Danger Zone: Rydex Series Real Estate Funds

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and MarketWatch.com.

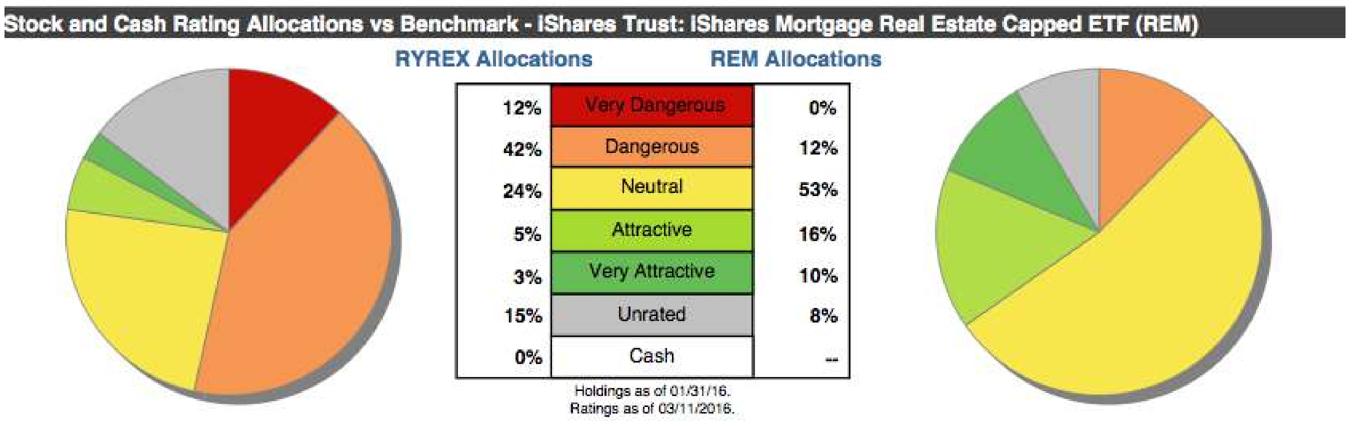
The only justification for mutual funds to have higher fees than ETFs is "active" management that leads to out-performance. How can a fund that has significantly worse holdings than its benchmark hope to outperform? After all, it's the performance of a funds holdings that drive the performance of a fund. Rydex Series Real Estate Funds (RYREX, RYCRX, RYHRX) are in the Danger Zone due to alarmingly poor holdings and overly high fees.

Poor Holdings Makes Outperformance Unlikely

Investors in Rydex Series Real Estate Fund are paying a fee with the hopes that the fund manager can allocate to a better basket of stocks than can be found in its ETF benchmark, the iShares Mortgage Real Estate Capped ETF (REM). Rydex is giving investors very different asset allocation than the benchmark. Unfortunately, that asset allocation is much worse.

Per Figure 1, Rydex Real Estate Funds allocate 54% of assets to Dangerous-or-worse rated stocks while REM allocates just 12% of assets to Dangerous-or-worse rated stocks. On the flip side, REM allocates 26% of assets to Attractive-or-better rated stocks while RYREX allocates only 8% to Attractive-or-better rated stocks. If, Rydex Series Real Estate funds holds worse stocks than REM, then how can one expect outperformance?

Figure 1: Rydex Real Estate Fund Portfolio Asset Allocation



Sources: New Constructs, LLC and company filings

The 2nd Most Expensive Fund Under Coverage

With total annual costs (TAC) of 6.76%, RYREX is the second most expensive fund of the 849 sector ETFs and mutual funds under coverage. RYCRX (TAC of 5.77%) and RYHRX (TAC of 4.89%) also rank within the top 10 most expensive sector funds. More details can be seen in Figure 2. For comparison, the benchmark, REM charges total annual costs of 0.53%.

Figure 2: Rydex Real Estate Funds' Understated Costs

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
RYREX	6.76%	1.60%	**5.16%**
RYCRX	5.77%	2.35%	**3.42%**
RYHRX	4.89%	1.60%	**3.29%**

Sources: New Constructs, LLC and company filings.

Over a 10-year holding period, the 5.16 percentage point difference between RYREX's TAC and its reported expense ratio results in 65% less capital in investors' pockets.

To justify its higher fees, the Rydex Real Estate Funds must outperform its benchmark by the following over three years:

1. RYREX must outperform by 6.2% annually.
2. RYCRX must outperform by 5.21% annually.
3. RYHRX must outperform by 4.33% annually.

The bottom line is that with such high costs, it is highly unlikely that these Rydex managers will ever outperform their much cheaper ETF benchmark.

The Importance of Proper Due Diligence

One thing we've learned while analyzing tens of thousands of company filings over the past twenty years is never underestimate how wild or bad disclosures may be. As soon as you say, "there's no way a company would do that"…we find a company that has done that. The same is true for mutual funds. That is why, each quarter, we provide investors a guide to finding the best mutual funds and avoiding the worst mutual funds. Only performing proper due diligence can help avoid funds like RYREX, that not only hold low quality stocks, but also charge investors significant fees to do so.

Without proper analysis of fund holdings, investors might be overpaying or disappointed with performance.

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

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We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

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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