[What the instability of mutual fund Morningstar Ratings means for long-term investors – a commentary]

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What the instability of mutual fund Morningstar Ratings means for long-term investors – a commentary

Summary: If an investor expects the Morningstar star ratings to be stable, long-term indicators for long-term investing, then he probably will be quite disappointed by their lack of ratings persistence. Instead of the stars, The Skilled Investor recommends that investors give much higher priority to alternate metrics to screen mutual funds.   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 (See this related article: [How stable have Morningstar Ratings for mutual funds been over time?]) Warshawsky, et al. concluded by stating that: “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.”   Using simple indicators, like Morningstar’s stars, in an attempt to find a better investment is an understandable desire on the part of individual investors. However, if an investor expects the star ratings to be stable, long-term indicators for long-term investing, then he probably will be quite disappointed by their lack of ratings persistence. This is particularly true for investors who intend to select a ‘superior’ mutual fund and want to make additional investments going forward.   In selecting an apparently superior performing mutual fund, many investors probably presume that it will continue to be a superior performing fund. However, one also suspects that many investors who are influenced to purchase a 4 or 5 star rated fund are not aware that the ratings are likely to decline significantly in a relatively short period.   If a high Morningstar Rating were influential in an investor’s fund selection process, then perhaps he would also not be very interested in having to monitor his mutual funds’ star ratings closely to ensure that they remain high. Note, however, that there is evidence that certain other investors seem actually to track rating changes and base fund trading strategies on these ratings changes. (See: [Do mutual fund Morningstar Ratings changes influence individual investors?] and [Does it pay to trade when the Morningstar Rating of a mutual fund changes?]) The Skilled Investor suspects that the majority of investors who make decisions based on the stars are probably not interested in moving their assets frequently from one fund to another in pursuit of hopefully superior returns. Such a portfolio churning strategy can be costly in terms of time and energy. Churning also accelerates that recognition of taxes and may increase tax rates, if short-term rather than long-term capital gains are recognized. Furthermore, if investors buy funds through a broker or adviser and pay more frequent loads or sales charges, this will also damage their returns.   The information content of the star ratings from a superior performance prediction standpoint seems to be very low. In fact, the stars probably contain no useful information about superior future performance on a net returns basis at all.   Investment science indicates that very poor historical performance is more likely to have some mild predictive information about funds that may have inferior performance in the future. A 1 star Morningstar Rating for a low performing fund could indicate fund management problems and/or excessive fees and cost that might cause inferior performance to persist. (See: Do Morningstar Ratings predict risk-adjusted equity mutual fund performance? and Do the "new" Morningstar star Ratings predict superior fund performance?) If the stars really contained significant predictive information about relative performance, then their instability in star ratings would put an investor in a great quandary. If ratings fall, should the investor remain with the fund through a confident assurance that superior performance will return very soon? Alternatively, should he stop investing additional funds or even move all his funds to another highly rated fund? Does this lack of persistence in Morningstar’s star ratings really matter and should an investor make changes when their stars fall? For some thoughtful information about whether and when to sell an underperforming mutual fund, you might wish to consult www.fundalarm.com. If a fund that was formerly rated 4 or 5 stars falls to a 3 star rating this probably means little, because the 4 or 5 star rating was relatively meaningless to begin with. Investors are heavily influenced to select only 4 and 5 star rated funds. Instead, an investor should be completely open to choosing funds with a 3 star rating in the first place, because differences in future performance between 3, 4, and 5 star ratings are not discernable. This would also double the number of funds available for consideration. The Skilled Investor recommends that investors give much higher priority to alternate metrics to screen mutual funds, instead of the Morningstar stars. For alternative approaches to fund screening and selection, see: Rational selection of bond mutual funds and equity mutual funds -- overview Picking 4 and 5 star rated funds does not necessarily harm investors, but doing so without using other criteria first is likely to cause more financial harm than good. The good news is that selecting 4 and 5 star rated funds keeps investors away from the other end of the spectrum where funds with ratings of 1 and perhaps 2 stars might actually indicate sub-standard future performance. However, the bad news is that many funds with 4 and 5 star ratings could have excessive costs and other negatives. (See: What might be wrong with buying a mutual fund with a 4 or 5 star Morningstar Rating?) Note also, that in mid-2002 Morningstar made significant changes to its star rating system. While the stars look the same, Morningstar, Inc. has altered their underlying meaning. (See: How the new Morningstar Ratings for mutual funds have been determined since mid-2002) In particular, Morningstar moved from rating mutual funds within 4 four broad categories of mutual funds to rating them within 48 narrower categories. It is unclear whether this change will affect positively or negatively the star rating persistence for mutual funds. However, the scientific investment literature indicates that superior mutual fund performance just does not tend to persist – particularly in the light of expenses. Performance reversion toward the average is what investors should expect. Also, see these related rating service articles about Morningstar: ->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 ->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 * 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.)