How to Avoid the Worst Style ETFs

Question: Why are there so many ETFs?

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

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

1. Inadequate Liquidity

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

2. High Fees

ETFs 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 ETFs with total annual costs below 0.46%, which is the average total annual cost of the 441 U.S. equity style ETFs we cover. The weighted average is lower at 0.15%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Forensic Accounting Long-Short ETF (FLAG) is the most expensive style ETF and Schwab U.S. Large Cap ETF (SCHX) is the least expensive. Exchange Traded Concepts Trust provides one of the most expensive ETFs while Schwab (SCHX, SCHB) and State Street (SPLG, SPTM) ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Style ETFs

Ticker	Name	Style	Total Annual Cost
	Most Expensive		
FLAG	Forensic Accounting Long-Short ETF	All Cap Blend	1.80%
GARD	Reality Shares DIVCON Dividend Guard ETF	All Cap Blend	1.57%
FWDD	AdvisorShares Madrona Domestic ETF	All Cap Blend	1.39%
HUSE	US Market Rotation Strategy ETF	All Cap Blend	1.36%
NAIL	Direxion Daily Homebuilders & Supplies Bull 3X Shares	All Cap Blend	1.25%
	Least Expensive		
SCHX	Schwab U.S. Large-Cap ETF	Large Cap Blend	0.03%
SPLG	State Street SPDR Portfolio Large Cap ETF	Large Cap Blend	0.03%
ITOT	iShares Core S&P Total US Stock Market ETF	All Cap Blend	0.03%
SCHB	Schwab U.S. Broad Market ETF	All Cap Blend	0.03%
SPTM	State Street SPDR Portfolio Total Stock Market ETF	All Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings[1]. Schwab U.S. Large Cap ETF (SCHX) is the best ranked style ETF in Figure 1. SCHX's Neutral Portfolio Management rating and 0.03% total annual cost earns it an Attractive rating[2]. Alpha Architect U.S. Quantitative Value ETF (QVAL) is the best ranked style ETF overall. QVAL's Attractive Portfolio Management rating and 0.88% total annual cost earns it a Very Attractive rating.

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

On the other hand, State Street SPDR Portfolio S&P 500 High Dividend ETF (SPYD) holds poor stocks and earns our Unattractive rating, yet has low total annual costs of 0.08%. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETFs holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoid bad ETFs, but it is also the most important because an ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst holdings or portfolio management ratings.

Figure 2: Style ETFs with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
DIG	ProShares Ultra Oil & Gas	All Cap Blend	Unattractive
FPX	First Trust US Equity Opportunities ETF	All Cap Growth	Unattractive
VONV	Vanguard Russell 1000 Value Index Fund	All Cap Value	Unattractive
SPXT	ProShares S&P 500 Ex-Technology ETF	Large Cap Blend	Unattractive
SPYG	State Street SPDR Portfolio S&P 500 Growth ETF	Large Cap Growth	Neutral
SPYD	State Street SPDR Portfolio S&P 500 High Dividend	Large Cap Value	Unattractive
RYJ	Guggenheim Raymond James SB-1 Equity ETF	Mid Cap Blend	Unattractive
JKH	iShares Morningstar Mid-Cap Growth ETF	Mid Cap Growth	Unattractive
IWS	iShares Russell Mid-Cap Value ETF	Mid Cap Value	Unattractive
EQWS	PowerShares Russell 2000 Equal Weight Portfolio	Small Cap Blend	Unattractive
VBK	Vanguard Small-Cap Growth Index Fund	Small Cap Growth	Unattractive
RZV	PowerShares S&P Small Cap 600 Pure Value	Small Cap Value	Unattractive

Sources: New Constructs, LLC and company filings

iShares (JKH, IWS), PowerShares (EQWS, RZV), ProShares (SPXT, DIG), State Street (SPYG, SPYD), and Vanguard (VBK, VONV) appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

ProShares Ultra Oil & Gas (DIG) is the worst rated ETF in Figure 2. Guggenheim Raymond James SB-1 Equity ETF (RYJ), Vanguard Small Cap Growth Index Fund (VBK), iShares Morningstar Mid Cap Growth ETF (JKH), PowerShares Russell 2000 Equal Weight (EQWS), PowerShares S&P Small Cap 600 Pure Value (RZV), iShares Russell Mid Cap Value ETF (IWS) and State Street SPDR Portfolio S&P 500 High Dividend ETF (SPYD) earn an Unattractive predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

Our overall ratings on ETFs are on our stock ratings of their holdings and the total annual costs of investing in the fund.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF'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 ETFs HOLDINGs = PERFORMANCE OF ETF

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 and Kyle Guske II 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.

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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