# Don't Pay Fund Managers to Chase Momentum

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

Through 2Q20, the top five Technology companies (measured by core earnings), Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Facebook (FB), and Intel Corporation (INTC), accounted for 59% of the sector's total core earnings. With just a few firms driving the performance of the "Tech" sector, there are many stocks that benefit from the "Tech" label and the rising momentum that goes with it despite poor profitability and serious competitive disadvantages. For examples of some of these severely overvalued stocks, see our Most Dangerous Stocks for Fiduciaries reports.

Chasing momentum is neither a new or difficult strategy. Many individual investors have earned some great returns from this strategy. As a result, we see little reason for investors to pay fees to professional managers to chase momentum stocks for them. Wells Fargo Specialized Technology Fund (WFSTX) is in the Danger Zone.



### Backwards Looking Research Overrates This Fund

Investors that rely solely on past performance may miss the true risk of investing in this fund. Per Figure 1, WFSTX and WFTCX earn the 4-Star and 3-Star rating, respectively, from Morningstar.

Meanwhile, WFSTX earns our Very Unattractive Rating, the worst of our Predictive Risk/Reward Fund ratings, which leverage our superior research[1] featured by Harvard Business School and MIT Sloan. The other share class of this fund earns our Unattractive rating.

**Figure 1: Wells Fargo Specialized Technology Fund Ratings**

| Ticker | Morningstar Rating | New Constructs Rating |
|---|---|---|
| WFSTX | 4 Star | Very Unattractive |
| WFTCX | 3 Star | Unattractive |

Sources: New Constructs, LLC, company, ETF and mutual fund filings, and Morningstar

WFSTX allocates significantly more capital to companies with low profitability and high profit growth expectations baked into their stock prices, which makes its portfolio riskier than the benchmark and the overall market.

### Holdings Research Reveals a Low-Quality Portfolio

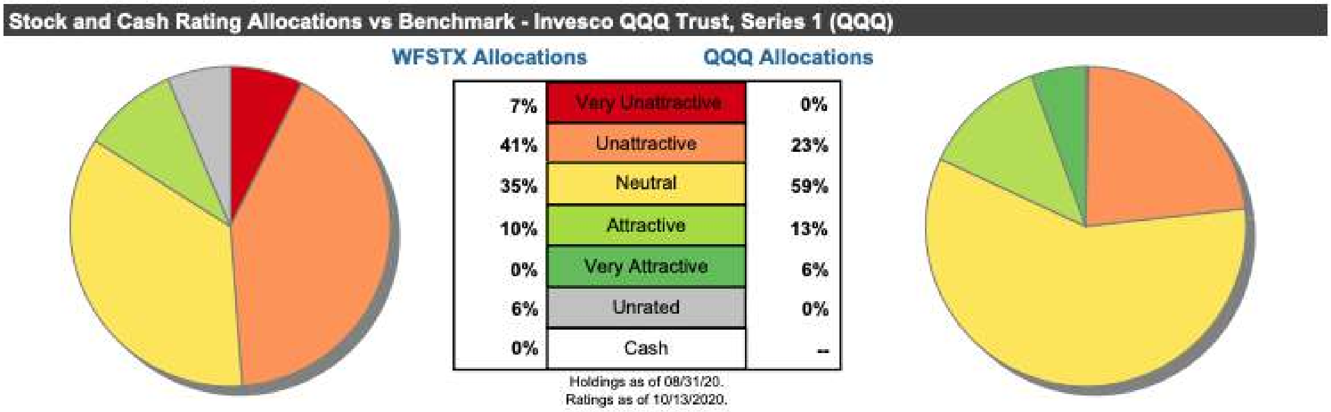
Per Figure 2, Wells Faro Specialized Technology Fund's asset allocation poses greater downside risk and holds less upside potential than its benchmark, the Invesco QQQ Trust (QQQ).

WFSTX allocates 48% of its portfolio to Unattractive-or-worse rated stocks compared to just 23% for QQQ. On the flip side, WFSTX's exposure to Attractive-or-better rated stocks is much lower, at 10%, versus QQQ at 19%.

Additionally, nine of WFSTX's top 10 holdings earn a Neutral-or-worse rating and make up 41% of the fund's portfolio.

