

Morningstar defends its star rating system

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The columns by Jack Naudi, "With MOST savings plan, the only way to go is Direct" and Larry Swedroe, "Checking ego at investment door helps you make better choices" (both published May 6) state that Morningstar's ratings for funds have been unable to predict future performance. Swedroe's column also states that Morningstar has acknowledged that the star rating has no predictive value.

While it is true that Morningstar has urged and continues to encourage investors to use the star ratings as a starting point in their investment search, our own research and that of two independent academic researchers indicates that, rather than being "about as accurate as a deck of tarot cards," the current version of the star rating does contain some predictive value.

Morningstar launched its new rating for funds in 2002, and every year since has updated a study on the rating's performance. In our most recent study, in November, director of mutual fund research Russ Kinnel examined how the ratings fared at predicting future performance over several three-year periods.

Russ found, in a trend consistent with past studies, that five-star funds tend to outperform four-star funds, and that the biggest performance gap is between five- and one-star funds. A link to his article and a chart of fund performance during the last three years can be found on our website, www.morningstar.com.

Thus, Swedroe's comment, "It may surprise some investors to learn that Morningstar Inc., with all of its resources, has admitted that its star rating has no predictive value" does not accurately reflect Morningstar's view.

The comment does not appear to reflect Swedroe's actual view, either. After all, Swedroe is an outspoken advocate of low-cost investing, in particular the funds of the DFA family.

As Swedroe must surely know, the Morningstar star rating system favors low-cost funds, including those of DFA. We are therefore puzzled as to why Swedroe would argue predictive value for low-cost funds with his system, yet deny predictive value with another company's system.

Finally, the independent research of Matthew R. Morey and Aron Gottesman, both of Pace University, also supports the ratings for funds as predictors of future performance.

Morey and Gottesman's study, published in the summer issue of the Journal of Investment Consulting, reports: "... We find widespread support for the notion that the new Morningstar rating system can predict future performance, at least within the first three years... Specifically, we find that higher rated funds, for the most part, significantly outperform lower rated funds. Moreover, the effect is relatively monotonic as even the next-to-lowest rated funds (two-star funds) significantly outperform the lowest rated funds (one-starfunds)."

For the entire study go to:

webpage.pace.edu/mmmorey/publicationspdf/redux.pdf.

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