ETF & Mutual Fund Rankings: Small Cap Growth Style

The Small Cap Growth style ranks eleventh out of the twelve fund styles as detailed in our 2Q16 Style Ratings for ETFs and Mutual Funds report. Last quarter, the Small Cap Growth style ranked eighth. It gets our Dangerous rating, which is based on aggregation of ratings of 12 ETFs and 430 mutual funds in the Small Cap Growth style as of May 4, 2016. See a recap of our 1Q16 Style Ratings here.

Figure 1 ranks from best to worst the nine small-cap growth ETFs that meet our liquidity standards and Figure 2 shows the five best and worst rated small-cap growth mutual funds. Not all Small Cap Growth style ETFs and mutual funds are created the same. The number of holdings varies widely (from 18 to 1209). This variation creates drastically different investment implications and, therefore, ratings.

Investors seeking exposure to the Small Cap Growth style 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 (only 4)				
SLYG	14%	39%	41%	**Neutral**
VIOG	14%	40%	41%	**Neutral**
IJT	14%	39%	41%	**Neutral**
RZG	12%	41%	38%	**Neutral**
Worst ETFs				
DWAS	14%	31%	38%	**Neutral**
VBK	7%	29%	48%	**Neutral**
VTWG	9%	30%	45%	**Neutral**
IWO	9%	30%	45%	**Neutral**
JKK	8%	27%	49%	**Neutral**

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

Sources: New Constructs, LLC and company filings

First Trust Small Cap Growth AlphaDEX Fund (FYC) 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				
VSCRX	27%	49%	6%	Attractive
PKSFX	27%	49%	6%	Attractive
PKSCX	27%	49%	6%	Attractive
NRGSX	12%	53%	24%	Attractive
NBGIX	12%	53%	24%	Attractive
Worst Mutual Funds				
ANOAX	5%	17%	50%	Very Dangerous
PQUAX	1%	16%	22%	Very Dangerous
DSGAX	4%	27%	43%	Very Dangerous
NSNAX	3%	26%	53%	Very Dangerous
GAMAX	10%	19%	41%	Very Dangerous

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

Sources: New Constructs, LLC and company filings

River Oak Discovery Fund (RIVSX) is excluded from Figure 2 because its total net assets (TNA) are below $100 million and do not meet our liquidity minimums.

SPDR S&P 600 Small Cap Growth ETF (SLYG) is the top-rated Small Cap Growth ETF and Virtus Small-Cap Core Fund (VSCRX) is the top-rated Small Cap Growth mutual fund. SLYG earns a Neutral rating and VSCRX earns an Attractive rating.

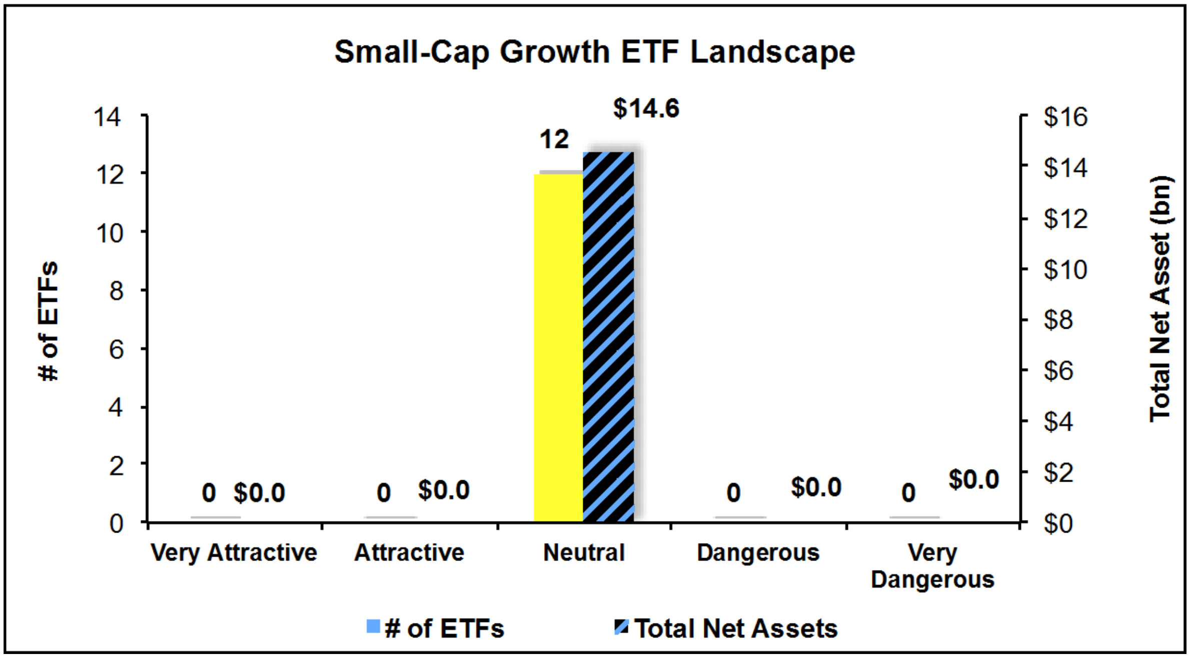
iShares Morningstar Small-Cap Growth ETF (JKK) is the worst-rated Small Cap Growth ETF and Goodwood SMID Cap Discovery Fund (GAMAX) is the worst-rated Small Cap Growth mutual fund. JKK earns a Neutral rating and GAMAX earns a Very Dangerous rating.

