Cheap Funds Dupe Investors – 2Q24

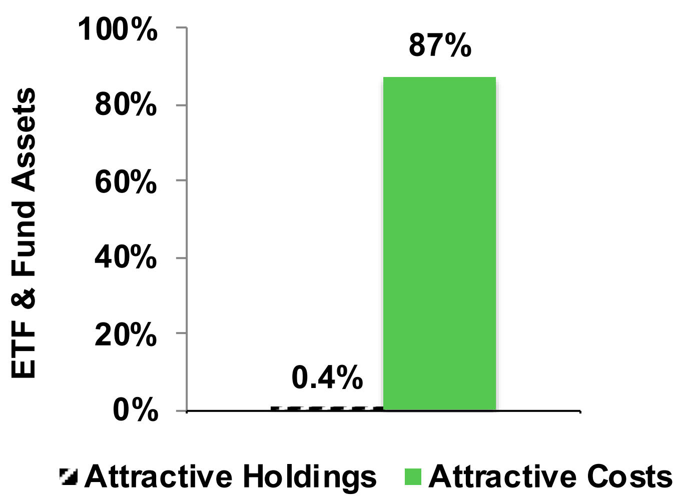
Hunting for bargains is a best practice in any endeavor. But when it comes to investing, a cheap fund is not necessarily a good fund. A fund that has done well in the past is not guaranteed to do well in the future (e.g. 5-star kiss of death) and active management has a long history of underperformance. Most research focuses on finding funds with low fees and impressive past performance. Future returns, however, are determined primarily by a fund's current holdings – not fees or past performance.

Proprietary Robo-Analyst technology[1] empowers our unique ETF and mutual fund rating methodology, which leverages a rigorous analysis of fund holdings[2] and enables investors to find funds with high-quality holdings AND low fees. More reliable & proprietary fundamental data, as shown in The Journal of Financial Economics and proven to generate a new source of alpha, drives our 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. Our predictive fund ratings make finding such funds easier than ever. A fund's predictive rating is based on its holdings, its total costs, and how it ranks when compared to the universe of over 7,000 ETFs and mutual funds we cover.

Figure 1 shows that 87% of fund assets are in ETFs and mutual funds with low costs but only 0.4% of assets are in ETFs and mutual funds with attractive holdings. This discrepancy is eye-opening.

Figure 1: Allocation of Fund Assets by Holdings Quality and 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 good stocks.
    - With about twice as many funds as stocks in the market, there are simply 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 our research automation technology in the case Disrupting Fundamental Analysis with Robo-Analysts.
[2] See how our models overcome flaws in Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

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 24 out of 7,243 (<1%) ETFs and mutual funds earn an Attractive-or-better Portfolio Management Rating. 99% of assets are in funds that do not justify their costs and overcharge investors for poor portfolio management.

Figure 2: Distribution of ETFs & Mutual Funds By Portfolio Management Rating

	Portfolio Management Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	24	1847	5372
% of Assets	0.4%	16%	83%

Source: New Constructs, LLC and company filings

Figure 3 shows that investors successfully find low-cost funds because 87% of assets are held in ETFs and mutual funds that have Attractive-or-better rated total annual costs (TAC), our apples-to-apples measure of the all-in cost of investing in any given fund.

Out of the 7,243 ETFs and mutual funds we cover, 2,864 (40%) earn an Attractive-or-better TAC rating. One example of a low-cost fund that rates poorly overall is Vanguard Real Estate II Index Fund (VRTPX), which gets an overall predictive rating of Very Unattractive. Even with low fees of 0.10%, we expect the fund to underperform because it holds too many Unattractive-or-worse rated stocks. Low fees cannot boost fund performance, only good stock picking can do that.

Figure 3: Distribution of ETFs & Mutual Funds By Total Annual Costs Ratings

	Total Annual Costs Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	2864	2605	1774
% of Assets	87%	6%	7%

Source: New Constructs, LLC and company filings

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

But they do not.

Figure 4 shows that 2,173 ETFs and mutual funds, which account for 68% of ETF and mutual fund assets, have 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 By Predictive Ratings

	Predictive Ratings		
	Attractive-or-better	Neutral	Unattractive-or-worse
# of ETFs & Funds	2173	2897	2173
% of Assets	68%	21%	11%

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, Euclidean Fundamental Value ETF (ECML) has both low costs and quality holdings.

Why is the most popular fund rating system based on backward-looking 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 overcharge investors for poor portfolio management. How else could they get away with selling so many Unattractive-or-worse ETFs and mutual funds?

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 of certain Index Label Myths.

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

This article was originally published on April 24, 2024.

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

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It's Official: We Deliver the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. The stock market is missing footnotes – and only we have that critical data.
2. Legacy fundamental datasets suffer from significant inaccuracies, omissions, and biases.
3. Our proprietary drives novel alpha. Our measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

In The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

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.

Superior Models

Ernst & Young features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

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 Harvard Business School. 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.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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