



Cheap Funds Dupe Investors – 3Q19

Fund holdings affect fund performance more than fees or past performance. A cheap fund is not necessarily a good fund. A fund that has done well in the past is not guaranteed to do well in the future ([e.g. 5-star kiss of death](#) and [active management has long history of underperformance](#)). Yet, traditional fund research focuses only on low fees and past performance.

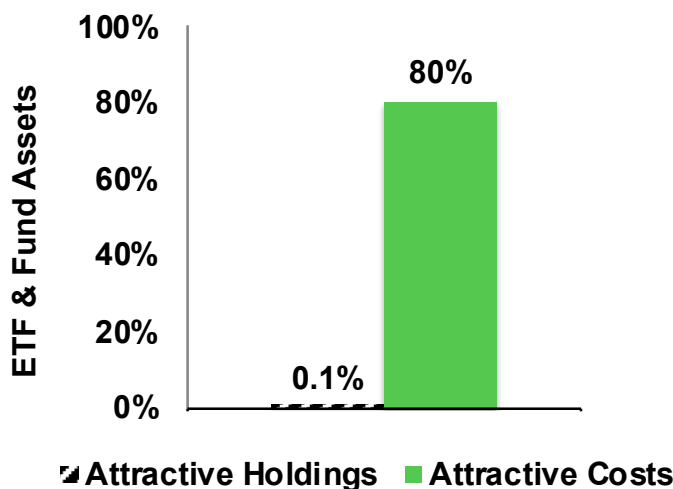
Our [Robo-Analyst technology](#)¹ empowers our unique [ETF and mutual fund rating methodology](#), which leverages our rigorous analysis of fund holdings² and enables investors to find funds with high quality holdings (the best chances for outperformance) – AND – low fees.

Get the best fundamental research

Investors are good at picking cheap funds. We want them to be better at picking funds with good stocks. Both are required to maximize success. We make this easy with our [predictive fund ratings](#). A fund's predictive rating is based on its holdings, its total costs, and how it ranks when compared to the rest of the 7000+ ETFs and mutual funds we cover.

Figure 1 shows that 80% of fund assets are in ETFs and mutual funds with low costs but only 0.1% of assets are in ETFs and mutual funds with Attractive holdings. This discrepancy is eye opening. Perhaps, if more investors had access to research on fund holdings, they would allocate to more Attractive-or-better rated funds.

Figure 1: Allocation of Fund Assets by Holdings Quality and By Costs



Sources: New Constructs, LLC and company filings

We see two key opportunities for improvement in the ETF and mutual fund industry:

1. More research into the quality of holdings.
 - Not enough research focuses on the quality of [portfolio management of funds](#)
2. More allocation by managers to high-quality holdings or good stocks.
 - With about twice as many funds as stocks in the market, there simply are not enough good stocks to fill all the funds.

These opportunities are related. If investors had more insight into the quality of funds' holdings, we think they

¹ Harvard Business School features the powerful impact of our research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).

² This [paper](#) compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.



would allocate a lot less money to funds with poor quality holdings. Many funds would cease to exist.

Quality of holdings is the single most important factor in determining an ETF or mutual fund's future performance. No matter how low the costs, if the ETF or mutual fund holds bad stocks, performance will be poor. Costs are easier to find, but research on the quality of holdings is almost non-existent.

Figure 2 shows investors are not putting enough money into ETFs and mutual funds with high-quality holdings. Only 37 out of 7833 (<1%) ETFs and mutual funds allocate a significant amount of value to quality holdings. 99% of assets are in funds that do not justify their costs and over charge investors for poor portfolio management.

Figure 2: Distribution of ETFs & Mutual Funds (Count & Assets) By Portfolio Management Rating

	Portfolio Management Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	37	2674	5122
% of Assets	0.1%	50%	50%

Source: New Constructs, LLC and company filings

Figure 3 shows that investors successfully find low-cost funds. 80% of assets are held in ETFs and mutual funds that have Attractive-or-better rated [total annual costs](#), our apples-to-apples measure of the all-in cost of investing in any given fund.

Out of the 7833 ETFs and mutual funds we cover, 2390 (31%) earn an Attractive-or-better total annual costs rating.

Clearly, ETF and mutual funds investors are smart shoppers when it comes to finding cheap investments. But cheap is not necessarily good.

Invesco S&P Small Cap Utilities & Communication Services ETF (XLU) gets an overall predictive rating of Very Unattractive because no matter how low its fees (0.14%) we expect it to underperform because it holds too many Unattractive-or-worse rated stocks. Low fees cannot boost fund performance. Only good stocks can boost performance.

Figure 3: Distribution of ETFs & Mutual Funds (Count & Assets) By Total Annual Costs Ratings

	Total Annual Costs Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	2390	3205	2238
% of Assets	80%	10%	10%

Source: New Constructs, LLC and company filings

Investors should allocate their capital to funds with both high-quality holdings and low costs because those are the funds that offer investors the best performance potential.

But they do not. Not even close.

Figure 4 shows that 53% of ETF and mutual fund assets are allocated to funds with low costs and high-quality holdings according to our predictive fund ratings, which are based on the quality of holdings and the [all-in costs](#) to investors.

**Figure 4: Distribution of ETFs & Mutual Funds (Count & Assets) By Predictive Ratings**

	Predictive Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	2352	3137	2344
% of Assets	53%	35%	12%

Source: New Constructs, LLC and company filings

Investors deserve forward-looking ETF and mutual fund research that assesses both costs and quality of holdings. For example, State Street SPDR Portfolio S&P 500 Value ETF (SPYV) has both low costs and quality holdings.

Why is the [most popular](#) fund rating system based on backward-looking past performance?

We do not know, but we do know that the lack of transparency into the quality of portfolio management provides cover for the ETF and mutual fund industry to continue to over charge investors for poor portfolio management. How else could they get away with selling so many Unattractive-or-worse ETFs and mutual funds?

Well, maybe, the industry is not getting away with it anymore given the huge flow of fund away from active to passive management.

The late John Bogle was correct — investors should not pay high fees for active portfolio management. His index funds provided investors with many low-cost alternatives to actively managed funds.

However, by focusing entirely on costs, he overlooked the primary driver of fund performance: the stocks held by funds. Investors also need to beware certain [Index Label Myths](#).

Research on the quality of portfolio management of funds empowers investors to make better investment decisions. Investors should no longer pay for poor portfolio management.

This article originally published on [July 22, 2019](#).

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

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

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.



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.