How to Avoid the Worst Sector Mutual Funds

Question: Why are there so many mutual funds?

Answer: Mutual fund management is profitable, so Wall Street creates more products to sell.

The large number of mutual funds 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 fund holdings and provides investors with a new source of alpha. We leverage this data to identify two red flags you can use to avoid the worst mutual funds:

1. High Fees

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

To ensure you are paying at or below average fees, invest only in mutual funds with total annual costs below 2.17%, – the average total annual costs of the 718 U.S. equity Sector mutual funds we cover. The weighted average of mutual funds we have assets under management data for is lower at 1.24%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows MainGate MLP Fund (AMLPX) is the most expensive sector mutual fund and SA Real Estate Securities Fund (SAREX) is the least expensive. MainGate provides three of the most expensive mutual funds while Fidelity mutual funds are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
	Most Expensive		
AMLPX	MainGate MLP Fund	Energy	17.35%
MLCPX	MainGate MLP Fund	Energy	15.92%
IMLPX	MainGate MLP Fund	Energy	13.89%
MLPLX	Invesco Funds SteelPath MLP Alpha Plus Fund	Energy	11.92%
MLPMX	Invesco Funds SteelPath MLP Alpha Plus Fund	Energy	11.23%
	Least Expensive		
SAREX	SA Real Estate Securities Fund	Real Estate	0.00%
JRS	Nuveen Real Estate Income Fund	Real Estate	0.00%
FSRNX	Fidelity Real Estate Index Fund	Real Estate	0.08%
FESIX	Fidelity SAI Real Estate Index Fund	Real Estate	0.08%
NREEX	Neuberg Berman Real Estate Fund	Real Estate	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Vanguard Financial Index Fund (VFAIX) is one of the best ranked sector mutual funds overall. VFAIX's Neutral Portfolio Management rating and 0.10% total annual cost earns it a Very Attractive rating.[2]

[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.

On the other hand, Fidelity Real Estate Index Fund (FSRNX) holds poor stocks and receives our Unattractive rating, yet has low total annual costs of 0.08%. 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.

2. 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
ICBMX	ICON Natural Resources and Infrastructure Fund	Basic Materials	Unattractive
FSHOX	Fidelity Select Construction and Housing	Consumer Cyclicals	Unattractive
VCSAX	Vanguard Consumer Staples Index Fund	Consumer Non-cyclicals	Unattractive
HNRIX	Hennessy Energy Transition Fund	Energy	Unattractive
HISFX	Hennessy Small Cap Financial Fund	Financials	Unattractive
RYOIX	Rydex Biotechnology Fund	Healthcare	Unattractive
RYPIX	Rydex Transportation Fund	Industrials	Unattractive
JRS	Nuveen Real Estate Income Fund	Real Estate	Unattractive
MGRPX	Morgan Stanley Growth Portfolio	Technology	Unattractive
FGKMX	Fidelity Advisor Communication Services	Telecom Services	Unattractive
PRUQX	PGIM Jennison Utility Fund	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

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

Morgan Stanley Growth Portfolio (MGRPX) is the worst rated mutual fund in Figure 2 based on our predictive overall rating. ICON Natural Resources and Infrastructure Fund (ICBMX), PGIM Jennison Utility Fund (PRUQX), Hennessy Energy Transition Fund (HNRIX), Rydex Biotechnology Fund (RYOIX), and Nuveen Real Estate Income Fund (JRS) 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 reflects our stock ratings of their holdings and a measure of 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. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF MUTUAL FUND's HOLDINGs – FEES = 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 technology to get the diligence required to make prudent investment decisions.

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

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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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