Morningstar Ratings should be used with caution

Category : Mutual Fund Rating Services - Morningstar Star Ratings

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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. As Mickey Mouse is to The Walt Disney Company and Ronald McDonald is to the McDonald’s Corporation, the five-star Morningstar Rating* system has become the most prominent branding symbol of Morningstar, Inc.1 Morningstar’s stars have become a highly influential investment selection indicator in the financial marketplace – particularly with individual investors and with many of the financial advisors serving them. Morningstar seems to understand the impact of its stars. For example, when altering its star rating system in mid-2002, it said, “We don’t make changes to an industry icon lightly. But the time has come to revamp the Morningstar Rating for funds – the ubiquitous star rating.”2 The star ratings are indeed ubiquitous in Morningstar’s materials, in the promotional efforts of mutual funds, in the financial media, and elsewhere. Morningstar publishes star ratings for stock and bond mutual funds, variable annuities, and common stocks. Some materials published by Morningstar discuss the company’s view that their star rating system has limited investment utility. While these caveats may be known to the relatively few individual investors who look for this information, such caveats appear to receive far less attention in the marketplace than do the star ratings themselves. [See: What does Morningstar, Inc. say its mutual fund stars can do? and What does Morningstar, Inc. say its mutual fund stars cannot do?] The Skilled Investor believes that discerning investors will benefit from a deeper understanding of Morningstar’s stars and from knowing what the scientific finance literature has said about them. The Skilled Investor has concluded that individual investors and their advisors should not follow the stars blindly, as so many seem to do. The Morningstar star ratings are grossly oversimplified indicators. If investors become blinded by the stars, they are more likely to end up with suboptimal investment returns in the end. (See: Do Morningstar Ratings predict risk-adjusted equity mutual fund performance? and Do the "new" Morningstar star Ratings predict superior fund performance?) Certain characteristics of the Morningstar Ratings could lead to less than optimal investment results. In particular, the Morningstar Rating system is designed to be too broadly inclusive. A fund with at least three years of performance history could be awarded a very high star rating, simply because its stock-picking has been lucky. However, such a highly rated fund may also have high fees, front- and back-end loads, 12b-1 fees, high turnover, and hidden costs that are more likely to undermine its future performance. Furthermore, Morningstar Ratings have been quite unstable over time. You cannot buy a fund with a particular star rating and have assurance that its rating will stay the same over time. (See: How stable have Morningstar Ratings for mutual funds been over time?) It is doubtful that most individual investors understand these and other potential problems with the star ratings. Many investors appear simply to be mesmerized by the stars, and they just follow them without further considerations. The Skilled Investor has a different view about which screening metrics an investor should use to reduce the number of mutual funds down to a more manageable set for evaluation in detail. Better, more scientifically grounded investment selection metrics are available, which should be used instead of the stars. The Morningstar star ratings should simply be ignored, except to screen out the worst performing 1-star and perhaps 2-star funds. There are other equity mutual fund selection and screening criteria that are more likely to identify funds with better long-term prospects. (See: Rational selection of bond mutual funds and equity mutual funds -- overview) Also, see these related ratings service articles on Morningstar: ->Investment astrology – should you pick investments according to the Morningstars? ->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 ->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 -> What the instability of mutual fund Morningstar Ratings means for long-term investors – Commentary ->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) 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.)

2) Benz, Christine. “Special Report: Introducing Morningstar’s New Star Rating .” July 03, 2002. http://news.morningstar.com/article/article.asp?id=77455&_QSBPA=Y