[1] Our core earnings are a superior measure of profits, as demonstrated in Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. The paper empirically shows that our data is superior to "Operating Income After Depreciation" and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

**Figure 2: WFSTX Allocates Capital to More Low-Quality Holdings**




Sources: New Constructs, LLC and company, ETF and mutual fund filings

Given the unfavorable allocation of Attractive-or-better vs. Unattractive-or-worse rated stocks relative to the benchmark, WFSTX appears poorly positioned to generate the outperformance required going forward to justify its fees.

**Active Management Strategy Fails to Find Value**

In its fact sheet, Wells Fargo Specialized Technology Fund outlines the strategy for choosing investments for the fund:

- Invest in companies that use technology in an innovative way to gain a strategic, competitive edge
- Emphasize growth, quality, and valuation through judgement of
  - Estimated future growth
  - Quality of management
  - Balance sheet strength
  - Cash flow generation
  - Uniqueness of product niche
- Highlight higher valuation market leaders

Such a strategy looks great on paper – what investors wouldn't want stocks with quality management, a strong balance sheet, and cash flow generation? However, without the use of specific metrics that accurately reflect profitability and valuation, e.g. core earnings, return on invested capital (ROIC), and price-to-economic book value (PEBV), the fund routinely invests in stocks with low-quality earnings, negative cash flows, and expensive valuations.

**Stock Selection Methodology Finds Bad Stocks**

Our research shows that WFSTX allocates to stocks with lower ROICs and higher valuations than the benchmark.

Figure 3 contains our detailed rating for WFSTX, which includes each of the criteria we use to rate all funds under coverage. These criteria are the same for our Stock Rating Methodology because the performance of a fund's holdings equals the performance of a fund after fees.

**Figure 3: Wells Fargo Specialized Technology Fund Rating Breakdown**

| Risk/Reward Rating | Portfolio Management: Quality of Earnings: Economic vs Reported EPS | Quality of Earnings: ROIC | Valuation: FCF Yield | Valuation: Price to EBV | Valuation: Market-Implied GAP | Asset Allocation: Cash % | Total Annual Costs |
|---|---|---|---|---|---|---|---|
| Very Unattractive | Misleading Trend | Bottom Quintile | <-5% | >3.5 or -1<0 | >50 | >20% | >4% |
| Unattractive | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 | 8%<20% | 2%<4% |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 | 2.5%<8% | 1%<2% |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 | 1%<2.5% | 0.5%<1% |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | 0<3 | <1% | <0.5% |
| **Actual Values** | | | | | | | |
| **WFSTX** | **Positive EE** | **24%** | **-1%** | **5.9** | **75 yrs** | **<1%** | **4.1%** |
| **Benchmarks** | | | | | | | |
| Sector ETF (QQQ) | Positive EE | 35% | 1% | 4.9 | 52 yrs | - | 0.2% |
| S&P 500 ETF (SPY) | Positive EE | 22% | 1% | 3.1 | 34 yrs | - | 0.1% |
| Small Cap ETF (IWM) | Positive EE | 3% | -0% | 3.8 | 36 yrs | - | 0.2% |

Sources: New Constructs, LLC and company, ETF and mutual fund filings

As Figure 3 shows, WFSTX's holdings are inferior to its benchmark, QQQ, and the S&P 500 (SPY). Specifically:

- WFSTX's ROIC is 24% and below the 35% earned by QQQ.
- WFSTX's free cash flow yield of -1% is worse than the 1% of QQQ and SPY.
- The PEBV ratio for WFSTX is 5.9, which is significantly greater than the 4.9 for QQQ holdings and the 3.1 of SPY holdings.
- Our discounted cash flow analysis reveals an average market implied growth appreciation period (GAP) of 75 years for WFSTX's holdings compared to 52 years for QQQ and 34 years for SPY.

In other words, the stocks held by WFSTX generate inferior cash flows and have higher valuations compared to QQQ and SPY. The market expectations for stocks held by WFSTX imply profit growth (measured by PEBV ratio) that is well above the profit growth expectations embedded in QQQ's and SPY's holdings. Lower historical profits and higher expectations for future profits are a bad combination. Furthermore, in the current market, there is no reason to allocate to overvalued stocks when there are many industry leading firms trading at historical discounts.

