



How to Avoid the Worst Sector 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.

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The large number of ETFs has little to do with serving your best interests. More reliable & [proprietary](#) fundamental data, proven in [The Journal of Financial Economics](#), drives our research and analysis of ETF holdings. 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 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 average or below average fees, invest only in ETFs with [total annual costs](#) below 0.47%, which is the average total annual costs of the 257 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.30%, which highlights how investors tend to put their [money in ETFs with low fees](#).

Figure 1 shows Invesco KBW High Dividend Yield Financial ETF (KBWD) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. Fidelity provides three of the least expensive ETFs.

Figure 1: 5 Most and Least Expensive Sector ETFs

| Ticker | Name | Sector | Total Annual Cost |
|-----------------|---|------------------------|-------------------|
| Most Expensive | | | |
| SCHH | Schwab U.S. REIT ETF | Real Estate | 0.08% |
| USRT | iShares U.S. Core U.S. REIT ETF | Real Estate | 0.09% |
| FSTA | Fidelity MSCI Consumer Staples Index ETF | Consumer Non-cyclicals | 0.09% |
| FNCL | Fidelity MSCI Financials Index ETF | Financials | 0.09% |
| FCOM | Fidelity MSCI Communication Services Index ETF | Telecom Services | 0.09% |
| Least Expensive | | | |
| KBWD | Invesco KBW High Dividend Yield Financial ETF | Financials | 1.38% |
| EMLP | First Trust North American Energy Infrastructure Fund | Energy | 1.07% |
| KOIN | Exchange Traded Capital Link NextGen Protocol | Technology | 1.06% |
| ARKW | ARK Next Generation Internet ETF | Technology | 0.88% |
| BBP | Virtus LifeSci Biotech Products ETF | Healthcare | 0.88% |

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.¹ Fidelity MSCI Consumer Staples Index ETF (FSTA) is the best ranked sector ETF in Figure 1. FSTA's Attractive [Portfolio Management rating](#) and 0.09% total annual cost

¹ Three independent studies from respected institutions prove the superiority of our data, models, and ratings. Learn more [here](#).



earns it a Very Attractive rating.² First Trust Consumer Staples AlphaDEX Fund (FXG) is the best ranked sector ETF overall. FXG's Attractive Portfolio Management rating and 0.70% total annual cost also earns it a Very Attractive rating.

On the other hand, Schwab U.S. REIT ETF (SCHH) holds poor stocks and earns our Very Unattractive, yet has low total annual costs of 0.08%. 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 avoiding bad ETFs, but it is also the most important because an ETF's performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each sector with the worst holdings or [portfolio management ratings](#).

Figure 2: Sector ETFs with the Worst Holdings

| Ticker | Name | Sector | Portfolio Management Rating |
|--------|---|-----------------------|-----------------------------|
| XME | State Street SPDR S&P Metals Mining ETF | Basic Materials | Unattractive |
| BUYZ | Franklin Disruptive Commerce ETF | Consumer Cyclical | Unattractive |
| IYK | iShares U.S. Consumer Goods ETF | Consumer Non-cyclical | Neutral |
| IEO | iShares U.S. Oil & Gas Exploration & Production | Energy | Unattractive |
| PSCF | Invesco S&P Small Cap Financials ETF | Financial | Unattractive |
| FBT | First Trust NYSE ARCA Biotechnology | Healthcare | Unattractive |
| JETS | U.S. Global Jets ETF | Industrials | Unattractive |
| SCHH | Schwab U.S. REIT ETF | Real Estate | Unattractive |
| ARKK | ARK Innovation | Technology | Unattractive |
| JHCS | John Hancock Multifactor Media and Communications | Telecom Services | Unattractive |
| VPU | Vanguard Utilities Index Fund | Utilities | Unattractive |

Sources: New Constructs, LLC and company filings

iShares appears more often than any other provider in Figure 2, which means that they offer the most ETFs with the worst holdings.

ETF Series U.S. Global Jets ETF (JETS) is the worst rated ETF in Figure 2. ARK Innovation ETF (ARKK), First Trust NYSE ARCA Biotechnology Index (FBT), iShares U.S. Oil & Gas Exploration & Production (IEO), Franklin Templeton Disruptive Commerce ETF (BUYZ), and Schwab U.S. REIT ETF (SCHH) 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

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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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
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Best Fundamental Data in the World

Forthcoming in [The Journal of Financial Economics](#), a top peer-reviewed journal, [Core Earnings: New Data & Evidence](#) proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior [fundamental data](#), [earnings](#) models, and [research](#). More [details](#).

Key quotes from the paper:

- “[New Constructs’] *Total Adjustments* differs significantly from the items identified and excluded from Compustat’s adjusted earnings measures. For example... 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global’s (SPGI) Adjustments* individually.” – pp. 14, 1st para.
- “A final source of differences [between New Constructs’ and S&P Global’s data] is due to data collection oversights...we identified cases where Compustat did not collect information relating to firms’ income that is useful in assessing core earnings.” – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg’s in [Getting ROIC Right](#). See the [Appendix](#) for direct comparison details.

Key quotes from the paper:

- “...an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC.” – pp. 8, 5th para.
- “The majority of the difference...comes from New Constructs’ machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies.” – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts’ stock ratings outperform those from human analysts as shown in this [paper](#) from Indiana’s Kelley School of Business. Bloomberg features the paper [here](#).

Key quotes from the paper:

- “the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant.” – pp. 6, 3rd para.
- “Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts.” – pp. 20, 3rd para.

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