

The Best & Worst Consumer Discretionary Sector ETFs

Structural Integrity – and – Investment Merits

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- Retail HOLDRS (RTH) is our top pick for Consumer Discretionary sector ETFs.
- We rate the investment merit of the top 6 Consumer Discretionary sector ETFs.
- We benchmark the individual ETFs against the entire Consumer Discretionary sector and the S&P 500.
- This research enables investors to analyze ETFs and mutual funds as they do stocks.
- We offer custom and enhanced ETFs based on our top-ranked stock rating system.
- Our ETF analysis is based on aggregation of models for companies held by the fund and weighted according to the fund's allocations to those companies, excluding cash.



Figure 1: The Investment Merit of the Top Consumer Discretionary Sector ETFs

Fund/Benchmark	% of Fund Allocated to Each Rating					Overall Fund Rating
	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous	
RTH	17.7%	24.7%	57.6%	0.0%	0.0%	Attractive
Overall Sector	8.9%	27.4%	38.0%	23.7%	2.0%	Attractive
XLY	9.2%	31.3%	39.9%	14.1%	1.1%	Neutral
XRT	5.0%	21.0%	39.1%	30.4%	4.4%	Neutral
XHB	0.0%	9.4%	33.1%	43.7%	7.9%	Dangerous

* % may not add up to 100% due to the exclusion of cash and holdings not in our coverage universe.

Sources: New Constructs, LLC and company filings

Methodology

Our Risk/Reward ratings have a solid track record of outperformance for investors.

[Barron's ranked us #1 for stock-picking.](#)

Custom ETFs: [Contact us](#) for best-of-breed and enhanced ETF products for a particular sector or index.

This report offers recommendations on Consumer Discretionary sector ETFs and benchmarks for (1) investors considering buying Consumer Discretionary sector ETFs and for (2) comparing individual ETFs to the Consumer Discretionary sector and the S&P 500. Our analysis is based on aggregating results from our models on each of the companies included in every ETF and the overall sector (471 companies) based on data as of April 19th, 2011. We aggregate results for the ETFs in the same way the ETFs are designed. Our goal is to empower investors to analyze ETFs in the same way they analyze individual stocks.

To make an informed ETF investment, investors must consider:

- 1) **Structural Integrity:** ability of an investment vehicle to fulfill its stated objective. We use [XTF, an ETF research firm](#), to find the top 6 Consumer Discretionary sector ETFs with the best structural integrity rating.
- 2) **Investment Merit:** investment quality of the ETF based on its holdings. We apply our stock rating system to each ETF's holdings to determine its investment merit.

Given the [success](#) of our rating system for individual stocks, we believe its application to groups of stocks (i.e. ETFs and funds) helps investors make more informed ETF and mutual fund buying decisions. Barron's featured our unique ETF research in "[The Danger Within](#)".

Recommendations Summary

If you require exposure to the Consumer Discretionary sector:

We recommend investors buy Retail HOLDRS (RTH). RTH allocates 42% of its value to Attractive-or-better-rated stocks and allocates no value to Dangerous-or-worse-rated stocks. RTH also earns an above-average XTF rating of 9 and an Attractive Overall Risk/Reward Rating.

If you require exposure to any other sector:

We recommend investors review our [Sector ETF Roadmap](#) report or our [9 other sector ETF reports](#), beginning with our Consumer Staples and Health Care sector reports, which are the only other sectors to earn an Attractive Overall Risk/Reward rating.

If you require exposure to a Consumer Discretionary ETF or an index ETF:

We recommend investors buy the following Consumer Discretionary ETFs over an S&P 500 ETF: RTH and XLY.

If you are looking for exposure to the best stocks in the market:

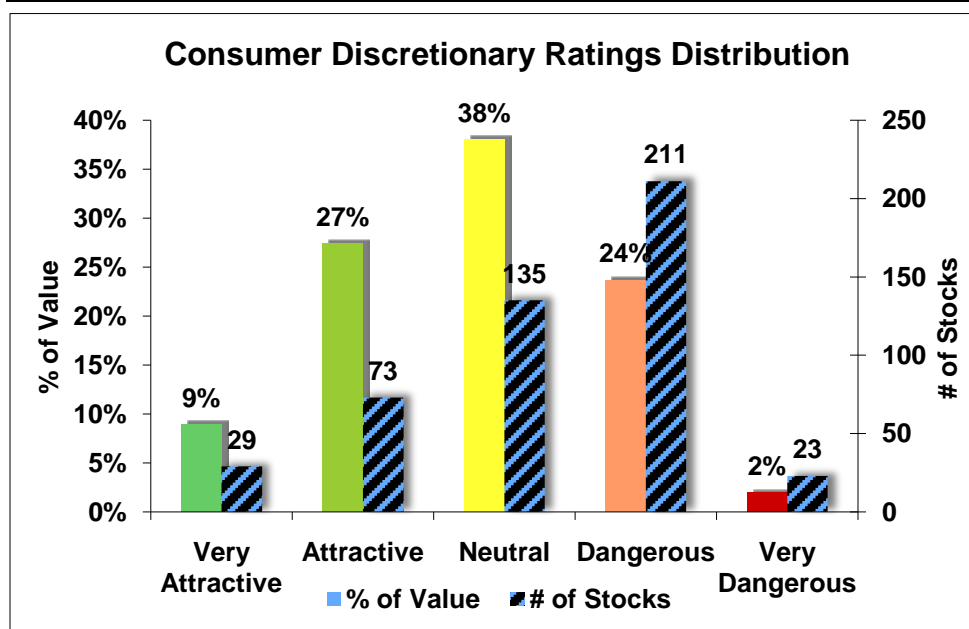
We recommend you buy our [Most Attractive Stocks](#).

