How to Avoid the Worst Style 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 investors' best interests. Below are three red flags investors can use to avoid the worst mutual funds:

1. Inadequate Liquidity

This issue is the easiest issue 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 1.81%, which is the average total annual cost of the 6259 U.S. equity Style mutual funds we cover. The weighted average is lower at 1.07%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows American Growth Fund Series One (AMRAX) is the most expensive style mutual fund and Vanguard 500 Index Fund (VFFSX) is the least expensive. American Funds (AMRAX, AMRBX, AMRGX, AMRCX) provides four of the most expensive mutual funds while Fidelity (FFSMX, FSKAX, FXAIX) mutual funds are among the cheapest.

Figure 1: 5 Least and Most Expensive Style Mutual Funds

Ticker	Name	Style	Total Annual Cost
Most Expensive			
AMRAX	American Growth Fund Series One	All Cap Blend	9.55%
AMRBX	American Growth Fund Series One	All Cap Blend	9.26%
AMRGX	American Growth Fund Series One	All Cap Blend	9.17%
COPLX	Copley Fund	All Cap Value	8.27%
AMRCX	American Growth Fund Series One	All Cap Blend	8.08%
Least Expensive			
VFFSX	Vanguard 500 Index Fund	Large Cap Blend	0.02%
VSTSX	Vanguard Total Stock Market Index Fund	All Cap Blend	0.02%
FFSMX	Fidelity Total Market Index Fund	All Cap Blend	0.02%
FSKAX	Fidelity Total Market Index Fund	All Cap Blend	0.02%
FXAIX	Fidelity 500 Index Fund	Large Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Vanguard 500 Index Fund (VFFSX) is the best ranked style mutual fund in Figure 1. VFFSX's Neutral Portfolio Management rating and 0.02% total annual cost earn it an Attractive fund rating. Jensen Quality Value Fund (JNVIX) is the best ranked style mutual fund overall. JNVIX's Attractive Portfolio Management rating and 1.15% total annual cost earn it a Very Attractive fund rating.

On the other hand, Fidelity Small Cap Index Fund (FSSNX) holds poor stocks and earns our Unattractive rating, yet has low total annual costs of 0.09%. 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 style with the worst holdings or portfolio management ratings.

Figure 2: Style Mutual Funds with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
COREX	Avondale Core Investment Fund	All Cap Blend	Very Unattractive
TFCGX	PFS Taylor Frigon Core Growth Fund	All Cap Growth	Unattractive
TRLIX	TIAA-CREF Large Cap Value Fund	All Cap Value	Unattractive
BLPIX	ProFunds Bull ProFund	Large Cap Blend	Unattractive
OTPIX	ProFunds NASDAQ 100 ProFund	Large Cap Growth	Unattractive
NRIGX	Integrity Energized Dividend Fund	Large Cap Value	Unattractive
SSEIX	AMG Southern Sun U.S. Equity Fund	Mid Cap Blend	Unattractive
FRSPX	Dreyfus Mid Cap Growth Fund	Mid Cap Growth	Unattractive
APHQX	Artisan Mid Cap Value Fund	Mid Cap Value	Unattractive
UISCX	USAA Small Cap Stock Fund	Small Cap Blend	Very Unattractive
DSGGX	Delaware Small Cap Growth Fund	Small Cap Growth	Unattractive
ROFIX	Royce Opportunity Fund	Small Cap Value	Very Unattractive

Sources: New Constructs, LLC and company filings

ProFunds (BLPIX, OTPIX) appear more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Delaware Small Cap Growth Fund (DSGGX) is the worst rated mutual fund in Figure 2. Dreyfus Mid Cap Growth Fund (FRSPX), PFS Taylor Frigon Core Growth Fund (TFCGX), USAA Small Cap Stock Fund (UISCX), Avondale Core Investment Fund (COREX), Integrity Energized Dividend Fund (NRIGX), and Royce Opportunity Fund (ROFIX) also earn a Very Unattractive 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[1] 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

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

Analyzing each holding within funds is no small task. Our Robo-Analyst technology enables us to perform this diligence with scale and provide the research needed to fulfill the fiduciary duty of care. More of the biggest names in the financial industry (see At BlackRock, Machines Are Rising Over Managers to Pick Stocks) are now embracing technology to leverage machines in the investment research process. Technology may be the only solution to the dual mandate for research: cut costs and fulfill the fiduciary duty of care. Investors, clients, advisors and analysts deserve the latest in technology to get the diligence required to make prudent investment decisions.

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

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3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

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