Don't Overpay for Subpar Asset Allocation

Through rigorous analysis of ~7,300+ ETFs and mutual funds, we recently identified a mid cap fund that provides exposure to good stocks, i.e. quality businesses at good prices. That was last week's Long Idea. This week's Danger Zone idea is the opposite. A mid cap mutual fund that allocates to bad stocks, i.e. companies that are less profitable and more expensive than those in its benchmark and the overall market. Add in well above-average costs, and future outperformance of this fund looks unlikely. BlackRock Mid Cap Growth Equity Portfolio (BMGAX) is this week's Danger Zone pick.

Forward-Looking Research Protects Investors

Most legacy fund research is backward-looking. In other words, it is based on past price performance. Our fund research takes a forward-looking approach based on proven superior fundamental analysis and ratings on each individual holding.

Figure 1 shows how our forward-looking Fund Ratings compare to Morningstar (MORN) ratings. We rate BMGAX Unattractive (equivalent to Morningstar's 1 Star) while Morningstar gives BMGAX a 3 Star rating. BMGCX, BMRRX, CMGIX, and CMGSX, other share classes of the mutual fund, also earn a 3 Star rating while we rate each Unattractive.

Figure 1: BlackRock Mid Cap Growth Equity Fund Ratings

Ticker	Morningstar Rating	New Constructs Rating
BMGAX	3 Star	Unattractive
BMGCX	3 Star	Unattractive
BMRRX	3 Star	Unattractive
CMGIX	3 Star	Unattractive
CMGSX	3 Star	Unattractive
BMGKX	2 Star	Unattractive

Sources: New Constructs, LLC, company filings, mutual fund filings, and Morningstar

Methodology Short on Details

BlackRock Mid Cap Growth Equity Fund invests in "equity securities issued by U.S. mid-capitalization growth companies…that fund management team believes have above-average earnings growth potential."

Unfortunately, investors are given few quantifiable details about how the fund managers go about selecting these stocks. The fund's website describes the fund as follows:

1. A high conviction, mid-cap growth strategy.
2. Combines diversified sources of growth.
3. Seeks to outperform in all markets.

The fund's prospectus also notes that the investment strategy of the fund is to invest in mid cap companies which have above-average earnings growth potential.

Without any more specifics on how this fund's managers pick stocks, we judge BMGAX based on what we can measure: the quality of the stocks they hold.

Our analysis reveals BMGAX's investment process leads to holdings with lower returns on invested capital (ROIC), lower cash flows, and more expensive valuations than its benchmark and the S&P 500. More details below.

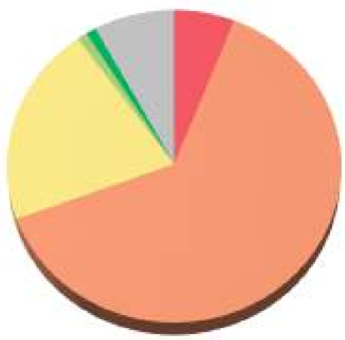
Holdings Research Reveals a Low-Quality Mid Cap Portfolio

Our holdings analysis, which leverages our Robo-Analyst technology[1], reveals that BMGAX holds lower-quality stocks than its benchmark iShares Russell Mid-Cap Growth ETF (IWP). For reference, IWP earns an Attractive rating.

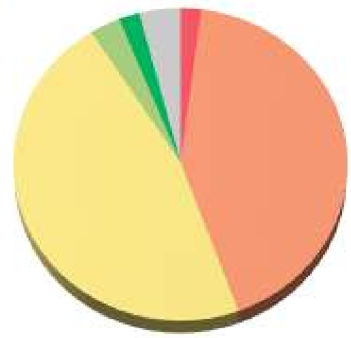
Per Figure 2, BMGAX allocates 70% of its portfolio to Unattractive-or-worse rated stocks compared to 44% for IWP. On the flip side, BMGAX allocates only 2% of its assets to Attractive-or-better rated stocks compared to 5% for IWP.

