Simplifying investment decision making can be taken too far

Category : Mutual Fund Rating Services - Morningstar Star Ratings

Published by The Skilled Investor on Jul/20/2005

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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.   There are about as many equity mutual funds as there are “investment quality” public companies in the U.S. The Wilshire 5000 equity index, which contains slightly over 5,000 companies, includes virtually all US headquartered firms that have a market capitalization worth paying attention to from an investment standpoint.1 In contrast, the Investment Company Institute counted 5,130 equity and hybrid mutual funds at the end of 2003.2 U.S. companies represented approximately 90% of these funds’ total invested assets. Individual investors are challenged to sort through these thousands of mutual funds. How can they rationally select the few that will receive their precious investment funds? Many seem to use the Morningstar Ratings* as a shorthand method of doing so. (See: Do mutual fund Morningstar Ratings changes influence individual investors? and Does it pay to trade when the Morningstar Rating of a mutual fund changes?)   From a marketing standpoint, the Morningstar stars are brilliant in both concept and execution. Investors are very familiar with critical and survey-based star ratings systems that have been applied to a variety of services, including hotels, restaurants, and movies. These star ratings serve as a popular mechanism to simplify decisions about mass market consumer products and services that have relatively low cost or risk.   Simple star ratings systems for consumers can be subject to bias and manipulation. The credibility of a high star rating is only as good as the critic who determined it or the quality of the patron survey process that was used. However, the maximum risk with a highly rated movie is to feel disappointed and think you wasted your time and a relatively small amount of money. Restaurants and hotels are somewhat more expensive, but they are still one-time events. Based on experience, you can decide whether to repeat a hotel or restaurant purchase.   However, fund investment decisions made based on star ratings can have far more significant personal financial impact. 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. Simplification of investment decision-making can be taken too far. Investors need to look both at the characteristics of any simple investment indicator and at the opportunity cost of using it versus alternatives. This is particularly true with Morningstar Ratings, since there is evidence that mutual fund companies market these stars selectively. They tend to promote the stars with highly rated funds, but neglect to mention them when star ratings are average or low. (See: How Morningstar Ratings for mutual funds are used as a marketing tool) Investors want rational selection criteria based upon scientific evidence. Investment indicators that are not as simplistic as the stars could lead to superior decisions.   Here are some investment strategies and mutual fund selection criteria that are more likely than star ratings to identify funds with potentially superior risk-adjusted returns: ->choose very broadly diversified funds (See: What is the cost to investors of sub-optimal diversification?)   ->diversify across multiple mutual funds to reduce variability (See: How many mutual funds are needed for a well-diversified portfolio? – evidence and How many mutual funds are needed for a well-diversified portfolio? – a commentary)   ->choose funds with lower management fees (See: Choose mutual funds with lower investment management expenses) ->never pay loads or periodic sales charges (See: Avoid mutual funds with sales commissions and 12b-1 fees) ->pick funds with low turnover (See: Avoid mutual funds with higher investment portfolio turnover) ->insure that a fund is has economically adequate minimum size (See: Choose mutual funds with a minimum economical portfolio size) ->eliminate from consideration only those funds with significantly inferior historical performance. (See: Evaluate historical investment performance, but only after using other investment screening criteria) Also, see these related articles: ->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? ->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 ->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.wilshire.com/Indexes/

2) Investment Company Institute. “Mutual Fund Factbook.” 2003 and “Trends in Mutual Fund Investing.” February 2004 http://www.ici.org/