Recommendations Detail

Click [here](#) for more info on risk/reward rating system and our approach to equity research.

If you want to be in a sector ETF, the Consumer Staples, Consumer Discretionary and Health Care sectors are the best places to shop due to their Attractive Overall Risk/Reward ratings. Figure 2 shows how the Consumer Discretionary sector's stocks and the market value attributed to them stack up under the microscope of our risk/reward rating system.

Figure 2: Consumer Discretionary Sector – Allocation & Holdings by Risk/Reward Rating



Sources: New Constructs, LLC and company filings

The Consumer Discretionary sector has 26% of its value invested in Dangerous-or-worse-rated stocks and 36% of its value invested in Attractive-or-better-rated stocks. The Consumer Discretionary sector's heavy allocation to Attractive-or-better-rated stocks creates opportunities for Attractive-or-better-rated ETFs. Despite this fact, there is only one Attractive-rated ETF.

The key takeaway is that the Consumer Discretionary sector offers both good and poor investment opportunities. The value of each ETF is derived from its constituents, so ETFs like RTH that overweight Attractive-or-better-rated stocks are great investment opportunities while ETFs like XHB that overweight Neutral-or-worse-rated stocks should be avoided or sold short.

When analyzing the Consumer Discretionary sector ETFs, we started by identifying those ETFs with acceptable structural integrity as measured by XTF. We chose the 6 ETFs with an XTF rating above the sector average XTF rating where we cover at least 90% of the value of the ETF. For details on the XTF structural integrity ratings as well as the holdings and weightings for each ETF, see XTF.com.

Figure 3: Consumer Discretionary ETFs With Acceptable Structural Integrity

TICKER	ETF Description	# of Holdings *	XTF RATING
XLY	Select Sector SPDR-Consumer Discretionary	79	9.4
VCR	Vanguard Consumer Discretionary Index Fund	368	9
RTH	Retail HOLDRS	18	9
XRT	SPDR S&P Retail ETF	92	8.6
PBS	PowerShares Dynamic Media	30	7.2
XHB	SPDR S&P Homebuilders ETF	35	6.8

* # of Holdings excludes cash

Sources: New Constructs, LLC; XTF and company filings

[Contact us](#) for details on our ratings for any stocks in any equity ETF.

Figure 3 clearly shows that not all Consumer Discretionary ETFs are made the same. Different ETFs have meaningfully different numbers of holdings and, therefore, different allocations to holdings. Given the differences in holdings and allocations, these ETFs will likely perform quite differently.

After determining the structural integrity, we analyzed the investment merit of each ETF based on how it allocates value to each stock it holds. Figure 4 shows how the 6 Consumer Discretionary sector ETFs stack up versus each other, the overall sector, and the S&P 500 based on their Overall Risk/Reward ratings and the allocation of their holdings by rating.

Figure 4: Investment Merit Based on Holdings and Allocations

Fund/Benchmark	% of Fund Allocated to Each Rating					Overall Fund Rating
	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous	
RTH	17.7%	24.7%	57.6%	0.0%	0.0%	Attractive
Overall Sector	8.9%	27.4%	38.0%	23.7%	2.0%	Attractive
XLY	9.2%	31.3%	39.9%	14.1%	1.1%	Neutral
S&P 500	21.2%	21.1%	34.0%	16.9%	6.8%	Neutral
VCR	8.6%	25.7%	35.7%	19.3%	1.8%	Neutral
PBS	7.3%	25.8%	37.2%	20.9%	3.0%	Neutral
XRT	5.0%	21.0%	39.1%	30.4%	4.4%	Neutral
XHB	0.0%	9.4%	33.1%	43.7%	7.9%	Dangerous

* % may not add up to 100% due to the exclusion of cash and holdings not in our coverage universe.

