ETF & Mutual Fund Rankings: Financials Sector

The Financials sector ranks sixth out of the ten sectors as detailed in our 2Q16 Sector Ratings for ETFs and Mutual Funds report. Last quarter, the Financials sector ranked seventh. It gets our Neutral rating, which is based on aggregation of ratings of 38 ETFs and 249 mutual funds in the Financials sector as of April 15, 2016. See a recap of our 1Q16 Sector Ratings here.

Figures 1 and 2 show the five best and worst rated ETFs and mutual funds in the sector. Not all Financials sector ETFs and mutual funds are created the same. The number of holdings varies widely (from 21 to 572). This variation creates drastically different investment implications and, therefore, ratings.

Investors seeking exposure to the Financials sector should buy one of the Attractive-or-better rated ETFs or mutual funds from Figures 1 and 2.

Figure 1: ETFs with the Best & Worst Ratings – Top 5

	Allocation of ETF Holdings			
Ticker	Attractive-or-better Stocks	Neutral Stocks	Dangerous-or-worse Stocks	Predictive Rating
Best ETFs				
IYG	47%	44%	7%	Very Attractive
KIE	36%	49%	8%	Very Attractive
KBWB	26%	67%	4%	Very Attractive
IYF	31%	41%	18%	Very Attractive
VFH	30%	41%	20%	Very Attractive
Worst ETFs				
FRI	5%	36%	51%	Dangerous
FTY	4%	36%	58%	Dangerous
SRET	19%	26%	27%	Dangerous
PSR	4%	28%	57%	Dangerous
REZ	5%	37%	52%	Dangerous

* Best ETFs exclude ETFs with TNAs less than $100 million for inadequate liquidity.

Sources: New Constructs, LLC and company filings

PowerShares KBW Property & Casualty Insurance Portfolio (KBWP) is excluded from Figure 1 because its total net assets (TNA) are below $100 million and do not meet our liquidity minimums.

Figure 2: Mutual Funds with the Best & Worst Ratings – Top 5

	Allocation of Mutual Fund Holdings			
Ticker	**Attractive-or-better Stocks**	**Neutral Stocks**	**Dangerous-or-worse Stocks**	**Predictive Rating**
Best Mutual Funds				
FSRBX	38%	52%	4%	Very Attractive
FSPCX	28%	50%	7%	Very Attractive
DVFYX	38%	31%	9%	Very Attractive
VFAIX	34%	41%	19%	Very Attractive
DFFCX	38%	31%	9%	Very Attractive
Worst Mutual Funds				
DAREX	4%	42%	47%	Very Dangerous
KREAX	2%	37%	50%	Very Dangerous
RYHRX	7%	26%	55%	Very Dangerous
RYCRX	7%	26%	55%	Very Dangerous
RYREX	7%	26%	55%	Very Dangerous

* Best mutual funds exclude funds with TNAs less than $100 million for inadequate liquidity.

Sources: New Constructs, LLC and company filings

Schwab Financial Services Fund (SWFFX) is excluded from Figure 2 because its total net assets (TNA) are below $100 million and do not meet our liquidity minimums.

iShares U.S. Financials Services ETF (IYG) is the top-rated Financials ETF and Fidelity Select Banking Portfolio (FSRBX) is the top-rated Financials mutual fund. Both earn a Very Attractive rating.

iShares Residential Real Estate Capped ETF (REZ) is the worst rated Financials ETF and Rydex Series Real Estate Fund (RYREX) is the worst rated Financials mutual fund. REZ earns a Dangerous rating and RYREX earns a Very Dangerous rating.

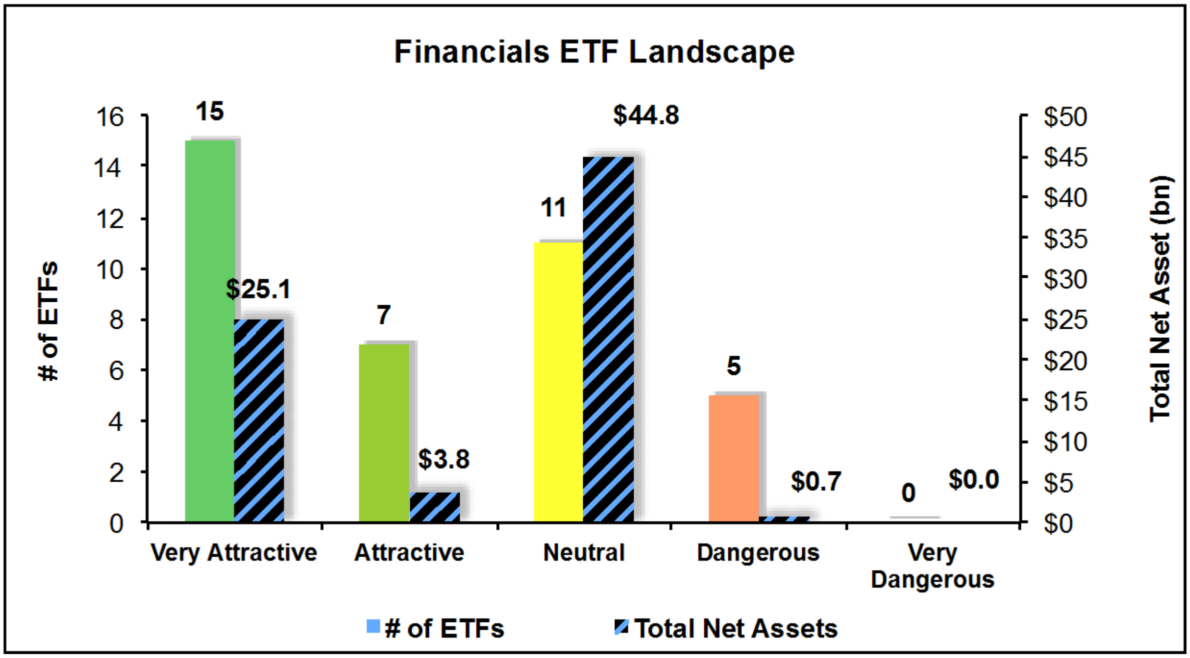
595 stocks of the 3000+ we cover are classified as Financials stocks.