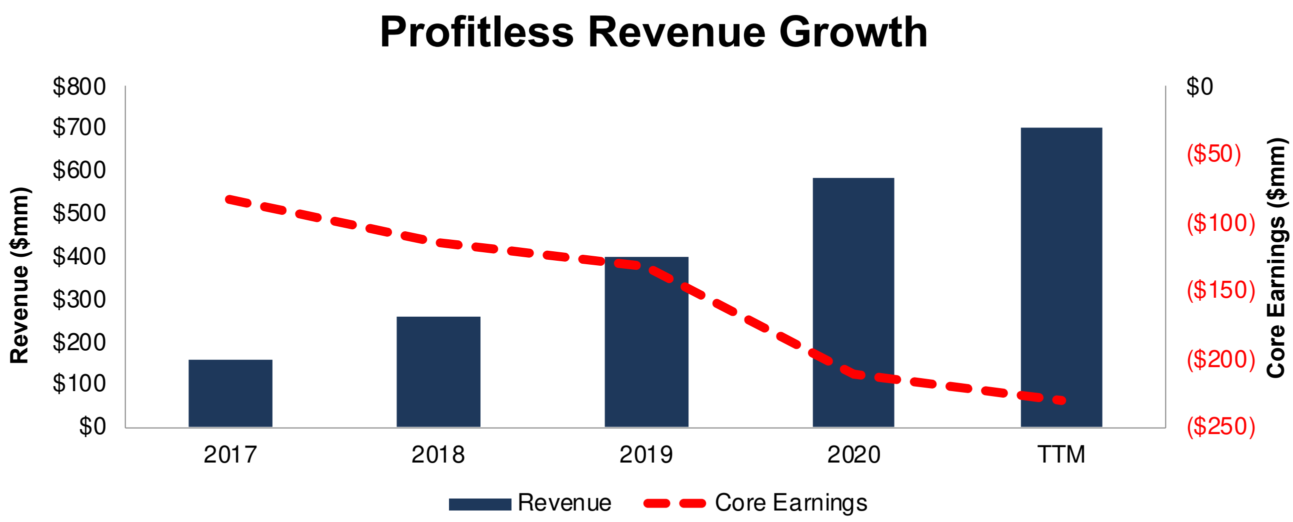
**Portfolio Allocates to Some of the Most Dangerous Stocks**

In our Most Dangerous Stocks for Fiduciaries, we feature highly overvalued stocks, such as Tesla (TSLA), Shopify (SHOP), and Spotify (SPOT) as companies with poor profitability and competitive disadvantages matched with valuations that imply they will take huge market share.

WFSTX allocates to all three of those stocks. Across its entire portfolio, 52 out of 83 holdings (which equates to 67% of assets) have a market-implied GAP greater than 50 years. In other words, the stock prices of these companies imply they will earn an ROIC greater than weighted average cost of capital (WACC) on incremental investments for more than 50 years.

One of WFSTX's largest holdings, Okta (OKTA: $243/share) reminds us of the stocks we've selected as the Most Dangerous for Fiduciaries. From fiscal 2017-2020, Okta's revenue has grown by 54% compounded annually while core earnings have fallen from -$83 million to -$211 million over the same time, per Figure 4. Over the TTM period, core earnings have fallen further to -$231 million.

**Figure 4: Okta's Revenue & Core Earnings Since 2017**




Sources: New Constructs, LLC and company filings

Economic earnings, which not only account for unusual items on the income statement but also changes to the balance sheet, look even worse. Economic earnings have declined from -$83 million in fiscal 2017 to -$266 million TTM. Okta's ROIC has also been negative throughout its time as a public company and fell from -13% in fiscal 2019 to -17% in fiscal 2020, before improving slightly to -11% TTM.