Sources: New Constructs, LLC; XTF and company filings

Attractive ETFs:

RTH is the only Consumer Discretionary ETF to earn an Attractive Overall Risk/Reward rating and therefore, is the only Consumer Discretionary ETF we recommend.

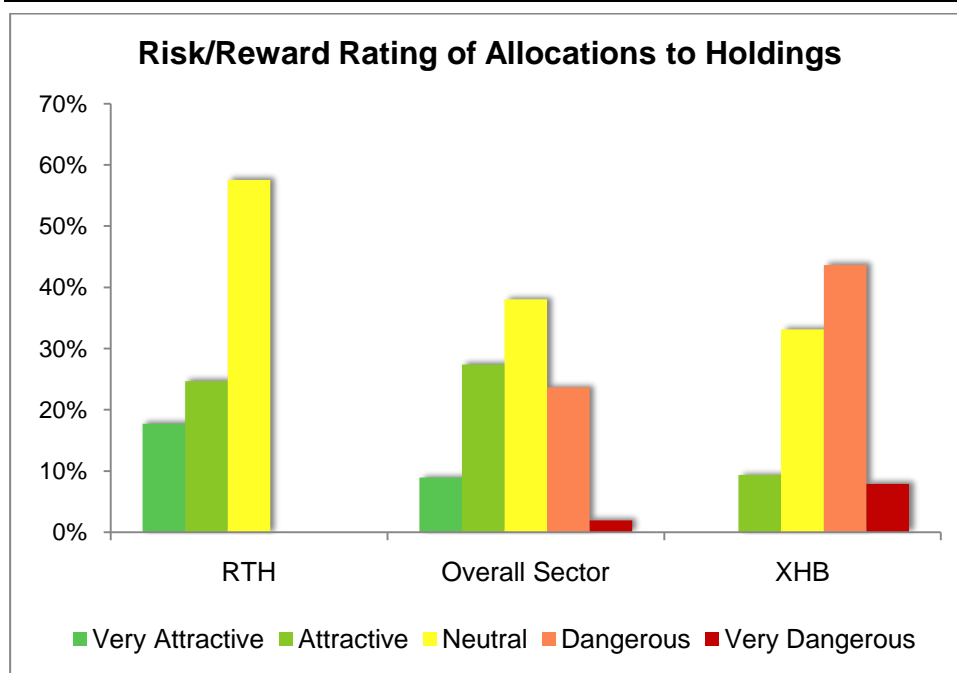
Neutral ETFs:

XLY, VCR, PBS, and XRT allocate the value of their funds in a way that earns them a Neutral Overall Risk/Reward rating. We recommend investors buy the Very Attractive and Attractive stocks in this sector before buying any of the Consumer Discretionary ETFs except RTH. [Contact us](#) for the full list of 102 Consumer Discretionary companies that earn an Attractive-or-better Overall Risk/Reward rating.

Dangerous ETFs:

We recommend investors avoid or sell short XHB because of its Dangerous Overall Risk/Reward rating. Figure 5 contrasts the difference in investment merit between RTH, XHB and the overall sector.

Figure 5: Attractive and Dangerous Consumer Discretionary Sector ETFs



Sources: New Constructs, LLC; XTF and company filings

Benchmark Comparisons

Sector Benchmark

RTH's ratings are the same as the overall sector's ratings, except for Price-to-EBV and GAP. RTH has a significantly shorter GAP than the overall sector (11 years versus the sector's 29-year GAP), earning it a Neutral rating. However, RTH has a higher Price-to-EBV compared to the sector (1.5 versus the sector's 1.1 Price-to-EBV).

Figure 6: RTH – Risk/Reward Rating

Overall Risk/Reward Rating	Quality of Earnings		Valuation		
	Econ v Reported Earnings (bn)	ROIC	FCF Yield	Price-to-EBV	GAP (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	More than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg	\$2.31 / \$4.51	11.8%	3.9%	1.5	11

Sources: New Constructs, LLC and company filings

Figure 7: Consumer Discretionary Sector – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Econ v Reported EPS	ROIC	FCF Yield	Price-to-EBV	GAP (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	More than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg	\$0.64 / \$2.52	12.2%	3.5%	1.1	29
Median	\$-0.16 / \$0.93	6.2%	4.1%	2.0	27

Sources: New Constructs, LLC and company filings

RTH more effectively allocates capital than the overall Consumer Discretionary sector. Per [Figure 4](#) above, RTH allocates 42% of its value to Attractive-or-better-rated stocks while the sector only allocates 36%. RTH also allocates none of its value toward Dangerous-or-worse-rated stocks compared to the sector's Dangerous-or-worse weightings of 26%.

