

Behind the Star System: Morningstar defends its mutual fund ratings in the face of new competition.

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Abstract (Document Summary)

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to include in their portfolios. Morningstar's purely quantitative approach rates funds on a curve: 10% are assigned the lowest, one-star rating and 10% receive the top, five-star rating, with 22.5% each assigned two and four stars and 35% assigned three stars. Funds receive separate ratings for three-, five- and 10-year performance, along with an overall rating based on a weighted average of the available time-period ratings. Ratings on 10% to 15% of the funds change each month. That may seem like a lot, but star ratings bounce around less than performance decile rankings, which investors used before the star system, according to Don Phillips, Morningstar's managing director. Only a fund's risk, return and cost go into Morningstar's calculations, not fund manager changes or other events that could affect performance.

Full Text (1171 words)

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Before Morningstar began rating mutual funds like hotels or restaurants, investors had no easy way to evaluate and compare funds. Twenty years later, the star ratings developed by the Chicago-based financial information company remain the dominant system for evaluating mutual funds. But what do the stars really indicate? Despite their influence—star ratings have been found to drive fund inflows—misperceptions about the stars persist, even among advisors. Early next year, Morningstar faces new competition from a company charging that the ratings approach is too narrow and of limited usefulness, a common criticism.

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factors investors should weigh when considering what to include in their portfolios. Morningstar's purely quantitative approach rates funds on a curve: 10% are assigned the lowest, one-star rating and 10% receive the top, five-star rating, with 22.5% each assigned two and four stars and 35% assigned three stars. Funds receive separate ratings for three-, five- and 10-year performance, along with an overall rating based on a weighted average of the available time-period ratings. Ratings on 10% to 15% of the funds change each month. That may seem like a lot, but star ratings bounce around less than performance decile rankings, which investors

used before the star system, says Don Phillips, Morningstar's managing director.

Only a fund's risk, return and cost go into Morningstar's calculations, not fund manager changes or other events that could affect performance. The ratings aren't meant to predict future performance, says Morningstar says. But that's how investors use them.

Morningstar has always offered a backward-looking glance at performance, more "achievement test than aptitude test," Phillips says. In the early 1980s, mutual fund companies would run ads trumpeting their very short-term performance—i.e., "We did great in February"—Phillips recalls.

Morningstar was the first to introduce a longer-term approach, he says.

Egan-Jones, a Pennsylvania-based credit rating agency, is developing a new mutual fund system to launch in the first quarter of next year that the firm claims will be more inclusive than that of the competition. "RIAs are looking for a lot more information than is being provided," says Christopher Pruette, managing director of Egan-Jones. He declined to specify Egan-Jones' methodology, but said it would evaluate more metrics than the star system and that it would involve a qualitative assessment. In early concept tests, RIAs have asked Egan-Jones to provide information such as the price-to-earnings ratios of individual stock holdings in funds. Unlike Morningstar and Lipper, Egan-Jones will charge RIAs for its ratings. The payment model isn't finalized—it could involve an annual subscription or a report-by-report charge, Pruette says, claiming that the depth of information will justify the price.

STAR POWER

Still, it won't be easy to erode Morningstar's market share. The star rating system holds a powerful influence over the investing public. A recent study by two Pace University finance professors quoted findings from the Atlanta Federal Reserve Bank that a fund's initial five-star rating produces inflows of 53% above normal. Conversely, lower-rated funds experience outflows. Paul Alan Davis, a former RIA who now manages equity funds for Schwab Investment Management, says many of his former clients would balk when he would recommend a one- or two-star fund. He anticipated the rise of emerging market funds and recommended them to clients before they took off, when the category included many low-rated funds. "We had to show them the cycles," Davis says. "You don't want to be chasing the market and yesterday's winners." Advisors can help clients counter one drawback of

Morningstar's system, which is that it fosters this type of returns-chasing behavior, Davis says.

Morningstar takes the prospect of increased competition in stride. "We have a lot of competition already," says Phillips. The company has held its own against other mutual fund rankings offered by Standard & Poor's, Lipper and Value Line.

The entrenched nature of the star rating system belies the fact that some advisors don't fully understand it. John Blood, vice president of investments at broker-dealer Commonwealth Financial Network, worked at Morningstar from 1999 to 2000 as a mutual fund analyst. He says he was surprised to discover that some advisors think there is a subjective component to the ratings, or that they are meant to predict future performance. Morningstar publishes a detailed star rating methodology and occasional papers on the stars, but these efforts may not educate consumers about the methodology, "It's so well understood internally," says Blood. "I'm not sure they fully appreciate the misperceptions out there."

RATINGS Versus RANKINGS

Semantics might lie behind one common misperception of the Morningstar star rating, suggests A. Michael Lipper, founder of the eponymous fund information company. Lipper sold his company to Reuters in 1998 and now manages money at his own firm in New Jersey. "The basic fallacy is calling it a rating," he says of Morningstar's system. The word "rating" implies a value judgment, while "ranking" conveys a more numerical approach, he says.

Lipper ranks funds in five categories—total return, consistent return, preservation, tax efficiency and expenses—and investors should evaluate each category differently depending on their needs, Lipper says. The top 20% of funds in each category are called "Lipper Leaders," the bottom 20% receive a score of five, and the middle three quintiles are assigned scores of two, three or four.

Morningstar provides plenty of information for advisors who bother to understand the star ratings, Phillips says. Berkeley, Calif.-based planner Brian Pon agrees: "For people who are willing to read about it, I think they've done a decent job explaining it." Star ratings are just one of many factors that Pon uses to evaluate funds, including Litman/Gregory research, press articles and conference calls with fund representatives. He sometimes uses the stars as a way to winnow down the universe of mutual funds—

8,045 in the U.S. alone, according to the Investment Company Institute. Phillips agrees that the star ratings are a "starting point, not a conclusion." Morningstar publishes detailed, qualitative fund analyses on its website. Morningstar considered incorporating other components into its system, such as fund manager changes and a predictive element, but it's much easier said than done, Phillips notes. "There's a lot of moving parts out there," and each one raises its own complications. For each new data point you include, questions multiply about why you didn't include others. The enormous amount of information that's fed into the star rating—like bond fund distributions, for example—means Morningstar couldn't easily run its calculations more than once a month, Phillips says.

Phillips acknowledges that some people may rely too much on the star system. "There's always some segment of the population that will look for a shortcut," he says. If that's the case, then screening for past performance is still preferable to screening for poor performance and hoping the laggards turn around, he asserts. "This is a better shortcut for them than others they could be using."

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