**OKTA Is Priced to Take Nearly One-Third of Its TAM**

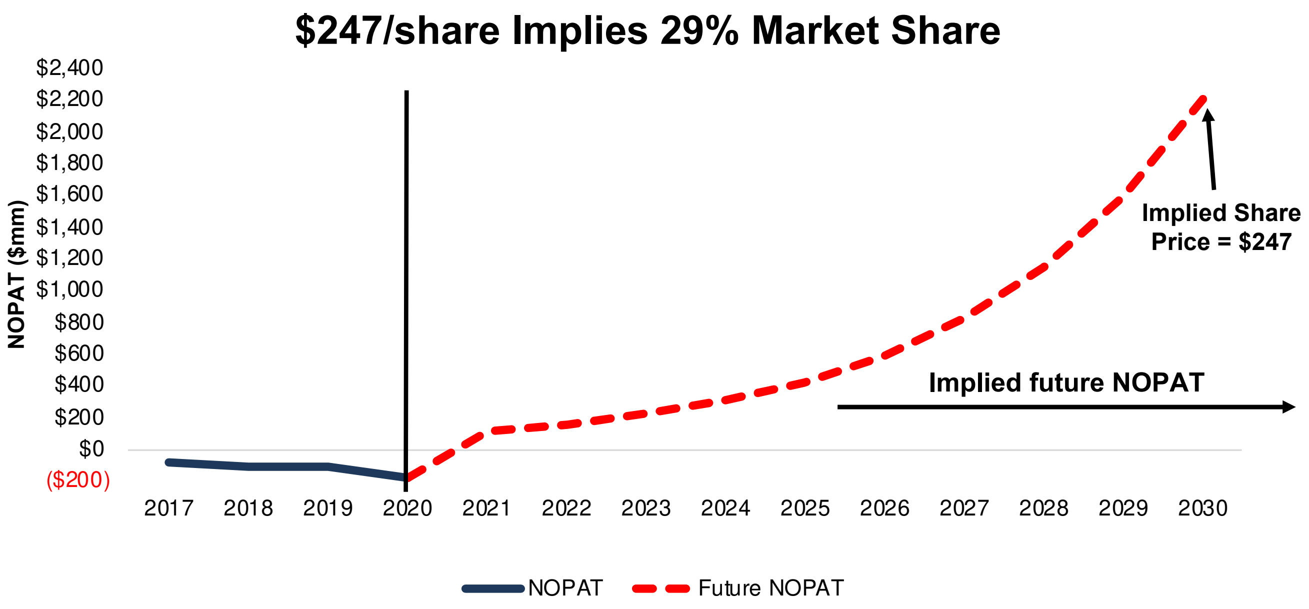
Despite the deterioration in Okta's fundamentals, shares are up ~111% year-to-date and 110% over the past year (S&P +18%) and are significantly overvalued. We use our reverse DCF model to quantify the growth in cash flows, and implied market share, Okta must achieve to justify its valuation.

To justify its current price of $243/share, OKTA must immediately achieve a 14% NOPAT margin (average of 65 Software firms under coverage with positive NOPAT margin – compared to -25% TTM) and grow revenue by 38% compounded annually (vs. consensus estimates of 26% CAGR) for the next 10 years. See the math behind this reverse DCF scenario.

In this scenario, Okta's revenue would reach $15.8 billion, or 29% of its total addressable market (TAM). For comparison, $15.8 billion is higher than the 2019 revenue for all the software firms we cover except for Microsoft (MSFT), Oracle (ORCL), and SAP (SAP).

Figure 5 compares the firm's implied future NOPAT in this scenario to its historical NOPAT.

