What might be wrong with buying a mutual fund with a 4 or 5 star Morningstar Rating?

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Summary: The star ratings are oversimplified. Many investors and their advisors use the stars as their primary decision criterion and as shorthand for fund selection. Alternate, more sophisticated approaches are available, which are more likely to lead to optimal returns. Scientific investment studies do not demonstrate that higher Morningstar Ratings* of mutual funds lead to higher returns. In general, scientific studies on the performance of mutual funds indicate that superior past performance is simply not an indicator of future performance. (See: What the instability of mutual fund Morningstar Ratings means for long-term investors – Commentary and Do Morningstar Ratings predict risk-adjusted equity mutual fund performance?) So, what is wrong with an investor chosing a fund, because it happens to have a 4 or 5 star rating? Perhaps nothing, unless the illusion that a 4 or 5 star rating predicts superior future performance will cause him to buy a mutual fund that has, in fact, a greater likelihood of under-performing in the future. Here are some of the potential problems with blindly buying 4 and 5 star funds: ->If an investor pays a higher management fee for a fund, because it had a 4 or 5 star rating, then on average this higher management fee is more likely to drag down future performance. (See: Choose mutual funds with lower investment management expenses) ->If an investor pays a front- or back-end load and/or incurs 12b-1 sales charges for a fund, because it had a 4 or 5 star rating, then on average these sales fees are more likely to drag down future performance. (See: Avoid mutual funds with sales commissions and 12b-1 fees) ->If an investor buys into a high turnover fund with excess trading expenses and higher market impact, because it had a 4 or 5 star rating, then on average these higher transaction costs are more likely to drag down future performance. (See: Avoid mutual funds with higher investment portfolio turnover) ->If an investor buys into a fund with higher accrued capital gains, because it had a 4 or 5 star-rated fund, then on average these accrued taxes are more likely to drag down the investor’s net returns. In addition, the 4 and 5 star superior performance illusion might cause investors to: ->focus on gross returns rather than net returns ->churn their portfolio, as they hop from one fund to another as ratings fall ->believe that active strategies were better and worth paying more for (For more information on these factors, see: Rational selection of bond mutual funds and equity mutual funds -- overview) In summary, the star ratings are oversimplified. Many investors and their advisors use the stars as their primary decision criterion and as shorthand for fund selection. Alternate, more sophisticated approaches are available, which are more likely to lead to optimal returns. One of Morningstar’s primary stated themes about its star rating system is that retail investors require simplification and ease-of-use in their investment indicators. The Skilled Investor is sympathetic with this desire for simplification on the part of individual investors. However, The Skilled Investor believes that it is incumbent upon those who simplify the complex subject of investing for individual investors, to be clear on the limitations of the simplification methods that are used. This is especially true when there is evidence that many investors are naive and either are not knowledgeable enough or have limited opportunities or time to perform deeper investment due diligence. When the underlying methods of simplification used to generate and easy-to-use investment indicators are different from other methods that are scientifically grounded, then there is a need to provide greater clarity. Individual investors could benefit from a better understanding of the likely information value of Morningstar’s stars as an investment indicator. If investors simply think that mutual funds with more stars are simply better, which many apparently do, then their attempts to invest rationally could be distorted. Investors could make decisions that they believe are sensible, when in fact their beliefs may fall far short of reality. On the one hand, Morningstar cautions investors on the value of their stars, while on the other hand the stars are very heavily promoted by the industry – in effect as a seal of approval. (See: “How Morningstar Ratings are used as a marketing tool”) Morningstar’s five star rating system has become a widely recognized brand within the retail financial services industry. Just as Americans have fallen in love with The Walt Disney Company’s Mickey Mouse brand, many individual investors appear to have fallen in love with Morningstar’s stars. Morningstar allows brokers, investment advisers, mutual funds, websites, and others to feature the star ratings prominently. If you search for the information on Morningstar.com, you will find that Morningstar offers many caveats about the utility of its star ratings. (See: What does Morningstar, Inc. say its mutual fund stars can do? and What does Morningstar, Inc. say its mutual fund stars cannot do?) It is unlikely that these caveats are being repeated frequently by Morningstar’s business partners. Instead, there seems to be a clear pattern of promoting funds when they happen to have a 4 or 5 star rating, while neglecting to feature the Morningstar Rating information prominently or at all, when the rating is 3 or fewer stars. While brokers and investment advisers heavily promote 4 and 5 star funds, one wonders how many really take the time to explain to their clients the same caveats that Morningstar offers on its website. (See: How Morningstar Ratings for mutual funds are used as a marketing tool) Furthermore, in 2002 the Morningstar Ratings underwent a very significant change in how they are derived. The visible star symbols remained the same, but the meaning was altered. One wonders what portion of retail investors really understood the investment implications of the star system before the change was made and how many understand the system now. Do they understand that the “personality” of the stars was altered in 2002, while the look stayed the same? (See: How the new Morningstar Ratings for mutual funds have been determined since mid-2002) 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? ->Simplifying investment decision making can be taken too far ->High Morningstar Ratings can lure you into funds with costly sales loads ->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? * 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.