Figure 2: BlackRock Mid Cap Growth Equity Fund Allocates to Far Worse Stocks than IWP

Stock Rating Allocations - BMGAX vs. IWP



BMGAX Allocations		IWP Allocations
6%	Very Unattractive	2%
64%	Unattractive	42%
21%	Neutral	46%
1%	Attractive	3%
1%	Very Attractive	2%
8%	Unrated	4%
0%	Cash	-



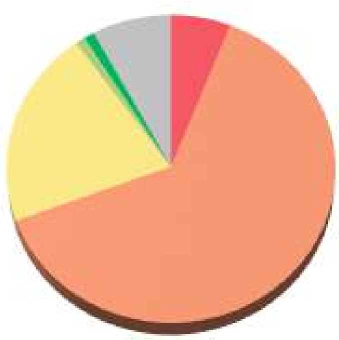
Sources: New Constructs, LLC, company, ETF, and mutual fund filings

Per Figure 3, our holdings analysis also reveals BMGAX's portfolio is lower quality than the S&P 500, as represented by State Street SPDR S&P 500 ETF (SPY), which earns an Attractive rating.

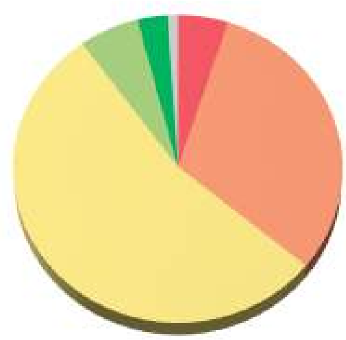
At just 36% of its portfolio, SPY allocates less to Unattractive-or-worse rated stocks compared to BMGAX. On the flip side, at 9% of its portfolio, SPY's exposure to Attractive-or-better rated stocks is higher than BMGAX.

Figure 3: BlackRock Mid Cap Growth Equity Fund Allocates to Worse Stocks than SPY

Stock Rating Allocations - BMGAX vs. SPY



BMGAX Allocations		SPY Allocations
6%	Very Unattractive	5%
64%	Unattractive	31%
21%	Neutral	54%
1%	Attractive	6%
1%	Very Attractive	3%
8%	Unrated	1%
0%	Cash	0%



Sources: New Constructs, LLC, company, ETF, and mutual fund filings

Given BMGAX allocates just 2% of assets to Attractive-or-better rated stocks, it appears poorly positioned to generate the outperformance required to justify higher active management fees.

Expensive Stocks Drive Unattractive Risk/Reward Rating

Figure 4 contains our detailed rating for BMGAX, which includes each of the criteria we use to rate all ETFs and mutual funds under coverage. These criteria are the same for our Stock Rating Methodology, as the

[1] See Harvard Business School case study: New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

performance of a mutual fund equals the performance of its holdings minus fees. Figure 4 also compares BMGAX's rating with those of IWP and SPY.

Figure 4: BlackRock Mid Cap Growth Equity Fund Rating Details

Risk/Reward Rating	Portfolio Management						Total Annual Costs
	Quality of Earnings		Valuation			Asset Allocation	
	Economic vs Reported EPS	ROIC	2 yr Avg FCF (excl cash) Yield	Price to EBV	Market-Implied GAP	Cash %	
Very Unattractive	Misleading Trend	Bottom Quintile	< -5%	> 3.5 or -1< 0	> 50	> 20%	> 4%
Unattractive	False Positive	4th Quintile	-5% < -1%	2.4< 3.5 or < -1	20 < 50	8% < 20%	2% < 4%
Neutral	Neutral EE	3rd Quintile	-1% < 3%	1.6< 2.4	10 < 20	2.5% < 8%	1% < 2%
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1< 1.6	3 < 10	1% < 2.5%	0.5% < 1%
Very Attractive	Rising EE	Top Quintile	> 10%	0< 1.1	0 < 3	< 1%	< 0.5%
Actual Values							
BMGAX	Neutral EE	12%	-1%	7.2	96 yrs	< 1%	3.3%
Benchmarks							
Style ETF (IWP)	Positive EE	17%	1%	5.9	83 yrs	-	0.3%
S&P 500 ETF (SPY)	Positive EE	32%	2%	4.3	73 yrs	-	0.1%
Small Cap ETF (IWM)	Positive EE	6%	0%	4.1	56 yrs	-	0.2%

