Does it pay to trade when the Morningstar Rating of a mutual fund changes?

Category : Mutual Fund Rating Services - Morningstar Star Ratings

Published by The Skilled Investor on Jul/21/2005

Does it pay to trade when the Morningstar Rating of a mutual fund changes?

Summary: A study found that active trading when Morningstar Ratings changed lead to positive pre-expense returns at all levels of star ratings changes. However, the “excess” returns to these strategies did not hold up once associated expenses were considered. Expenses for monitoring, trading, and paying taxes and loads easily outweighed any positive returns to these strategies. 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 mutual funds’ Morningstar Ratings* changed. 1 They demonstrated a direct relationship between star rating changes and investor reactions through an analysis of the flow of investments into and out of mutual funds. (To learn more about this study, please see: Do mutual fund Morningstar Ratings changes influence individual investors?) Because some investors actively trade when Morningstar ratings change, are these investors likely to profit from this strategy? Del Guercio and Tkac modeled a variety of investment strategies that involved buying/selling all mutual funds that gained or lost a particular star rating over a 34-month period. Returns from these active strategies were compared to market benchmark return strategy and a “four-factor” benchmark return strategy. The four return factors tested were: a) the market, b) value vs. growth, c) small vs. large capitalization, and d) momentum.) Del Guercio and Tkac found that active trading when Morningstar Ratings changed lead to positive pre-expense returns at all levels of star ratings changes. Furthermore, the pre-expense return to trading on a ratings decline by selling was higher than the return for buying on a ratings increase. However, before you run off and madly buy/sell mutual funds whenever their Morningstar Ratings change, consider that the “excess” returns to these strategies did not hold up once associated expenses were considered. While there is probably a small amount of investment information related to Morningstar Rating changes, this information could not be exploited economically – particularly by individual investors. Expenses for monitoring, trading, and paying taxes and loads would easily outweigh any positive returns to these strategies. You would also consume significant time in monitoring and implementing this strategy across dozens, hundreds, or thousands of mutual funds. Unless you implemented these trades directly with the funds, you would also pay and repay sales loads to your broker or adviser. Frequent trading would accelerate tax realization and increase taxes when short-term rather than long-term capital gains or losses were taken. Furthermore, all this activity would drive up accounting and tax preparation fees. Del Guercio and Tkac made the following comments about trading when Morningstar Ratings change:2 ->“Overall, the trading costs necessary to implement these pure strategies seem prohibitively expensive, especially for a small investor.” ->“Perhaps more telling, this strategy did not beat the 77.1% cumulative return on a passive S&P 500 index fund over this period. Given that the index strategy requires no monitoring of rating changes or trading, an investor would arguably have been better off investing in a passive index fund than engaging in this star-based strategy during our sample period.” In summary, the Del Guercio and Tkac study indicates that chasing changes in star ratings is a futile exercise with little likelihood of yielding positive returns after costs compared to a passive broad market index strategy. With the limited time individual investors have to spend on investment planning, evaluation, and execution, there are many other things that they can do with their time that would yield a positive and far higher “hourly wage” for the time that they expend. (See: “The Value and Opportunity Cost of Your Time”) You should also be very careful about what you infer from this information. Del Guercio and Tkac found only that changes in star ratings contained some investment information that was not economically practical to capture. Their study says nothing about the information value of a star rating that stays the same for some period – whether it is a high, medium, or low star rating. Sustained high performance is not necessarily a sign of skill. Instead, it could just be a streak of good luck. (See: Do Morningstar Ratings predict risk-adjusted equity mutual fund performance? and Distinguishing between true investment skill and luck) Also, see these related rating services 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? ->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? ->What the instability of mutual fund Morningstar Ratings means for long-term investors – Commentary ->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) 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.]

2) ibid, page 32