How To Avoid the Worst Sector Mutual Funds

Question: Why are there so many mutual funds?

Answer: mutual fund providers tend to make lots of money on each fund so they create more products to sell.

The large number of mutual funds has little to do with serving your best interests. Below are three red flags you can use to avoid the worst mutual funds:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all mutual funds with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the mutual fund and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the mutual fund and larger bid-ask spreads.

2. High Fees

Mutual funds should be cheap, but not all of them are. The first step here is to know what is cheap and expensive.

To ensure you are paying at or below average fees, invest only in mutual funds with total annual costs below 2.27%, which is the average total annual costs of the 682 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.18%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows Rydex Real Estate Fund (RYREX) is the most expensive sector mutual fund and Fidelity Real Estate Index Fund (FSRNX) is the least expensive. Rydex (RYREX, RYCRX, RYHRX, RYESX) provides four of the most expensive mutual funds while Fidelity (FSRNX, FESIX FSRVX) funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
RYREX	Rydex Real Estate Fund	Financials	8.33%
RYCRX	Rydex Real Estate Fund	Financials	7.30%
SFPAX	Saratoga Financial Services Portfolio	Financials	6.91%
RYHRX	Rydex Real Estate Fund	Financials	6.42%
RYESX	Rydex Energy Services Fund	Energy	6.35%
Least Expensive			
FSRNX	Fidelity Real Estate Index Fund	Financials	0.09%
FESIX	Fidelity SAI Real Estate Index Fund	Financials	0.10%
FSRVX	Fidelity Real Estate Index Fund	Financials	0.11%
VCDAX	Vanguard Consumer Discretionary Index Fund	Consumer Discretionary	0.11%
VITAX	Vanguard Information Technology Index Fund	Information Technology	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Vanguard Financials Index Fund (VFAIX) earns our Very Attractive rating and has low total annual costs of only 0.12%.

On the other hand, Vanguard Energy Index Fund (VENAX) holds poor stocks and receives our Dangerous rating, yet has low total annual costs of 0.12%. 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.

3. 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
FBMPX	Fidelity Multimedia Portfolio	Consumer Discretionary	Dangerous
ICLEX	ICON Consumer Staples Fund	Consumer Staples	Dangerous
PGEIX	Putnam Global Energy Fund	Energy	Dangerous
BREIX	Baron Real Estate Fund	Financials	Dangerous
PHLQX	Prudential Jennison Health Sciences Fund	Health Care	Dangerous
FSCGX	Fidelity Industrial Equipment Portfolio	Industrials	Dangerous
RIFYX	Victory RS Science and Technology Fund	Information Technology	Dangerous
FMFEX	Fidelity Advisor Materials Fund	Materials	Dangerous
FSTCX	Fidelity Telecommunications Portfolio	Telecom Services	Dangerous
FIUIX	Fidelity Telecom & Utilities Fund	Utilities	Dangerous

Sources: New Constructs, LLC and company filings

Fidelity (FBMPX, FSCGX, FMFEX, FSTCX, FIUIX) appears more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Fidelity Telecommunications Portfolio (FSTCX) is the worst rated mutual fund in Figure 2. Victory RS Science and Technology (RIFYX), Putnam Global Energy (PGEIX), Baron Real Estate Fund (BREIX), Prudential Jennison Health Sciences Fund (PHLQX) and Fidelity Telecom & Utilities Fund (FIUIX) also earn a Very Dangerous predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

Our overall ratings on mutual funds are based primarily on our stock ratings of their holdings.

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' performance. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF MUTUAL FUND's HOLDINGs = PERFORMANCE OF MUTUAL FUND

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

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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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