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[High Morningstar Ratings can lure you into mutual funds with costly sales loads](#)

Category : Mutual Fund Rating Services - Morningstar Star Ratings

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High Morningstar Ratings can lure you into mutual funds with costly sales loads

Summary: A loaded fund with a high star rating can cloud an investor's judgment. A loaded fund with a 4- or 5- star rating is not likely to retain its high rating in the future. While loaded funds with high star ratings are good for sales advisor/agents on commission, they may not be the best funds for you. Individual investors who use the Morningstar Ratings* to select funds need to become more knowledgeable about how the stars are defined. In addition, they need to have a more sophisticated understanding of certain implications about these star ratings. (See: [How the new Morningstar Ratings for mutual funds have been determined since mid-2002](#) and [Do Morningstar Ratings predict risk-adjusted equity mutual fund performance?](#)) For example, investment science indicates that mutual fund sales loads are a waste of investors' money. While sales loads are mildly penalized in the calculation of the Morningstar Ratings, loaded funds are still grouped with no-load funds. The scientific investment literature indicates that luck is far more likely than skill to explain variations in returns across actively managed mutual funds. Despite the handicap imposed on loaded funds by Morningstar's rating methods, many loaded funds will perform well enough by chance to overcome this handicap, and they can still obtain a high star rating. High star ratings for these apparently exceptional, but costly loaded funds can cloud an investor's judgment. Advisor/sales agents will wave a loaded fund's high star rating in an investor's face and insist that the load is worth paying "at least for this fund." Few advisors will promote no load funds, because they are not paid to sell them. The implication is that "despite the fact you will start the investment race in back of a very competitive field of no-load mutual funds, the superior future performance of this special fund will overcome the load." In reality, it is far more likely that you will just pay the agent's sales commission and not receive any superior returns in the future. A loaded fund with a 4- or 5- star rating is likely not to have a high rating in the future. Consider that the Morningstar star ratings have been highly unstable over time. A 2000 study by Warshawsky, et. al. showed that across all mutual funds, half of the funds that initially had a 4- or 5-star rating were rated 3-stars or lower after only one year. After two years, fully two-thirds of these funds had fallen to rating of 3-stars or lower. Among younger funds with only 3-year Morningstar Ratings, the decline was most striking. After one year, only 23% and 31% still had their high star ratings. Even more incredible, after two years during the January 1998 to December 1999 period, less than 1% retained their 4- or 5-star ratings! (See: [How stable have Morningstar Ratings for mutual funds been over time?](#) and [What the instability of mutual fund Morningstar Ratings means for long-term investors ‐ Commentary](#)) When one considers that previously high performing mutual funds tend to revert toward average performance and that Morningstar Ratings are highly unstable, then buying a loaded fund with 4- or 5-star rating is probably a poor idea. Nevertheless, many loaded with higher star ratings exist, and the industry's sales agents will not hesitate to tell you that these funds are "good funds." In reality, while they are good for the sales agents who get a sales commission, they are not necessarily the best funds for you. This is just one example why alternate selection criteria

shine brighter than just using the stars to choose a mutual fund. (See: [Excessive costs are a huge problem for individual investors](#)) Also, see these related rating service articles on 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](#) ->[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](#) ->[How Morningstar Ratings for mutual funds are used as a marketing tool](#) ->[Do mutual fund Morningstar Ratings changes influence individual investors?](#) ->[Does it pay to trade when the Morningstar Rating of a mutual fund changes?](#) ->[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) Mark Warshawsky, Mary DiCarlantonio, and Lisa Mullin. “The Persistence of Morningstar Ratings.” Journal of Financial Planning, September 2000