What Makes an ETF Bad?

Perspective | Brendan McCann

On the surface, investors face a daunting task when choosing an exchange-traded fund. Which one of the thousands that are available should they buy?

In practice, there are a few red flags that eliminate many ETFs from consideration. High fees, high turnover, and few holdings often undermine many ETFs' future performance.

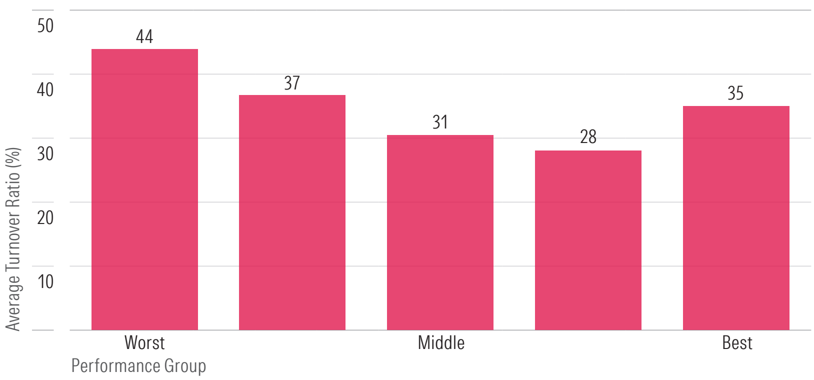
High Turnover

ETFs that trade more tend to do worse. Costs are part of the reason. Commissions and spreads can take their toll, but there's more to consider. Many of the ETFs that trade frequently are attempting to time the market in a variety of ways.

Some ETFs rotate in and out of different risk factors, sectors, or fundamental factors using quantitative models, simple ratios, or even astronomical seasons as signals. Not only do they generate more trading costs, but there's little evidence that they work. The signals used to trigger a buy or sell can be unreliable. Likewise, jumping in and out of different slices of the market means investors miss out when the omitted slices perform well. Investors are better off staying fully invested in the market.[1]

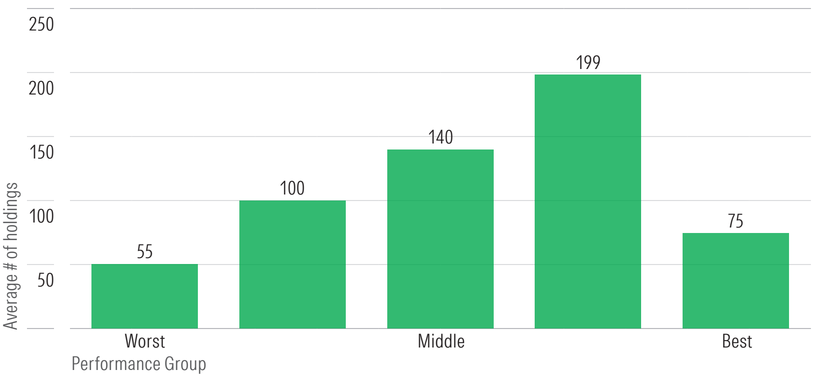
Tactical asset allocation ETFs illustrate the difficulty of timing the market. These funds try to outperform the market through frequent short-term adjustments to their portfolios based on projected market trends. However, their attempts have fallen short. On average, tactical asset allocation ETFs underperformed each of their benchmarks by 4.96 percentage points in 2024.

Exhibit 1 Median Turnover



Source: Morningstar Direct. Data as of April 30, 2025.

Exhibit 2 Median Number of Average Stock Holdings



Source: Morningstar Direct. Data as of April 30, 2025.

Few Holdings

Exhibit 2 shows the worst-performing funds held the fewest stocks. The benefits of diversification, made popular by Harry Markowitz, are at play. Holding fewer stocks means an ETF has a higher likelihood of missing out on the market's best performers. An ETF that buys the haystack is guaranteed to buy the needle. But buying only *part* of the haystack means the needle may get left behind.

ETFs with fewer holdings suffer from the same symptoms as those that try to time the market. The opportunity costs of not holding winners compound over time and erode long-term performance.

High Fees

Poor performers tend to have high fees because costs paid come directly out of an ETF's return. If every ETF surveyed had an identical return before fees, then fees would be the sole determinant of a fund's peer-relative performance. Exhibit 3 shows that ETFs with higher fees performed worse than those with lower fees. Investing in low-fee ETFs may not guarantee