**Figure 5: Current Valuation Implies Huge Growth in Profits**



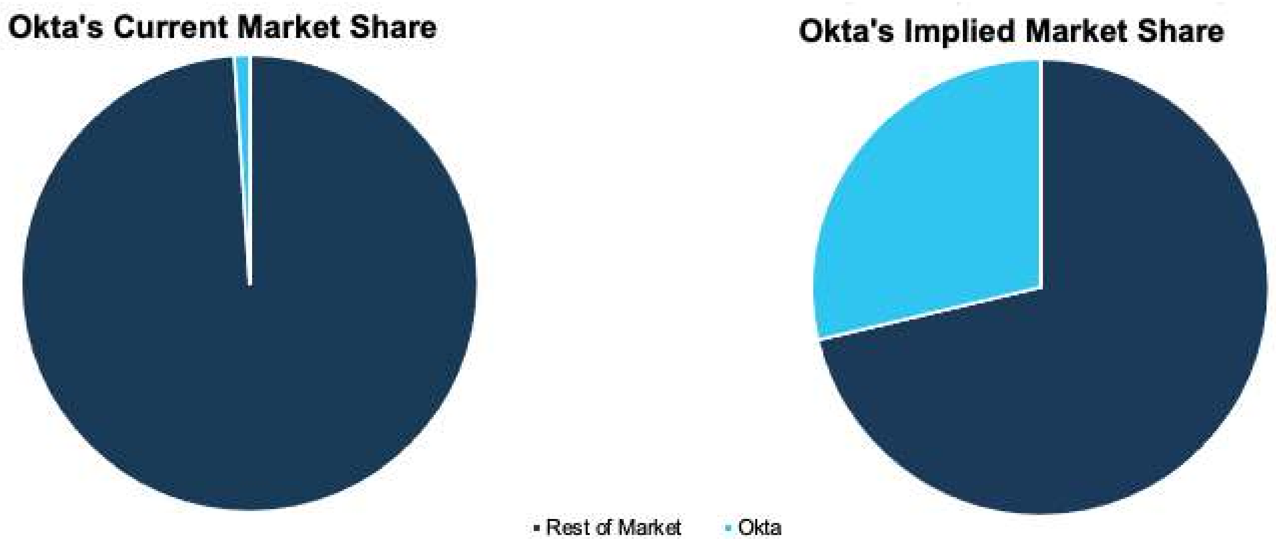

Sources: New Constructs, LLC and company filings.

Okta's revenue in fiscal year 2020 represented just 1% of the firm's self-defined TAM of $55 billion. To calculate this TAM, Okta assumes:

- $30 billion for the Workforce Identify market, which assumes 50,000 businesses with over 250 employees[2] buy all of Okta's current products at the current price ($15 billion from the U.S. and $15 billion from international businesses)
- $25 billion for the Customer Identity market, which assumes an undisclosed penetration rate of 4.4 billion Facebook users and service employees worldwide.

The revenue growth required to justify its stock price means Okta will hold 29% of its TAM. See Figure 6.

**Figure 6: Current Valuation Implies Drastic Increase in Market Share**




Sources: New Constructs, LLC and company filings.

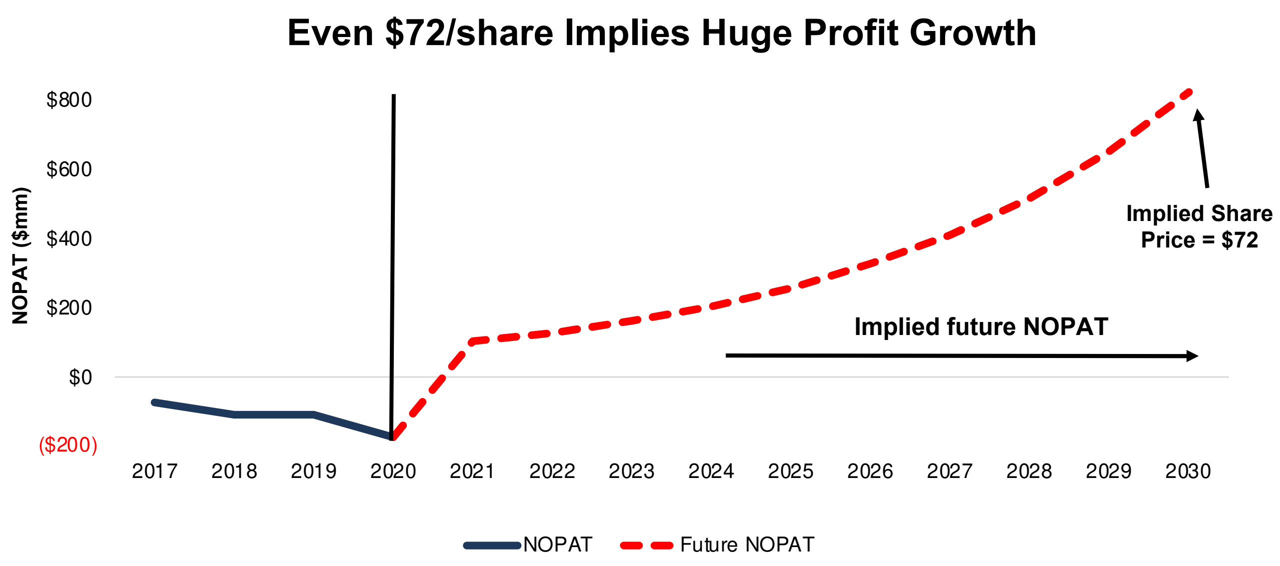
[2] Based on 2019 U.S. Bureau of Labor count of businesses provided in Okta's fiscal 1Q21 earnings presentation.

**Significant Downside Risk in Owning OKTA**

Even if Okta grows at consensus estimates, the stock is severely overvalued. If we assume Okta can achieve a 14% NOPAT margin and grow revenue by 26% compounded annually for the next decade, the stock is worth only $72/share today – a 70% downside to the current stock price. See the math behind this reverse DCF scenario. This scenario still implies Okta's revenue will be $5.9 billion in 2030, which would rank ahead of the TTM revenue of 115 out of the 122 Software companies under coverage.