ICON, PLC (ICLR: $65/share) is one of our favorite stocks held by NRGSX and earns an Attractive rating. Over the past decade, ICON has grown after-tax profit (NOPAT) by 33% compounded annually. The company has improved its return on invested capital (ROIC) from 5% in 2005 to a top-quintile 22% over the last twelve months. An overreaction to quarterly earnings has dropped ICLR and created a good buying opportunity. At its current price of $65/share, ICLR has a price-to-economic book value (PEBV) ratio of 1.2. This ratio means that the market expects ICON's NOPAT to grow only by 20% over the remainder of its corporate life. If ICON can grow NOPAT by just 8% compounded annually over the next decade, the stock is worth $99/share today – a 52% upside.

Cavium Inc. (CAVM: $48/share) is one of our least favorite stocks held by NSNAX and earns a Dangerous rating. Since 2007, Cavium's NOPAT has declined from $250,000 to -$11 million. The company's ROIC has fallen from 7% in 2010 to a bottom-quintile 0% over the last twelve months. Worst of all, Cavium has failed to generate positive economic earnings in any year since going public, which occurred in 2007. Despite the deterioration of Cavium's business, the stock remains overvalued. To justify its current price of $48/share, Cavium must immediately achieve 5% NOPAT margins (compared to -3% in 2015) and grow revenue by 20% compounded annually for the next 23 years. In this scenario, Cavium would be generating over $27 billion in revenue in 23 years, which is greater than Qualcomm's (QCOM) 2015 revenue. We feel this expectation is too optimistic.

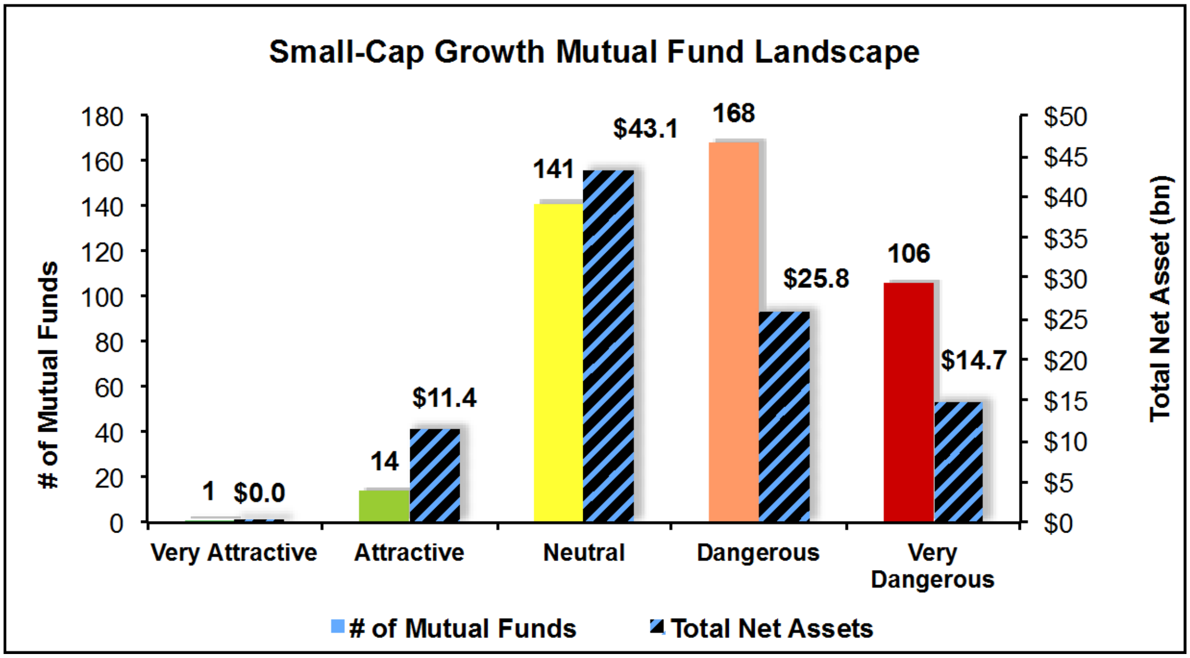
Figures 3 and 4 show the rating landscape of all Small Cap Growth ETFs and mutual funds.

Figure 3: Separating the Best ETFs From the Worst Funds



Sources: New Constructs, LLC and company filings

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



Sources: New Constructs, LLC and company filings

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

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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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