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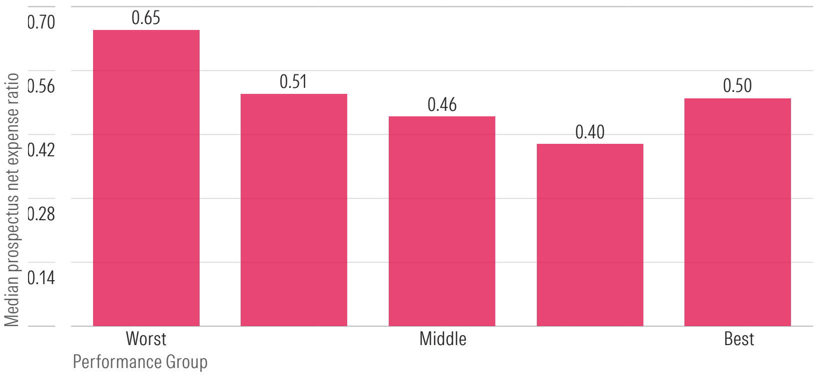
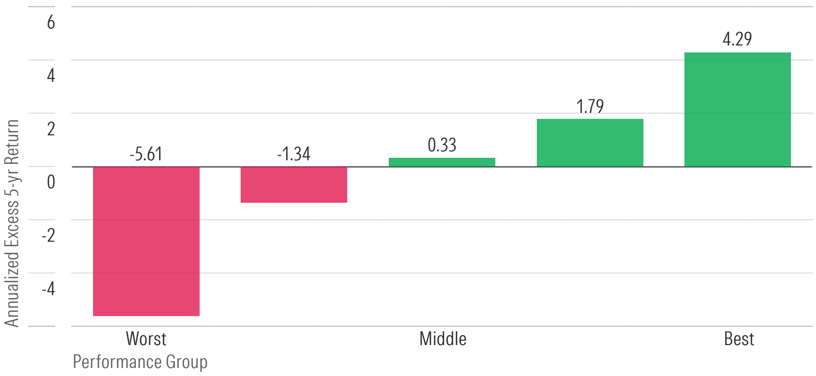
Exhibit 3 Median Fees (%)



Source: Morningstar Direct. Data as of April 30, 2025.

Exhibit 4 Median Excess Return by Performance Group (5-yr Annualized)



Source: Morningstar Direct. Data as of April 30, 2025.

success, but investing in high-fee ETFs ensures more of your return dissolves.

Red Flags

Exhibit 4 illustrates the median category-relative performance of five equally sized groups of stock ETFs over the five years through April 2025. A typical ETF from the best-performing quintile outperformed by more than 4 percentage points annualized, while the median from the worst group lagged by more than 5.5 percentage points. Overall, fees, turnover, and number of holdings tended to align with expectations. The better-performing groups had lower fees, broader portfolios, and lower turnover than those at the other end of the spectrum.

Fund closures varied across each group. Closures among the worst performers stood out like an NBA player at a grade-school basketball game. Just as poor-performing athletes get cut from the team, poor-performing ETFs get cut from the lineup.

Fund companies usually dispose of their losers, or those that perform poorly and garner few assets. Some are worse than others. The worst companies usually throw an assortment of ETFs against the wall to see what sticks. Investors would do well to scrutinize those ETFs closely to ensure theirs don't land on the floor.

The second-best-performing group exemplified the good characteristics to look for. It had the highest number of holdings, the lowest fees, and the lowest turnover. It also had the fewest closures. However, the trend reversed for the top-performing group. ETFs in this group held fewer stocks, had higher turnover, and charged higher fees than the second-best-performing group.

How so? Riskier strategies can pay off in the short term. They can make large bets that performed well in hindsight. But investors should consider how those bets will fare over the long term. Many of the best-performing funds in the short term could be disastrous in the future.

A closer look at the ETFs in the top-performing group helps explain what's going on. Single-stock derivative income ETFs, such as **YieldMax MSTR Option Income Strategy ETF** MSTY and **Kurv Yield Premium Str Netflix ETF** NFLP, counted themselves among the best-performing ETFs over the past five years. Their incredible returns are a direct result of how their underlying stocks performed.

But there's more to these ETFs than just a single stock. They claim that investors can receive income and capital growth, both good things. However, they use a covered-call strategy to generate income by selling calls against the stocks they represent. That caps the ETFs' upside. Each one underperformed its target stock by double-digit percentage points (annualized) from each ETF's inception date. In many instances, investors would have earned a higher total return by just holding the stock.

These ETFs also lack any downside protection. Only the premium received from selling the call can cushion their falls. But that cushion has failed to provide much support. **YieldMax MRNA Option Income Strategy ETF** MRNY is exposed to **Moderna** MRNA stock, which has been in freefall since its 2021 peak. The ETF was launched in late 2023 and has performed worse than the stock, despite the ETF's income cushion. Its negative 52% annualized return since inception through April 2025 left a lot to be desired.

Niche thematic ETFs also have red flags. Negative-rated **ARK Innovation ETF** ARKK would have been in the top-performing group had I analyzed ETFs from 2015 through 2020. However, its fall from grace landed it in the worst-performing category over the trailing five years through April 2025. It exhibited all the warning signs leading up to its crash: Few holdings, high fees, and high turnover forewarned investors.

Some investors have been reluctant to dispose of ARKK, despite its lacking performance. Some still believe it will turn around. Others may dread selling it at a loss, which would make the loss real. Although that's poor logic. Investors tend to sell the high performers too early and hold on to the losers too long, just in case they come back.[2]

In an odd twist of fate, YieldMax created a Frankenstein ETF off of ARKK: **YieldMax ARKK Option Income Strategy ETF** OARK. It has underperformed ARKK from inception through April 2025.

Past performance doesn't guarantee future returns, especially if an ETF made some risky bets that paid off in the recent past. Investors looking to hop on one of these get-rich-quick trains may disregard the warning signs. They'd be better off avoiding, or at least closely scrutinizing, an ETF with high turnover, high fees, and few holdings.

The highest performers in the latest period can often be the worst performers in the following period. Chasing outlandish returns can quickly burn your portfolio to the ground. Investments that are too good to be true are often just that. M

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[1] Rekenthaler, J. 2023. "Why Market Timing Fails." Morningstar. https://www.morningstar.com/columns/rekenthaler-report/why-market-timing-fails

[2] Shefrin, H., & Statman, M. 1985. "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence." J. Finance, Vol. 40, No. 3, P. 777.