How to Avoid the Worst Sector ETFs

Question: Why are there so many ETFs?

Answer: ETF issuance is profitable, so Wall Street keeps cranking out more products to sell.

The large number of ETFs has little to do with serving your best interests as an investor. More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research and analysis of ETF holdings and provides investors with a new source of alpha. 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. Small ETFs also generally have lower trading volume, which translates to higher trading costs via larger bid-ask spreads.

2. High Fees

ETFs should be cheap, but not all of them are. The first step here is to benchmark what cheap means.

To ensure you are paying average or below average fees, invest only in ETFs with total annual costs below 0.54% – the average total annual costs of the 315 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.25%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows AdvisorShares Restaurant ETF (EATZ) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. AdvisorShares and WBI provide four of the most expensive ETFs while State Street ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
EATZ	AdvisorShares Restaurant ETF	Consumer Cyclicals	3.37%
BEDZ	AdvisorShares Hotel ETF	Consumer Cyclicals	3.25%
AMZA	InfraCap MLP ETF 1.25x Shares	Energy	3.11%
WBIF	WBI BullBear Value 3000 ETF	Financials	1.94%
WBIL	WBI BullBear Quality 3000 ETF	Financials	1.78%
Least Expensive			
SCHH	Schwab U.S. REIT ETF	Real Estate	0.08%
XLP	Consumer Staples Select Sector SPDR	Consumer Non-cyclicals	0.09%
XLV	Health Care Select Sector SPDR	Healthcare	0.09%
XLF	Financial Select Sector SPDR	Financials	0.09%
XLC	Communication Services Select Sector SPDR	Telecom Services	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Consumer Staples Select Sector SPDR (XLP) is the best ranked sector ETF in Figure 1. XLP's Neutral Portfolio Management rating and 0.09% total annual cost earns it a Very Attractive rating.[2] Invesco KBW Property & Casualty Insurance ETF (KBWP) is the second-best ranked sector ETF overall. KBWP's Attractive Portfolio Management rating and 0.39% 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 Unattractive rating, despite having low total annual costs of 0.08%. No matter how cheap an ETF looks, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its management fee.

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
EATZ	AdvisorShares Restaurant ETF	Consumer Cyclicals	Unattractive
PSL	Invesco Dorsey Wright Consumer Staples Momentum	Consumer Non-cyclicals	Unattractive
CNRG	State Street SDPR S&P Kensho Clean Power ETF	Energy	Unattractive
PFI	Invesco Dorsey Wright Financial Momentum ETF	Financials	Unattractive
WDNA	WisdomTree BioRevolution Fund	Healthcare	Unattractive
ROKT	State Street SPDR S&P Kensho Final Frontiers ETF	Industrials	Unattractive
PPTY	U.S. Diversified Real Estate ETF	Real Estate	Unattractive
CTEX	ProShares S&P Kensho Cleantech ETF	Technology	Unattractive
GAMR	Amplify Video Game Leaders ETF	Telecom Services	Unattractive
XLU	Utilities Select Sector SPDR ETF	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

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

WisdomTree BioRevolution Fund (WDNA) is the worst rated ETF in Figure 2 based on our predictive overall rating. Utilities Select Sector SPDR Fund (XLU), U.S. Diversified Real Estate ETF (PPTY), and AdvisorShares Restaurant ETF (EATZ) 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. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF ETFs HOLDINGs – FEES = PERFORMANCE OF ETF

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

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