Sources: New Constructs, LLC, company, ETF, and mutual fund filings

As Figure 4 shows, BMGAX is inferior to IWP in all five criteria that make up our Portfolio Management rating. Specifically:

- BMGAX's holdings have a Neutral Economic Earnings vs. EPS rating compared to Positive EE vs. EPS for IWP and SPY.
- BMGAX's ROIC is 12%, which is lower than IWP's (17%) and SPY's (32%) ROIC.
- BMGAX's 2-yr average free cash flow (FCF) yield of -1% is lower than IWP's at 1% and SPY's at 2%.
- The price-to-economic book value (PEBV) ratio for BMGAX is 7.2, which is greater than the 5.9 for IWP and the 4.3 for SPY.
- Our discounted cash flow (DCF) analysis reveals an average market-implied growth appreciation period (GAP) of 96 years for BMGAX's holdings compared to 83 years for IWP's and 73 years for SPY's holdings.

Market expectations for stocks held by BMGAX imply profits will grow substantially more than the stock's held by IWP and SPY (measured by PEBV ratio).

This rigorous holdings analysis reveals that BMGAX provides exposure to less profitable mid cap companies, while taking much more valuation risk than the benchmark and S&P 500.

Fees Only Make Owning BMGAX Worse

At 3.28%, BMGAX's total annual costs (TAC) are higher than 87% of Mid Cap Growth mutual funds under coverage. For comparison, the simple average TAC of all the Mid Cap Growth mutual funds under coverage is 1.64% and the asset-weighted average is 1.43%. IWP charges just 0.25% and SPY also has total annual costs of just 0.10%. Why pay higher fees for inferior stock selection?

Our TAC metric accounts for more than just the expense ratio. We consider the impact of front-end loads, back-end loads, redemption fees, and transaction costs – the latter of which adds 0.10% to BMGAX's TAC.

Figure 5 shows our breakdown of BMGAX's total annual costs, which we provide for all ~6,100+ mutual funds and ~1,100+ ETFs under coverage.

Figure 5: BlackRock Mid Cap Growth Equity Fund's Total Annual Costs Breakdown

Total Annual Costs Breakdown		
All Cost Types	BMGAX	IWP
Front-End Load	2.00%	--
Expense Ratio	1.19%	0.25%
Back-End Load	0.00%	--
Redemption Fee	0.00%	--
Transaction Costs	0.10%	--
Total Annual Costs	**3.28%**	**0.25%**

Sources: New Constructs, LLC, company, ETF, and mutual fund filings

To justify charging higher fees, BMGAX must outperform its benchmark by 302 basis points annually over three years.

However, BMGAX's 3-year quarter-end trailing annual return has underperformed IWP by 665 basis points and SPY by 1683 basis points. BMGAX has also underperformed over the 1-year and 5-year periods.

Given that 70% of assets are allocated to stocks with Unattractive-or-worse ratings, and 98% are allocated to stocks with Neutral-or-worse ratings, BMGAX is likely to continue underperforming.

Get an Edge from Holdings-Based Fund Analysis Based on Superior Stock Research

We offer clients in-depth reports for all ~7,300 ETFs and mutual funds under coverage. Click below for a free copy of our BMGAX standard mutual fund report.

