How to Avoid the Worst Style 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 investors' 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 investors can use to avoid the worst mutual funds:

1. Inadequate Liquidity

This issue is the easiest issue 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 1.69%, which is the average total annual cost of the 6232 U.S. equity Style mutual funds we cover. The weighted average is lower at 0.98%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows American Growth Fund Series Two (AMREX) is the most expensive style mutual fund and iShares S&P 500 Index Fund (BSPGX) is the least expensive. American Growth (AMREX, AMRBX, AMRAX, AMRGX, AMRCX) provides five of the most expensive mutual funds while Vanguard (VSTSX and VFFSX) mutual funds are among the cheapest.

Figure 1: 5 Most and Least Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
Most Expensive			
AMREX	American Growth Fund Series Two	All Cap Blend	13.23%
AMRBX	American Growth Fund Series One	All Cap Blend	11.96%
AMRAX	American Growth Fund Series One	All Cap Blend	8.66%
AMRGX	American Growth Fund Series One	All Cap Blend	8.24%
AMRCX	American Growth Fund Series One	All Cap Blend	7.56%
Least Expensive			
BSPGX	iShares S&P 500 Index Fund	Large Cap Blend	0.02%
VSTSX	Vanguard Total Stock Market Index Fund	All Cap Blend	0.02%
VFFSX	Vanguard 500 Index Fund	Large Cap Blend	0.02%
FXAIX	Fidelity 500 Index Fund	Large Cap Blend	0.02%
SWPPX	Schwab S&P 500 Index Fund	Large Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] iShares S&P 500 Index Fund (BSPGX) is the best ranked style mutual fund in Figure 1. BSPGX's Neutral Portfolio Management rating and 0.02% total annual cost earns it an Attractive rating.[2] Fidelity Blue Chip Value Fund (FBCVX) is the best ranked style mutual fund overall. FBCVX's Attractive Portfolio Management rating and 0.81% total annual cost earns it a Very Attractive rating.

On the other hand, Fidelity Mid Cap Growth Index Fund (FMDGX) holds poor stocks and receives our Unattractive rating, yet has low total annual costs of 0.06%. 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 style with the worst holdings or portfolio management ratings.

Figure 2: Style Mutual Funds with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
AMREX	American Growth Fund Series Two	All Cap Blend	Very Unattractive
INSIX	Catalyst Insider Buying Fund	All Cap Growth	Very Unattractive
NVDEX	Wells Fargo Diversified Equity Fund	All Cap Value	Unattractive
BLPIX	ProFunds Bull Fund	Large Cap Blend	Unattractive
PCLCX	PACE Large Co Growth Equity Investments	Large Cap Growth	Unattractive
UPDDX	Upright Growth & Income Fund	Large Cap Value	Unattractive
WEHIX	Weitz Hickory Fund	Mid Cap Blend	Unattractive
DBMYX	BNY Mellon Small/Mid Cap Growth Fund	Mid Cap Growth	Unattractive
TASMX	Transamerica Small/Mid Cap Value	Mid Cap Value	Very Unattractive
SLPIX	ProFunds Small Cap Fund	Small Cap Blend	Very Unattractive
PCSGX	PACE Small/Medium Co Growth Equity Investments	Small Cap Growth	Very Unattractive
PVEYX	PACE Small/Medium Co Value Equity Investments	Small Cap Value	Very Unattractive

Sources: New Constructs, LLC and company filings

PACE appears more often than any other providers in Figure 2, which means that it offers the most mutual funds with the worst holdings.

BNY Mellon Small/Mid Cap Growth Fund (DBMYX) is the worst rated mutual fund in Figure 2. American Growth Fund Series Two (AMREX), Weitz Hickory Fund (WEHIX), PACE Small/Medium Co Growth Equity Investments (PCSGX), Profunds Small Cap Fund (SLPIX), Transamerica Small/Mid Cap Value (TASMX), Catalyst Insider Buying Fund (INSIX), PACE Small/Medium Co Value Equity Investments (PVEYX), and Upright Growth & Income Fund (UPDDX) 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

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.

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.

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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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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