Do mutual fund Morningstar Ratings changes influence individual investors?

Category : Mutual Fund Rating Services - Morningstar Star Ratings

Published by The Skilled Investor on Jul/21/2005

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Summary: An analysis of the flow of investments into and out of mutual funds demonstrated a direct relationship between Morningstar Rating changes and investor reactions. Morningstar ratings upgrades resulted in positive abnormal mutual fund investment inflows, and downgrades caused lower than normal ***inflows or increased outflows***. The dollar effects of ratings involving 4 and 5 stars we the strongest. In a 2004 article, William Reichenstein cited a study by Financial Research Corporation.1 He said, “in 1999 funds with four or five stars took in $233.6 billion, while lower rated funds had outflows of $132 billion.”2 Do the stars really have such a direct impact on investor behavior, or is this just a coincidence? While Morningstar3 itself largely avoids making performance prediction claims about its Morningstar Rating* system, there is significant evidence that investors believe that the stars have predictive powers and they buy accordingly. (See: What does Morningstar, Inc. say its mutual fund stars can do? and What does Morningstar, Inc. say its mutual fund stars cannot do?) In “Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows,” Professor Diane Del Guercio of the University of Oregon and Ms. Paula Tkac of the Federal Reserve Bank of Atlanta studied investor behavior, when the Morningstar Ratings of mutual funds changed.4 Through an analysis of the flow of investments into and out of mutual funds, they demonstrated a direct relationship between star rating changes and investor reactions. Their approach was to study “events,” which were defined as either 1) first publication of an initial star rating for a fund with three years of returns or 2) changes in the overall star rating of a fund that had previously received a star rating. By focusing on change events and by measuring subsequent mutual fund investment flows and performance, Del Guercio and Tkac developed insights about investor behavior and linked these behaviors directly to changes in Morningstar’s star ratings. For the period November 1996 to October 1999, Del Guercio and Tkac analyzed 1,637 initial star rating events and 10,735 changes in star ratings. The data indicated that about 10% of funds experience a star rating upgrade or downgrade each month. Del Guercio and Tkac analyzed the impact of these events on the flow of funds into or out of these mutual funds. They compared this post-event investment flow with a baseline of investment flows before the event. By using this method, they associated ratings change events with “abnormal” changes in investment flows above or below baseline cash flows in or out of funds. Del Guercio and Tkac found different investor behaviors. Apparently, some investors actively monitored star rating changes and invested additional money or took money out of mutual funds very quickly in response to star rating changes. Morningstar reported that their website traffic picked up significantly around the beginning of the month, when rating changes were announced. Other investors took longer to react – probably because they learned of rating events though other channels. For example, it takes up to several months for mutual funds to revise their advertising in publications to include new star rating information. Del Guercio and Tkac found that “of the 37 domestic equity ads that report a star rating (in June 1999), only 10% use the most recent rating (as of May 1999), while 32% use a one-month old rating and 54% use a two-month old rating.”5 Additionally, it can take financial advisors several months to react to ratings changes and to induce their clients to make purchases.

For advisors, 4 and 5 star funds seem to be much easier to sell than lower star rated funds. Del Guercio and Tkac suggested that trustees of defined contribution retirement plans, such as 401(k)s, might also affect abnormal fund flows, because they are more likely to choose funds with higher, particularly 5 star, ratings. Trustees seem to use star ratings as a naïve means to fulfill their fiduciary duties to choose the “best” investment vehicles. For example, John Hancock Funds EVP, Keith Hartstein, said, “(Morningstar) ratings are a significant part of marketing. I can’t tell you the number of times we as an industry sit in front of people picking managers for their 401(k) plan and hear them start the conversation saying, “We’re only selecting four- and five-star funds”.”6 Del Guercio and Tkac found that an initial or new 5 star rating very significantly affected investment flows. On average, such funds experienced a $26 million abnormal increase in investment flows over seven months or about 53% above normal. More mature funds that experienced an upgrade to a 4 to a 5 star rating experienced on average a $44 million increase in investment, which represented a 35% abnormal increase. Del Guercio and Tkac said, “in contrast, a downgrade from 5 to 4 stars has a much smaller impact of only -$8 million in abnormal flow, suggesting that flow response to a downgrade from 5 star status is not symmetric to an upgrade to 5 stars. Unlike a downgrade from 5 to 4 stars, we do find a large and significant response to a downgrade from 4 to 3 stars, suggesting that investors punish funds whose performance falls below a 4 star rating.”7 Concerning other star ratings changes, Del Guercio and Tkac determined that for up-grades and downgrades of ratings that were below 4 stars, the results were also significant. In general, Morningstar ratings upgrades resulted in positive abnormal mutual fund investment inflows, and downgrades caused lower than normal flows. However, the dollar effects of lower star ratings changes were not as strong as ratings changes involving 4 and 5 stars. Del Guercio and Tkac provided very convincing evidence that Morningstar rating initiations and changes directly and significantly affect investor behaviors. Do these investor responses to changes in the star ratings have a positive, negative, or neutral impact on investors’ financial welfare? To understand how investors who decide to trade on Morningstar Ratings changes are likely to make out, see this related article, Does it pay to trade when the Morningstar Rating of a mutual fund changes? 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 ->How the new Morningstar Ratings for mutual funds have been determined since mid-2002 ->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 Morningstar Ratings for mutual funds are used as a marketing tool ->How stable have Morningstar Ratings for mutual funds been over time? ->What the instability of mutual fund Morningstar Ratings means for long-term investors – Commentary ->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.frcnet.com

2) William Reichenstein. “Morningstar’s New Star-Rating System: Advances and Innovations.” Journal of Financial Planning. March 2004. Article 5. http://www.fpanet.org/journal/articles/2004_Issues/jfp0304-art5.cfm (March 29, 2004)

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.)

4) Diane Del Guercio and Paula A. Tkac. “Star Power: The Effect of Morningstar Ratings on

Mutual Fund Flows.” Working paper, May 2002 [Also, Federal Reserve Bank of Atlanta. Working Paper Series. Working Paper 2001-15. August 2001] [Note that this article uses the May 2002 version.]

5) ibid, page 14

6) Ian McDonald, “Mutual Fund Ratings Come Under Fire.” Wall Street Journal. January 15, 2003, page D1

7) op cit., Del Guercio and Tkac, page 4