How to Avoid the Worst Sector 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.

Get the best fundamental research

The large number of ETFs has little to do with serving your best interests. Only our research utilizes the superior data and earnings adjustments featured by the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence." We leverage this data to identify three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest 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 average or below average fees, invest only in ETFs with total annual costs below 0.48%, which is the average total annual costs of the 261 U.S. equity Sector ETFs we cover. The weighted average is lower at 0.25%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Procure Space ETF (UFO) is the most expensive sector ETF and Schwab U.S. REIT ETF (SCHH) is the least expensive. Procure (UFO) provides one of the most expensive ETFs while Fidelity (FENY, FMAT, FIDU) ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector ETFs

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
UFO	Procure Space ETF	Industrials	1.91%
KBWD	Invesco KBW High Dividend Yield Financial ETF	Financials	1.77%
KOIN	Innovation Shares NextGen Protocol ETF	Technology	1.06%
FFTY	Innovator IBD 50 ETF	Financials	0.89%
BBP	Virtus LifeSci Biotech Products ETF	Healthcare	0.88%
Least Expensive			
SCHH	Schwab U.S. REIT ETF	Real Estate	0.08%
USRT	iShares Core U.S. REIT ETF	Real Estate	0.09%
FENY	Fidelity MSCI Energy Index ETF	Energy	0.09%
FMAT	Fidelity MSCI Materials Index ETF	Basic Materials	0.09%
FIDU	Fidelity MSCI Industrials Index ETF	Industrials	0.09%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Fidelity MSCI Industrials Index ETF (FIDU) is the best ranked sector ETF in Figure 1. FIDU's Neutral Portfolio Management rating and 0.09% total annual cost earns it an Attractive rating.[2] Invesco Dynamic Building & Construction ETF (PKB) is the best ranked sector ETF overall. PKB's Attractive Portfolio Management rating and 0.66% total annual cost also earns it a Very Attractive rating.

On the other hand, iShares Core U.S. REIT ETF (USRT) holds poor stocks and earns our Unattractive rating, yet has low total annual costs of 0.09%. No matter how cheap an ETF, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its price.

3. Poor Holdings

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

Figure 2: Sector ETFs with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
PSCM	Invesco S&P Small Cap Materials ETF	Basic Materials	Unattractive
BUYZ	Franklin Disruptive Commerce ETF	Consumer Cyclicals	Unattractive
PBJ	Invesco Dynamic Food & Beverage ETF	Consumer Non-cyclicals	Neutral
PSCE	Invesco S&P Small Cap Energy ETF	Energy	Unattractive
KBWD	Invesco KBW High Dividend Yield ETF	Financials	Unattractive
FBT	First Trust NYSE Arca Biotechnology Index Fund	Healthcare	Unattractive
UFO	Procure Space ETF	Industrials	Unattractive
RDOG	ALPS REIT Dividend Dogs ETF	Real Estate	Unattractive
XITK	SPDR FactSet Innovative Technology ETF	Technology	Unattractive
JHCS	John Hancock Multifactor Media and Communication	Telecom Services	Unattractive
PSCU	Invesco S&P Small Cap Utilities & Communication	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

Invesco appears more often than any other providers in Figure 2, which means that it offers the most ETFs with the worst holdings.

Franklin Disruptive Commerce ETF (BUYZ) is the worst rated ETF in Figure 2. Procure Space ETF (UFO), First Trust NYSE Arca Biotechnology Index Fund (FBT), Invesco S&P Small Cap Energy ETF (PSCE), ALPS REIT Dividend Dogs ETF (RDOG), Invesco S&P Small Cap Utilities & Communication (PSCU), and SPDR FactSet Innovative Technology ETF (XITK) 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 ETFs are on our stock ratings of their holdings and the total annual costs of investing in the ETF.

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

[1] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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.

This article originally published on May 6, 2020.

Disclosure: Kyle Guske II owns USRT. David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, or theme.

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The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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