

How Morningstar Ratings for mutual funds are used as a marketing tool

Category : Mutual Fund Rating Services - Morningstar Star Ratings

Published by [The Skilled Investor](#) on Jul/21/2005

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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 relatively infrequent. The Morningstar Ratings* are widely available to individual investors. Current star ratings with free screening tools are easily found on various websites including Morningstar.com,¹ Yahoo! Finance,² and MSN Moneycentral.³ Mutual fund companies seem to feed “four- and five-star only” investor beliefs. They appear to know what individual investors believe about the stars, and they give their customers what they want. Advertising practices by mutual fund families are selective concerning which mutual fund star ratings they will advertise. If a star rating is mentioned in ad copy, four- and five-star funds seem to garner virtually all of mutual fund advertising dollars. 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. In “Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows,” Professor Diane Del Guercio of the University of Oregon and Paula Tkac of the Federal Reserve Bank of Atlanta studied the industry’s use of Morningstar ratings. They found “that of the 33 distinct funds that advertised a Morningstar Rating in Barron’s, Money Magazine, or the Money & Investing section of the Wall Street Journal in June 1999, 18 or 55% had a 5-star rating (and) 45% had a 4-star rating. No funds advertised less than a 4-star rating.”⁴ (See: [Do mutual fund Morningstar Ratings changes influence individual investors?](#)) Mutual funds offer fund summary sheets known variously as “fact sheets,” “sales flyers,” “performance or commentary sheets,” etc. that are available for downloading from their websites. If you inspect them, you will notice a common, if not standard, practice relating to Morningstar Ratings. The star rating for a fund will be featured prominently at the top the summary sheet, but only if it has a four- or five-star rating. These flyers tend to be used by commissioned sales agents or financial “advisors” to induce their clients to purchase funds. Apparently, a fund with a four- or five-star rating are easier to sell, even if it may have a high expense ratio, a front-end load charge, high turnover, or some other higher cost related factor which is likely to reduce investors’ net returns. Lower star ratings are usually not to be found in these summary sheets. For other mutual funds within the same fund family, the summary sheets neglect to include any Morningstar Rating that is 3-stars or lower — even though 2/3 of funds receive a 3-, 2-, or 1-star rating. To find the star ratings for these other funds, you must do your own research on another website. You could do so by looking up a fund’s current star rating on Morningstar’s site or by going to Yahoo! Finance, MSN Moneycentral, or to other sites that feature a full listing of Morningstar Ratings. Clearly, mutual fund families are not providing the Morningstar Ratings as a standard performance comparison tool across all their funds. Instead, they treat the stars as a convenient marketing tool that exploits investor beliefs about performance prediction, when even Morningstar has generally avoided making such claims. (See: [What does Morningstar, Inc. say its mutual fund stars can do?](#),

[What does Morningstar, Inc. say its mutual fund stars cannot do?](#) and [Do the "new" Morningstar star Ratings predict superior fund performance?](#)) 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](#) ->[Simplifying investment decision making can be taken too far](#) ->[High Morningstar Ratings can lure you into funds with costly sales loads](#) ->[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](#) ->[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>

2) <http://finance.yahoo.com>

3) <http://moneycentral.msn.com>

4) Diane Del Guercio and Paula A. Tkac. “Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows.” Working paper, May 2002: page 29