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. Only our research utilizes the superior data and earnings adjustments featured by the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence." We leverage this data to identify 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 703 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.23%, which highlights how investors tend to put their money in mutual funds with low fees.

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

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
RYTLX	Rydex Series Telecommunications Fund	Telecom Services	8.48%
RYCSX	Rydex Series Telecommunications Fund	Telecom Services	7.47%
SBMBX	Saratoga Energy and Basic Materials Portfolio	Energy	6.92%
SFPAX	Saratoga Financial Services Portfolio	Financials	6.78%
RYMAX	Rydex Series Telecommunications Fund	Telecom Services	6.61%
	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 (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
FIJFX	Fidelity Advisor Materials Fund	Basic Materials	Unattractive
FGKMX	Fidelity Advisor Communication Services Fund	Consumer Cyclicals	Unattractive
PGLOX	T. Rowe Price Global Consumer Fund	Consumer Non-cyclicals	Unattractive
DLDYX	BNY Mellon Natural Resources Fund	Energy	Unattractive
DVFYX	Davis Financial Fund	Financials	Unattractive
PHLQX	Prudential Jennison Health Sciences Fund	Healthcare	Unattractive
FSDAX	Fidelity Defense and Aerospace Portfolio	Industrials	Unattractive
VREPX	Voya Real Estate Fund	Real Estate	Unattractive
USSCX	USAA Science & Technology Fund	Technology	Very Unattractive
FIJGX	Fidelity Advisor Telecommunications Fund	Telecom Services	Unattractive
PRUQX	Prudential Jennison Utility Fund	Utilities	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.

Fidelity Advisor Materials Fund (FIJFX) is the worst rated mutual fund in Figure 2. BNY Mellon Natural Resources Fund (DLDYX), Prudential Jennison Health Sciences Fund (PHLQX), Voya Real Estate Fund (VREPX), and USAA Science & Technology Fund (USSCX) 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.

This article originally published on October 29, 2019.

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