How to Avoid the Worst Style ETFs

Question: Why are there so many ETFs?

Answer: ETF providers tend to make lots of money on each ETF so they create more products to sell.

The large number of ETFs 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 ETFs:

1. Inadequate Liquidity

This issue is the easiest issue to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the ETF and larger bid-ask spreads.

2. High Fees

ETFs 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 ETFs with total annual costs below 0.40%, which is the average total annual cost of the 468 U.S. equity Style ETFs we cover. The weighted average is lower at 0.13%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Northern Lights HCM Defender 500 Index ETF (LGH) is the most expensive style ETF and JPMorgan BetaBuilders U.S. Equity ETF (BBUS) is the least expensive. Northern Lights Fund Trust III (LGH, QQH) provides two of the most expensive ETFs while Schwab U.S. Broad Market ETF (SCHB) is among the cheapest.

Figure 1: 5 Most and Least Expensive Style ETFs

Ticker	Name	Style	Total Annual Cost
	Most Expensive		
LGH	Northern Lights HCM Defender 500 Index ETF	Large Cap Blend	1.52%
QQH	Northern Lights HCM Defender 100 Index ETF	Large Cap Blend	1.52%
CCOR	Listed Funds Core Alternative ETF	Large Cap Value	1.37%
DUSL	Direxion Daily Industrials Bull 3X Shares	All Cap Blend	1.12%
ACT	AdvisorShares Vice ETF	All Cap Blend	1.10%
	Least Expensive		
BBUS	JPMorgan BetaBuilders U.S. Equity ETF	Large Cap Blend	0.02%
VTI	Vanguard Total Stock Market Index Fund	All Cap Blend	0.03%
SCHB	Schwab U.S. Broad Market ETF	All Cap Blend	0.03%
ITOT	iShares Core S&P Total U.S. Stock Market ETF	All Cap Blend	0.03%
SPTM	State Street SPDR Portfolio Total Stock Market ETF	All Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] State Street SPDR Portfolio Total Stock Market ETF (SPTM) is the best ranked style ETF in the least expensive section of Figure 1. SPTM's Neutral Portfolio Management rating and 0.03% total annual cost earns it a Neutral rating.[2] Arrow QVM Equity Factor ETF (QVM) is the best ranked style ETF overall. QVM's Very Attractive Portfolio Management rating and 0.72% total annual cost earns it a Very Attractive rating.

On the other hand, Schwab U.S. Small Cap ETF (SCHA) holds poor stocks and earns our Unattractive rating, yet has low total annual costs of 0.04%. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoid bad ETFs, but it is also the most important because an ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst holdings or portfolio management ratings.

Figure 2: Style ETFs with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
GIGE	SoFi Gig Economy ETF	All Cap Blend	Unattractive
FPX	First Trust U.S. Equity Opportunities ETF	All Cap Growth	Unattractive
DVOL	First Trust Dorsey Wright Momentum & Low Volatility	All Cap Value	Unattractive
IWB	iShares Russell 1000 ETF	Large Cap Blend	Neutral
NULG	Nuveen ESG Large Cap Growth ETF	Large Cap Growth	Neutral
DDIV	First Trust Dorsey Wright Momentum & Dividend ETF	Large Cap Value	Neutral
CSD	Invesco S&P Spin-Off ETF	Mid Cap Blend	Unattractive
BOSS	Global X Founder-Run Companies ETF	Mid Cap Growth	Unattractive
NUMV	Nuveen ESG Mid Cap Value ETF	Mid Cap Value	Unattractive
PRFZ	Invesco FTSE RAFI U.S. 1500 Small-Mid	Small Cap Blend	Unattractive
MFMS	RBB Fund MFAM Small Cap Growth ETF	Small Cap Growth	Unattractive
RZV	Invesco S&P Small Cap 600 Pure Value ETF	Small Cap Value	Unattractive

Sources: New Constructs, LLC and company filings

First Trust and Invesco appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

RBB Fund MFAM Small Cap Growth ETF (MFMS) is the worst rated ETF in Figure 2. SoFi Gig Economy ETF (GIGE) and First Trust U.S. Equity Opportunities ETF (FPX) 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 ETFs are on our stock ratings of their holdings and the total annual costs of investing in the ETF.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF'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.

PERFORMANCE OF ETFs HOLDINGs = PERFORMANCE OF ETF

[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.

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 Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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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.

Learn more.

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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 20

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 14

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 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, 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 33-34

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