For explanation and details behind our risk/reward rating system, see one of our Company Valuation reports, which are available for free [here](#).

Market Benchmark

RTH outperforms the S&P 500 in valuation ratings. RTH earns an Attractive FCF Yield rating compared to the S&P 500's Neutral rating. RTH also has a Neutral GAP rating compared to the S&P 500's Dangerous GAP rating.

RTH has similar quality of earnings ratings compared to the S&P 500. RTH's market-weighted ROIC of 11.8% earns it an Attractive rating while the S&P 500's market-weighted ROIC of 18.3% earns it a Very Attractive rating.

Figure 8: RTH – Risk/Reward Rating

Overall Risk/Reward Rating	Quality of Earnings		Valuation		
	Econ v Reported Earnings (bn)	ROIC	FCF Yield	Price-to-EBV	GAP (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	More than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg	\$2.31 / \$4.51	11.8%	3.9%	1.5	11

Sources: New Constructs, LLC and company filings

Figure 9: S&P 500 – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Econ v Reported EPS	ROIC	FCF Yield	Price-to-EBV	GAP (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	More than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg	\$0.74 / \$4.06	18.3%	2.4%	1.4	24
Median	\$0.26 / \$2.24	7.9%	3.2%	1.4	12

Sources: New Constructs, LLC and company filings

RTH allocates capital more effectively than the S&P 500. Per [Figure 4](#) above, RTH allocates none of its value to Dangerous-or-worse-rated stocks while the S&P 500 allocates 24%. RTH and the S&P 500 similarly allocate capital to Attractive-or-better-rated stocks.

Appendix: Risk/Reward Rating System

Our Risk/Reward Rating System assigns a rating to every stock we cover according to what we believe are the 5 most important criteria for assessing the risk versus reward of stocks. See table that follows for details.

Overall Risk/Reward Ranking	The Overall Risk/Reward Ranking provides a final rating based on the equal-weighted average rating of each criterion.
Very Dangerous	FCF Yield is not included in the average.
Dangerous	FCF Yield is not included in the average.
Neutral	All criteria are equal-weighted in the average calculation.
Attractive	All criteria are equal-weighted in the average calculation.
Very Attractive	All criteria are equal-weighted in the average calculation.

Economic vs Reported Earnings	Rates stocks based on how their Economic Earnings compare to their Reported Earnings. Values based on Latest Fiscal Year.
Very Dangerous	Negative and declining Economic Earnings despite positive and rising Reported Earnings
Dangerous	Same as above except Reported Earnings are not rising or Reported Earnings are not positive
Neutral	Negative Economic and Reported Earnings
Attractive	Economic Earnings are positive
Very Attractive	Economic Earnings are positive and rising

Return on Invested Capital (ROIC)	Rates stocks based on their ROIC. Values based on Latest Fiscal Year.
Bottom Quintile	Very Dangerous = the bottom 20% of Russell 1000 companies
4th Quintile	Dangerous = the bottom 40% of Russell 1000 companies
3rd Quintile	Neutral = the middle 20% of Russell 1000 companies
2nd Quintile	Attractive = the top 40% of Russell 1000 companies
Top Quintile	Very Attractive = the top 20% of Russell 1000 companies

FCF Yield	Rates stocks based on their Free Cash Flow Yield. Values based on Latest Closing Stock price and Latest Fiscal Year.
<-5%	Very Dangerous = less than or equal to -5%
-5%<-1%	Dangerous = more than -5% but less than or equal to -1%
-1%<3%	Neutral = more than -1% but less than or equal to +3%
3%<10%	Attractive = more than +3% but less than or equal to +10%
>10%	Very Attractive = more than +10%

Price-to-EBV Ratio	Rates stocks based on their Price-to-Economic Book Value Ratio. Values based on Latest Closing Stock price and Latest Fiscal Year.
>3.5 or -1>0	Very Dangerous = greater than or equal to 3.5 or less than 0 but greater than -1
2.4>3.5 or <-1	Dangerous = greater than or equal to 2.4 but less than 3.5 and less than or equal to -1
1.6>2.4	Neutral = greater than or equal to 1.6 but less than 2.4
1.1>1.6	Attractive = greater than or equal to 1.1 but less than 1.6
0>1.1	Very Attractive = greater than or equal to 0 but less than 1.1

Growth Appreciation Period (yrs)	Rates stocks based on their Market-Implied Growth Appreciation Period. Values based on Latest Closing Stock price and Default Forecast Scenario.
>50	Very Dangerous = greater than or equal to 50 years
20>50	Dangerous = at least 20 years but less than 50
10>20	Neutral = at least 10 years but less than 20
3>10	Attractive = at least 3 years but less than 10
0>3	Very Attractive = at least 0 years but less than 3

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Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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