American Express (AXP: $62/share) is one of our favorite stocks held by IYG and earns a Very Attractive rating. We previously published a case study outlining how AXP could boost its value by $50 billion by making strategic decisions to boost return on invested capital (ROIC). Over the past six years, American Express has grown after-tax profit (NOPAT) by 6% compounded annually. At the same time, the company has improved its ROIC from 12% in 2005 to a top-quintile 20% in 2015. However, some short-term issues, which we identify in our case study, have left AXP undervalued. At its current price of $62/share, American Express has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means that the market expects American Express' NOPAT to permanently decline by 10%. If AXP can, instead, grow NOPAT by 6% compounded annually for the next decade, the stock is worth $98/share today – a 58% upside.

Essex Property Trust (ESS: $225/share) is one of our least favorite stocks held by REZ and earns a Very Dangerous rating. Essex earns its rating in large part to its misleading earnings. Over the past decade, GAAP net income has grown by 11% compounded annually. However, Essex's economic earnings, its true cash flows, have declined from $7 million to -$249 million over the same time period. Further highlighting the deterioration of Essex's operations, the company's ROIC has halved from 8% in 2005 to a bottom-quintile 4% in 2015. GAAP earnings have propped up shares for too long, and ESS remains overvalued. In order to justify its current price of $225/share, Essex must grow NOPAT by 12% compounded annually for the next 11 years. After a decade of shareholder value destruction, the expectations baked in ESS remain too high.

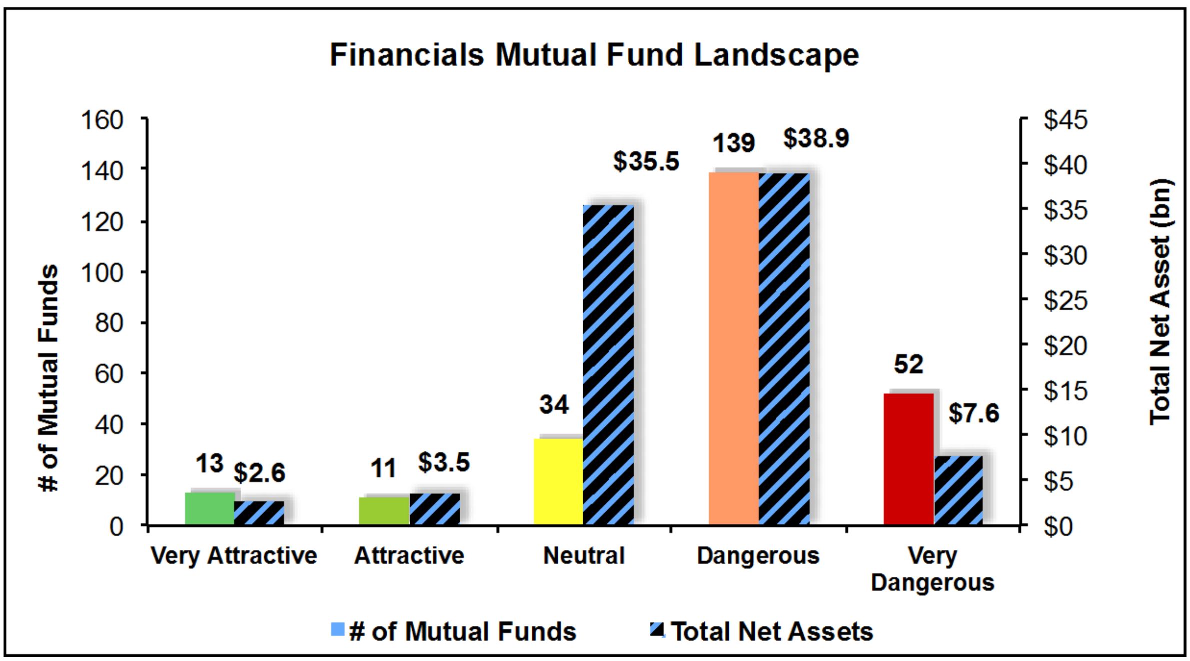
Figures 3 and 4 show the rating landscape of all Financials ETFs and mutual funds.

Figure 3: Separating the Best ETFs From the Worst ETFs



Sources: New Constructs, LLC and company filings

Figure 4: Separating the Best Mutual Funds From the Worst Mutual Funds



Sources: New Constructs, LLC and company filings

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

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic 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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