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 1.88%, which is the average total annual costs of the 670 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 Saratoga Financial Services Portfolio (SFPAX) is the most expensive sector mutual fund and Vanguard Real Estate II Index Fund (VRTPX) is the least expensive. Saratoga (SFPAX, SBMBX, SFPCX) provides three of the most expensive mutual funds while Vanguard (VRTPX, VUIAX, VINAX) mutual funds are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
SFPAX	Saratoga Financial Services Portfolio	Financials	6.80%
SBMBX	Saratoga Energy and Basic Materials Portfolio	Energy	6.31%
SFPCX	Saratoga Energy and Basic Materials Portfolio	Energy	5.15%
RYTLX	Rydex Telecommunications Fund	Telecom Services	4.97%
RYREX	Rydex Real Estate Fund	Real Estate	4.93%
	Least Expensive		
VRTPX	Vanguard Real Estate II Index Fund	Real Estate	0.09%
FESIX	Fidelity SAI Real Estate Index Fund	Real Estate	0.10%
FSRNX	Fidelity Real Estate Index Fund	Real Estate	0.10%
VUIAX	Vanguard Utilities Index Fund	Utilities	0.12%
VINAX	Vanguard Industrials Index Fund	Industrials	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Vanguard Industrials Index Fund (VINAX) is the best ranked sector mutual fund in Figure 1. VINAX's Unattractive Portfolio Management rating and 0.12% total annual cost earns it a Neutral rating.[2] Fidelity Banking Portfolio (FSRBX) is the best ranked sector mutual fund overall. FSRBX's Attractive Portfolio Management rating and 0.92% total annual cost also earns it a Very Attractive rating.

On the other hand, Vanguard Utilities Index Fund (VUIAX) holds poor stocks and receives our Unattractive rating, yet has low total annual costs of 0.12%. 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
FMFAX	Fidelity Advisor Materials Fund	Basic Materials	Unattractive
FDLSX	Fidelity Select Leisure Portfolio	Consumer Cyclicals	Unattractive
FSHOX	Fidelity Select Construction and Housing Portfolio	Consumer Non-cyclicals	Neutral
HNRGX	Hennessy BP Energy Fund	Energy	Unattractive
FNTEX	Fidelity Disruptive Finance Fund	Financials	Unattractive
PHLAX	PGIM Jennison Health Sciences Fund	Healthcare	Unattractive
VINAX	Vanguard Industrials Index Fund	Industrials	Unattractive
DAREX	Dunham Real Estate Stock Fund	Real Estate	Unattractive
ADNAX	American Beacon ARK Transformational Innovation	Technology	Unattractive
FTUAX	Fidelity Advisor Telecommunications Fund	Telecom Services	Unattractive
PRUAX	PGIM Jennison Utility Fund	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

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

Hennessy BP Energy Fund (HNRGX) is the worst rated mutual fund in Figure 2. Dunham Real Estate Stock Fund (DAREX), American Beacon ARK Transformational Innovation Fund (ADNAX), PGIM Jennison Health Sciences Fund (PHLAX), PGIM Jennison Utility Fund (PRUAX), and Fidelity Advisor Telecommunications Fund (FTUAX) 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] Compare our analytics on a mega cap company to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.
[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 Matt Shuler receive no compensation to write about any specific stock, sector, 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.

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 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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