

**[What does Morningstar Inc say its mutual fund stars can do?](#)**

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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. This article utilizes materials from Morningstar's website to summarize some of what representatives of Morningstar, Inc. say the Morningstar Ratings\* can do.<sup>1</sup> The Skilled Investor makes no claim that this article exhaustively summarizes all of Morningstar's commentary on what it believes its star ratings can do, nor does this necessarily represent Morningstar's best thinking on these topics. Only Morningstar could provide such information. For more information on this subject, please refer to [www.morningstar.com](http://www.morningstar.com). (See also this related article, [What does Morningstar, Inc. say its mutual fund stars cannot do?](#)) Note also, that in 2002 Morningstar, Inc. made significant changes to the methods that it uses to define the star ratings. The Skilled Investor believes that it is important for individual investors to understand how Morningstar defines its star ratings &ndash; particularly if that investor uses the stars significant in his mutual fund selection decisions. (See: [How the new Morningstar Ratings for mutual funds have been determined since mid-2002](#)) Morningstar has made the following statements about what its stars can do:

- 1 ->"help investors to focus on good planning, diversification, and fund selection."
- 2 ->"Our goal is to provide tools that help investors to make better decisions. Too often, investors pick good funds but use them poorly. They buy after a hot streak and sell when things go bad. In effect, they are buying high and selling low," said Don Phillips, Morningstar managing director. "By better preventing the ratings from being inappropriately skewed toward some categories and away from others, we hope the new Morningstar Rating will help investors to focus on good planning, diversification, and fund selection."
- 3 ->"Our new ratings recognize that successful investing begins with building a good plan. Once your plan is in place, the star rating will guide you to funds that have added value over time. If you build a suitable plan, pick outstanding funds and stick with them, you'll be in good shape."
- 4 ->"Identify fund managers who 'add value' or capture 'fund manager skill'"
- 5 ->"By using a more precise, portfolio-driven ratings group the new rating can more effectively measure whether a manager is adding value. Many of our customers already use the category rating to do this type of analysis, but the star rating will take it to a new level."
- 6 ->"Morningstar believes that 'mutual funds are only as good as the people behind them: the fund managers who make the investments. Because the fund manager is the person most responsible for a fund's performance, knowing who's calling the shots--as well as how long he or she has been doing it--is essential to smart mutual fund picking."
- 7 ->"Differentiate between funds of similar investment style or strategy"
- 8 ->"Because the new system gives funds in every category an equal shot at top ratings, it does a much better job of identifying winning funds whose styles are simply out of favor, while penalizing weak funds that are simply riding the coattails of a hot asset class."
- 9 ->"Allow investors to easily interpret past fund performance"
- 10 ->"Morningstar's

claims about performance evaluation have generally been restricted to history and not prediction.

->However, recently Morningstar published an article in late 2004 suggesting that preliminary data on the new Morningstar Ratings could have some predictive value regarding performance. (See: [Do the "new" Morningstar star Ratings predict superior fund performance?](#)) ->"Make it a lot

easier for individual investors to build a portfolio" 11 ->Provide a more intuitive measure of historical risk adjusted returns

->For example, when comparing the virtues of its newly revised star rating with the Sharpe Ratio, Morningstar stated, "If two funds have equal positive average excess returns, the one that has experienced lower return volatility receives a higher Sharpe ratio score. However, if the average excess returns are equal and negative, the fund with the higher volatility receives the higher score. While this result is consistent with portfolio theory, many retail investors find it counterintuitive. Unless advised appropriately, they may be reluctant to accept a fund rating based on the Sharpe ratio, or similar measures, in periods when the majority of funds have negative excess returns." 12

Also, see these related articles:

->[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 ->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 mutual fund Morningstar Ratings changes influence individual investors? ->Does it pay to trade when the Morningstar Rating of a mutual fund changes? ->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.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) Don Phillips, Morningstar Managing Director, Morningstar Press Release: "Morningstar, Inc. to Change "Star Rating" for Funds – Moving to Category-Based Rating, Enhancing Risk-Adjusted Return Measure." April 22, 2002.

<http://www.morningstar.com/press/release/item/0,1045,648,00.html>

3) Russel Kinnel. "Morningstar's New Star Rating. April 22, 2002.

<http://news.morningstar.com/article/article.asp?id=14071& QSBPA=Y>

4) Morningstar, Inc. "Fact Sheet: The New Morningstar Rating(tm) for Funds." 2002

[http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/MorningstarRatingForFunds\\_FactSheet.pdf](http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/MorningstarRatingForFunds_FactSheet.pdf)

5) Christine Benz. "Special Report: Introducing Morningstar's New Star

Rating." July 03, 2002. <http://news.morningstar.com/article/article.asp?id=77455& QSBPA=Y>

6) Kinnel, op. cit., April 22, 2002.

7) Morningstar Investing Classroom. Funds 200. "Who runs it?" March 22, 2004

<http://www.morningstar.com/Cover/Funds.html?topnav=funds>

8) Morningstar Press Release: "Morningstar, Inc. to Change "Star Rating" for Funds – Moving to Category-Based Rating, Enhancing Risk-Adjusted Return

Measure." April 22, 2002. <http://www.morningstar.com/press/release/item/0,1045,648,00.html>

9) Benz, op. cit., July 03, 2002.

10) Morningstar Press Release, op. cit., April 22, 2002.

11) Kinnel, op. cit., April 22, 2002.

12) "The New Morningstar Rating Methodology" Morningstar Research Report, 22

April 2002. page 6 [http://datalab.morningstar.com/Midas/PDFs/Research\\_StarRating.pdf](http://datalab.morningstar.com/Midas/PDFs/Research_StarRating.pdf) (Note that datalab.morningstar.com is a Morningstar website for institutional and advisory clients.)