomplete, and that the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures.”* – page 26

### **Fulfill fiduciary duties:**

*“An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A.”* – page 31





## ***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.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.