# How to Avoid the Worst Style ETFs

Question: Why are there so many ETFs?

Answer: ETF issuance is profitable, so Wall Street keeps cranking out more products to sell.



The large number of ETFs has little to do with serving your best interests as an investor. More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research and analysis of ETF holdings and provides investors with a new source of alpha. 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. Small ETFs also generally have lower trading volume, which translates to higher trading costs via larger bid-ask spreads.

**2. High Fees**

ETFs should be cheap, but not all of them are. The first step is to benchmark what cheap means.

To ensure you are paying at or below average fees, invest only in ETFs with total annual costs below 0.46% – the average total annual cost of the 689 U.S. equity Style ETFs we cover. The weighted average is lower at 0.13%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows Emles Alpha Opportunities ETF (EOPS) is the most expensive style ETF and JPMorgan BetaBuilders U.S. Equity ETF (BBUS) is the least expensive. State Street (SPGL, SPTM) ETFs are among the cheapest.

**Figure 1: 5 Most and Least Expensive Style ETFs**

| Ticker | Name | Style | Total Annual Cost |
|---|---|---|---|
| **Most Expensive** | | | |
| EOPS | Emles Alpha Opportunities ETF | All Cap Blend | 1.96% |
| CLSE | Convergence Long/Short Equity ETF | All Cap Blend | 1.74% |
| LBAY | Leatherback Long/Short Alternative Yield ETF | All Cap Blend | 1.60% |
| MBCC | Monarch Blue Chips Core ETF | Large Cap Blend | 1.39% |
| MGMT | Ballast Small/Mid Cap ETF | Small Cap Blend | 1.22% |
| **Least Expensive** | | | |
| BBUS | JPMorgan BetaBuilders U.S. Equity ETF | Large Cap Blend | 0.02% |
| SPLG | State Street SPDR Portfolio S&P 500 ETF | Large Cap Blend | 0.03% |
| VOO | Vanguard 500 Index Fund | Large Cap Blend | 0.03% |
| IVV | iShares Core S&P 500 ETF | Large Cap Blend | 0.03% |
| SPTM | State Street SPDR Portfolio S&P 1500 Composite | All Cap Blend | 0.03% |

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] iShares Morningstar Value ETF (ILCV) is the best ranked style ETF with low costs. ILVC's Attractive Portfolio Management rating and 0.04% total annual cost earns it a Very Attractive rating.[2] Alpha Architect U.S. Quantitative Value ETF (QVAL) is the best ranked style ETF overall that meets our liquidity minimums. QVAL's Very Attractive Portfolio Management rating and 0.54% total annual cost also earns it a Very Attractive rating.

On the other hand, iShares Morningstar Small Cap Growth ETF (ISCG) holds poor stocks and earns our Very Unattractive rating, despite having low total annual costs of 0.07%. No matter how cheap an ETF looks, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its management fee.

### 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 ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst portfolio management ratings, a function of the fund's holdings.

**Figure 2: Style ETFs with the Worst Holdings**

| Ticker | Name | Style | Portfolio Management Rating |
|---|---|---|---|
| GIGE | SoFi Gig Economy ETF | All Cap Blend | Unattractive |
| INNO | Harbor Disruptive innovation ETF | All Cap Growth | Unattractive |
| XSHD | Invesco S&P Small Cap High Dividend Low Volatility | All Cap Value | Unattractive |
| MEME | Roundhill MEME ETF | Large Cap Blend | Unattractive |
| FDG | American Century Focused Dynamic Growth ETF | Large Cap Growth | Unattractive |
| SPYV | State Street SPDR Portfolio S&P 500 Value ETF | Large Cap Value | Neutral |
| RYJ | Invesco Raymond James SB-1 Equity ETF | Mid Cap Blend | Unattractive |
| MRND | IndexIQ U.S. Mid Cap R&D Leaders ETF | Mid Cap Growth | Unattractive |
| VOE | Vanguard Mid Cap Value Index Fund ETF | Mid Cap Value | Unattractive |
| NSCS | Nuveen Small Cap Select ETF | Small Cap Blend | Unattractive |
| ISCG | iShares Morningstar Small Cap Growth ETF | Small Cap Growth | Unattractive |
| SLYV | State Street SPDR S&P 600 Small Cap Value | Small Cap Value | Unattractive |

Sources: New Constructs, LLC and company filings

Invesco and State Street appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

Roundhill MEME ETF (MEME) is the worst rated ETF in Figure 2. Tidal SoFi Gig Economy ETF (GIGE), Invesco S&P Small Cap High Dividend Low Volatility ETF (XSHD), Nuveen Small Cap Select ETF (NSCS), iShares Morningstar Small Cap Growth ETF (ISCG), and IndexIQ U.S. Mid Cap R&D Leaders ETF (MRND) 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 model 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. Don't just take our word for it, see what Barron's says on this matter.

[1] Three independent studies from respected institutions prove the superiority of our data, models, and ratings. Learn more here.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

PERFORMANCE OF ETFs HOLDINGs – FEES = 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 technology to get the diligence required to make prudent investment decisions.

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1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
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Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

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Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [ as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

**Superior Stock Ratings**

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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