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 2.10%, which is the average total annual costs of the 631 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.29%, 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 SAI Real Estate Fund (FESIX) is the least expensive. Rydex (RYREX, RYCRX, RYHRX) provides three of the most expensive mutual funds while Fidelity (FESIX, FSRNX, FSRVX) mutual 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	Real Estate	8.39%
RYCRX	Rydex Real Estate Fund	Real Estate	7.38%
SFPAX	Saratoga Advantage Financial Services	Financials	7.24%
SBMBX	Saratoga Advantage Energy & Basic Materials	Energy	7.12%
RYHRX	Rydex Real Estate Fund	Real Estate	6.47%
Least Expensive			
FESIX	Fidelity SAI Real Estate Fund	Real Estate	0.09%
FSRNX	Fidelity Real Estate Index Fund	Real Estate	0.09%
FSRVX	Fidelity Real Estate Index Fund	Real Estate	0.12%
VUIAX	Vanguard Utilities Fund	Utilities	0.12%
VITAX	Vanguard Information Technology Fund	Information Technology	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings. Vanguard Information Technology Fund (VITAX) is the best ranked sector mutual fund in Figure 1. VITAX's Neutral Portfolio Management rating and 0.12% total annual cost earn it a Very Attractive fund rating. Fidelity Consumer Finance (FSVLX) is the best ranked sector mutual fund overall. FSVLX's Attractive Portfolio Management rating and 1.14% total annual cost also earn it a Very Attractive fund rating.

On the other hand, Vanguard Energy Index Fund (VENAX) holds poor stocks and receives our Very Unattractive rating, yet has low total annual costs of 0.14%. 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
FCNAX	Fidelity Advisor Consumer Discretionary	Consumer Discretionary	Unattractive
PGCOX	Putnam Global Consumer Fund	Consumer Staples	Unattractive
CRZNX	MainStay Cushing Renaissance Advantage	Energy	Unattractive
ADAFX	Alpine Financial Services Fund	Financials	Unattractive
PHLAX	Prudential Jennison Health Sciences Fund	Health Care	Unattractive
PGIAX	Putnam Global Industrials Fund	Industrials	Unattractive
WFSTX	Wells Fargo Specialized Technology Fund	Information Technology	Unattractive
VMIAX	Vanguard Materials Index Fund	Materials	Unattractive
AREEX	American Century Real Estate Fund	Real Estate	Unattractive
FTUAX	Fidelity Advisor Telecommunications Fund	Telecom Services	Unattractive
RYUTX	Rydex Series Funds: Utilities Fund	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

Putnam (PGCOX, PGIAX) and Fidelity (FCNAX, FTUAX) appear more often than any other providers in Figure 2, which means that they offer the most mutual funds with the worst holdings.

Putnam Global Consumer Fund (PGCOX) is the worst rated mutual fund in Figure 2. With the exception of Fidelity Advisor Consumer Discretionary Fund (FCNAX), every fund in Figure 2 earns 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 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

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.[1] 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,

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

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, Kenneth James, and Kyle Guske II receive no compensation to write about any specific stock, sector, or theme.

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To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
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.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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