Figure 7 compares the firm's implied future NOPAT in this scenario to its historical NOPAT.

**Figure 7: Okta Could Fall 70% Even if It Grows at Consensus Estimates**




Sources: New Constructs, LLC and company filings.

Each of these scenarios also assumes Okta is able to grow revenue, NOPAT and FCF without increasing working capital or fixed assets. This assumption is unlikely but allows us to create best-case scenarios that demonstrate how high expectations embedded in the current valuation are. For reference, Okta's invested capital grew by an average of $460 million a year (78% of fiscal 2020 revenue) over the past three years.

**Excessive Fees Make Outperformance Even More Difficult**

At 4.05%, WFSTX's total annual costs (TAC) are higher than 97% of the 150 Technology mutual funds under coverage. For comparison, the average TAC of all Technology mutual funds under coverage is 1.96%, the weighted average is 1.56%, and the benchmark ETF (QQQ) has total annual costs of 0.22%.

Our TAC metric accounts for more than just expense ratios. We consider the impact of front-end loads, back-end loads, redemption fees, and transaction costs. For example, WFSTX's front-end load adds 2.19% to its total annual costs and its annual turnover ratio of 149% adds 0.32% to its total annual costs – neither of which are captured by the expense ratio. Figure 8 shows our breakdown of WFSTX's total annual costs, which is also available for all of the ~7,000 mutual funds under coverage.

**Figure 8: Wells Fargo Specialized Technology Fund Total Annual Costs Breakdown**

| Total Annual Costs Breakdown | | |
|---|---|---|
| **All Cost Types** | **WFSTX** | **QQQ** |
| Front-End Load | 2.19% | - |
| Expense Ratio | 1.54% | 0.22% |
| Back-End Load | 0.00% | - |
| Redemption Fee | 0.00% | - |
| Transaction Costs | 0.32% | - |
| **Total Annual Costs** | **4.05%** | **0.22%** |

Sources: New Constructs, LLC and company, ETF and mutual fund filings

To justify its higher fees, each class of the fund must outperform its benchmark by the following amounts over three years:

1. WFSTX must outperform by an average of 3.82% annually.
2. WFTCX must outperform by an average of 2.45% annually.

An in-depth analysis of WFSTX and its TAC is available in our standard mutual fund report.

**Free copy of our WFSTX report**

### WFSTX's Performance Can't Justify Its Fees

When we take into account its load, which adds 2.19% to its total annual costs, we see that WFSTX has failed to outperform and justify its fees.

WFSTX's load adjusted one-year quarter-end average annual total return underperformed QQQ by over 170 basis points. Its load adjusted three-, and five-year quarter-end average annual total returns have outperformed QQQ by 13 and 132 basis points, while the 10-year return underperformed by 218 basis points. None of the outperformance is great enough to justify its fees, as noted above.

Given that 48% of assets are allocated to stocks with Unattractive-or-worse ratings, WFSTX looks likely to continue to underperform moving forward.

### The Importance of Holdings-Based Fund Analysis

Smart fund (or ETF) investing means analyzing the holdings of each mutual fund. Failure to do so is a failure to perform proper due diligence. Simply buying a mutual fund or ETF based on past performance does not necessarily lead to outperformance. Similarly, blindly diversifying through index funds is no substitute for diligence. Only through holdings-based analysis can one determine if a fund's methodology leads managers to pick high-quality or low-quality stocks.

However, most investors don't realize they can access sophisticated fundamental research[3] using data that corrects market inefficiencies and generates alpha. Our Robo-Analyst technology analyzes the holdings of all 215 ETFs and mutual funds in the Technology sector and ~7,600 ETFs and mutual funds under coverage to avoid "the danger within." This diligence allows us to cut through the noise and identify potentially dangerous funds that traditional, backward-looking fund research may overlook, such as WFSTX.

### Better-Rated Technology Funds

The following are some Technology mutual funds that earn an Attractive rating, have more than $100 million in assets under management, and have below average TAC.

1. Red Oak Technology Select Fund (ROGSX) – 1.08% TAC
2. Fidelity Select Computers Portfolio (RDCPX) – 1.09% TAC

[3] Compare our analytics on a mega cap company to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

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

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

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### *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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