Free copy of our BMGAX report

Smart fund (or ETF) investing means analyzing each of the holdings of a fund. Failure to do so is a failure to perform proper due diligence. Simply buying an ETF or mutual fund based on past performance does not necessarily lead to outperformance. Only thorough holdings-based research can help determine if a fund's methodology leads managers to pick high-quality or low-quality stocks.

Most investors don't realize they can access superior fundamental research that enables them to overcome inaccuracies, omissions, and biases in legacy fundamental research and data. Our Robo-Analyst technology analyzes the holdings of all 307 ETFs and mutual funds in the Mid Cap Growth style and ~7,300 ETFs and mutual funds under coverage to avoid "the danger within".

Our diligence on holdings allows us to cut through the noise and identify potentially dangerous funds, like BlackRock Mid Cap Growth Equity Fund, that traditional, backward-looking fund research overrates.

Easily Make Any Fund, Even BMGAX, Better

As we show in The Paradigm Shift to DIY ETFs, new technologies enable investors to create their own fund without any fees while also enabling better, more sophisticated weighting methodologies. For example, if we take the same stocks already in BMGAX and reallocate the capital to them so that the stocks with the best Core Earnings get the most capital, we get a much better fund.

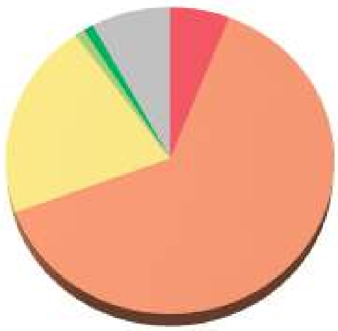
Figure 6 compares our new customized version of BGMAX to the original. Not surprisingly, our new version allocates more capital to better stocks:

- 57% of assets to Unattractive-or-worse rated stocks (compared to 70% for BMGAX)
- 15% of assets to Attractive-or-better rated stocks (compared to 2% for BMGAX).

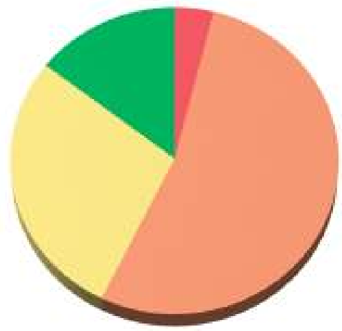
Compare the quality of stock allocation in as-is BMGAX vs. our customized version of BMGAX in Figure 6.

Figure 6: BlackRock Mid Cap Growth Equity Fund Allocation Could Be Improved

Stock Rating Allocations - BMGAX vs. Custom



BMGAX Allocations		Custom Allocation
6%	Very Unattractive	4%
64%	Unattractive	53%
21%	Neutral	28%
1%	Attractive	0%
1%	Very Attractive	15%
8%	Unrated	0%
0%	Cash	0%



Sources: New Constructs, LLC, company, and mutual fund filings

Better Options for Mid Cap Growth Funds

Below we present Mid Cap Growth ETFs or mutual funds that feature an Attractive rating, >$100 million in assets under management, and below average TAC:

1. VictoryShares THB Mid Cap ETF (MDCP) – 0.61% TAC and Attractive rating
2. iShares Morningstar Mid Cap Growth ETF (IMCG) – 0.07% TAC and Attractive rating
3. Vanguard Mid Cap Growth Index Fund (VOT) – 0.08% TAC and Attractive rating
4. Vanguard Mid Cap Growth Index Fund (VMGMX) – 0.11% TAC and Attractive rating

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Disclosure: David Trainer, Kyle Guske II, and Hakan Salt receive no compensation to write about any specific stock, sector, style, or theme.

Questions on this report or others? Join our online community and connect with us directly.

It's Official: We Deliver the Best Fundamental Data in the World

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. The stock market is missing footnotes – and only we have that critical data.
2. Legacy fundamental datasets suffer from significant inaccuracies, omissions, and biases.
3. Our proprietary drives novel alpha. Our measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

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

Ernst & Young 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 Harvard Business School. 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.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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