

Investment astrology – should you pick investments according to the Morningstars?

Category : Mutual Fund Rating Services - Morningstar Star Ratings

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Investment astrology – should you pick investments according to the Morningstars?

Summary: Morningstar, Inc. first introduced its five star Morningstar Rating* system for funds in 1985. Individual investors and their advisors appear to make investment decisions that are heavily influenced by the Morningstar Rating system. Because the stars are very widely used and often misunderstood, The Skilled Investor has published a variety of articles to help investors make more rational decisions about the stars. Ratings service articles related to Morningstar are listed below with brief summaries: ->[Morningstar Ratings should be used with caution](#)

->Summary: Investors appear to use the five-star Morningstar Rating system as a shorthand metric to identify supposedly superior funds. Unfortunately, the stars do not seem to identify funds with persistently superior future performance. However, the stars may help to identify inferior funds that are more likely to continue to perform poorly in the future. ->[How the new](#)

[Morningstar Ratings for mutual funds have been determined since mid-2002](#)

->Summary: As of June 30, 2002, Morningstar, Inc. began to use significantly revised methods to define its star ratings for mutual funds. This article summarizes Morningstar's new Morningstar Rating methods as defined in its publications. ->[The quality of the](#)

[old Morningstar Ratings prior to mid-2002](#)

->Summary: From 1985

to 2002, increasingly large numbers of individual investors directed billions of their investments dollars into funds that scored higher according to the old Morningstar Rating system. Morningstar has said that its old star ratings system had serious flaws. ->[Do the "new" Morningstar](#)

[star Ratings predict superior fund performance?](#)

->Summary: Compared to its old

system, early data indicates that Morningstar's new star ratings system may have some performance predictability. However, the new stars may just be a proxy for fund costs. Instead of using the stars, investors should use costs to screen funds, which are a more direct and proven indicator of future fund performance. ->[What does Morningstar, Inc. say its mutual](#)

[fund stars can do?](#)

->Summary: Morningstar has stated variously that its stars can help investors: a) to diversify, b) to identify fund managers who add value, c) to distinguish between similar funds, d) to easily interpret past fund performance, e) to make it easier to build a portfolio, and f) to provide a more intuitive measure of historical risk adjusted returns. ->[What does](#)

[Morningstar, Inc. say its mutual fund stars cannot do?](#)

->Summary: Morningstar

has stated that its stars cannot provide a single fund screening and selection measurement nor predict future mutual fund performance. Morningstar's position on performance prediction contrasts with the actions of many mutual fund investors who apparently believe that the star rating system has predictive powers. ->[Simplifying investment decision making can be](#)

[taken too far](#)

->Summary: Individual investors are challenged to select among thousands of mutual funds. Investment decision simplification is a laudable goal, but only if it is done in a way that is more likely to enhance expected risk-adjusted investment returns. ->

[High Morningstar Ratings can lure you into 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.

->[How Morningstar Ratings for mutual funds are used as a marketing tool](#)

->Summary: Mutual fund companies seem to exploit "four- and five-star only" investor beliefs. Advertising practices by mutual fund families are selective concerning which mutual fund star ratings they will advertise. You would be challenged to find any mutual fund family that advertises its one- or two-star rated funds, and the advertisement of a three-star fund is infrequent.

->[How stable have Morningstar Ratings for mutual funds been over time?](#)

->Summary: Morningstar Ratings have been quite unstable over time. If an investor buys a 4 or 5 star rated fund and expects it to stay that way, he is likely to be surprised.

->[What the instability of mutual fund Morningstar Ratings means for long-term investors – 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.

->[Do mutual fund Morningstar Ratings changes influence individual investors?](#)

->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 were the strongest.

->[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.

->[Do Morningstar](#)

[Ratings predict risk-adjusted equity mutual fund performance?](#)

->Summary:

Morningstar Ratings have demonstrated some modest predictive information about performance. However, most individual investors will probably be very surprised about what kind of predictive information the stars provide. The stars have been a mild predictor of inferior performance. However, investors act as if the stars predict superior future performance, yet they may contain no such information.

->[What might be wrong with buying a mutual fund with a 4 or 5 star Morningstar Rating?](#)

->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.

* 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. Morningstar's five-star rating system is the most visible aspect of this firm's broader set of products and services. From its website, Morningstar described itself as "a global investment research firm whose mission is to help investors make better decisions to reach their financial goals. Based in Chicago, the company offers an extensive line of print, software, and Web-based products and services for individual investors, professional financial advisors, and institutions. ... Founded in 1984, the company is now the trusted source for investment information, data, and analysis of stocks, mutual funds, exchange-traded funds, closed-end funds, separate accounts, and variable annuity/life subaccounts. ... Morningstar has a global presence in the investment community, with operations in the United States, Asia, Australia, Canada, Europe, and New Zealand. The company currently tracks, analyzes, and publishes information on nearly 100,000 investment securities."1

1) <http://www.morningstar.com> March 12, 2004