How stable have Morningstar Ratings for mutual funds been over time?

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How stable have Morningstar Ratings for mutual funds been over time?

Summary: Morningstar Ratings have been quite unstable over time. If an investor buys a 4- or 5-star rated fund and expects it to stay that way, he is likely to be surprised. In “The Persistence of Morningstar Ratings,” Mark Warshawsky, Mary DiCarlantonio, and Lisa Mullin of the TIAA-CREF Institute1 looked at Morningstar Ratings* to understand star rating persistence.2 They found that Morningstar Ratings changed frequently.3 (Also, see this related article: What the instability of mutual fund Morningstar Ratings means for long-term investors – Commentary) Individual investors might find the conclusions of Warshawsky, et al. to be unexpected. This is particularly true for any investor who wants to select a “superior” performing mutual fund to hold for the long-term. Warshawsky, et al. noted that individual investors increasingly have used mutual funds for long-term investing purposes. They quoted Federal Reserve Board data from 1998 indicating that more than 60% of net new household asset investments went toward purchasing mutual funds. Warshawsky, et al. analyzed the stability of Morningstar Ratings for equity and fixed income mutual funds and variable annuities. Table 1 below summarizes selected data from this study on the persistence of 4- and 5-star rated mutual funds over one-year and two-year periods.

Table 1 Percentage of Mutual Funds Initially Rated 4 or 5 Stars by Morningstar that were Still Rated 4- or 5-Stars at the End of 1 and 2 Year Periods

	1997	1998	1999	1998-1999
All 4 and 5 Star Rated Mutual Funds	56%	49%	55%	32%
4 and 5 Star Rated Funds with 3-Year Ratings	31%	23%	23%	Less than 1%
4 and 5 Star Rated Funds with 5-Year Ratings	48%	50%	54%	30%
4 and 5 Star Rated Funds with 10-Year Ratings	60%	55%	64%	37%

Across all mutual funds, half of the funds that initially had a 4- or 5-star rating at the beginning of a year no longer had a 4- or 5-star rating at the end of that year, and two-thirds had fallen out after only two years. While there were variations between the different years studied, both equity and fixed income funds demonstrated low persistence in their star ratings. Among younger funds with 3-year ratings, the decline was more striking. Only 23% to 31% of funds with 3-year Morningstar Ratings still had their 4 or 5 star ratings, after one year had elapsed. Even more incredible, after the two-year period from January 1998 to December 1999, less that 1% still held their 4 or 5 star ratings! Out of the 796 three-year rated funds with 4 or 5 stars at the beginning of 1998, only 3 of them were still rated 4 or 5 stars at the end of 1999! This tendency for many apparently superior star ratings to fall precipitously, should give investors concern when deciding whether to pay attention to the stars. To have between 2/3 and 3/4 of highly rated funds with 3 years of data to drop out of the 4-star and 5-star rating range after just one year, means that their most recent year’s performance was inferior to other funds in their peer group. Previously “mediocre” funds would then have become supposedly “superior” 4- and 5-star rated funds. This ratings instability might not inspire confidence in an investor looking for a fund to hold for the long-term.   More mature funds with 5-year and 10-year ratings were somewhat better able to hold on to their 4 and 5 star ratings than younger funds, but the fallout rate was still significant. For example, over the two-year period from 1998 to 1999, the percentage funds with 10-year ratings that managed to hold on to their 4- and 5-star ratings was only 37%. This apparently higher stability provides little comfort to individual investors.   The primary reason why older funds seem more stable is that the Morningstar Rating system includes older data that can mask higher variability in the more recent performance of a fund. The same factors causing ratings instability that was discussed above for 3-year ratings are at play with longer term ratings. Longer periods of historical data just dampen recent volatility, but the volatility is still there. (See: How the new Morningstar Ratings for mutual funds have been determined since mid-2002)   Concerning variable annuities, Warshawsky, et al. presented less comprehensive data, but the pattern of decline was similar and even slightly more pronounced. For example, the data indicated that the percent of all variable annuities that held on to their 4 or 5 star rating after one year was 41% during 1998 and 47% during 1999. This compared to 49% and 55%, respectively, for all mutual funds.   Warshawsky, et al. concluded by stating: “for those many investors to whom the overall Morningstar rating is useful information in deciding which mutual funds and variable annuities to include in their investment portfolios, the persistence of a high rating should matter a great deal. The results of this study indicate that persistence is hardly assured and is somewhat variable across years and investment categories.”   The scientific investment literature has long indicated that apparently superior historical fund performance is not a predictor of future performance. In fact, thousands of mutual funds and variable annuities with many trillions of dollars in assets compete to produce superior results. This competition ensures that the securities markets will be more efficient and thus be harder to “beat.” The bottom line is that superior past performance is largely a matter of luck and not skill.   Assigning more stars to lucky results does not transform luck into persistent skill. The instability of the Morningstar Ratings demonstrates this. Also, see these related articles: ->Investment astrology – should you pick investments according to the Morningstars? ->Morningstar Ratings should be used with caution ->The quality of the “old” Morningstar Ratings prior to mid-2002 ->Do the "new" Morningstar star Ratings predict superior fund performance? ->What does Morningstar, Inc. say its mutual fund stars can do? ->What does Morningstar, Inc. say its mutual fund stars cannot do? ->Simplifying investment decision making can be taken too far ->High Morningstar Ratings can lure you into funds with costly sales loads ->How Morningstar Ratings for mutual funds are used as a marketing tool ->How stable have Morningstar Ratings for mutual funds been over time? ->Do mutual fund Morningstar Ratings changes influence individual investors? ->Does it pay to trade when the Morningstar Rating of a mutual fund changes? ->Do Morningstar Ratings predict risk-adjusted equity mutual fund performance? ->What might be wrong with buying a mutual fund with a 4 or 5 star Morningstar Rating?   * The Morningstar Rating is a trademark of Morningstar, Inc. The Morningstar Rating has also been referred to in the media as the Morningstar stars, the star rating, the star rating system, etc.

1) http://www.tiaa-crefinstitute.org

2) Mark Warshawsky, Mary DiCarlantonio, and Lisa Mullin. “The Persistence of Morningstar Ratings.” Journal of Financial Planning, September 2000

3) http://www.morningstar.com and http://datalab.morningstar.com (Note that morningstar.com is a website for individual investors, and datalab.morningstar.com is a website for institutional and advisor clients.)