

When You Wish Upon a Star

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Abstract (Document Summary)

Just as "two thumbs up" suggests that a movie is worth seeing, a five-star rating from Morningstar is meant to signal that a mutual fund is a good investment. In the scoring system from the Chicago research firm, the stars--ranging from five for the brightest funds down to one for the dimmest--measure returns over at least three years and how much risk the funds took to earn them. Fund companies crow about their four- and five-star funds in their advertising, and those funds consistently attract more dollars than lower-rated funds. Now an independent study led by finance professor Matthew Morey of Pace University in New York City implies that the ratings have done a decent job of predicting returns. But you need to understand the unexpected (and very down-to-earth) reason that the stars are useful navigation guides. The star system wasn't always particularly good. Before 2002, Morningstar ranked funds on the same basic scale, so those in the raciest market sectors got most of the five-star ratings, while those in untrendy areas struggled to keep three stars.

Full Text (744 words)

A new study says Morningstar's ratings do indeed predict fund performance. The reason may surprise you.

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The star system wasn't always particularly good. Before 2002, Morningstar ranked funds on the same basic scale, so those in the raciest market sectors got most of the five-star ratings, while those in untrendy areas struggled to keep three stars. That became an astronomical problem in the late '90s, when mediocre technology funds looked more stellar than well-run funds focused on industrial stocks. When the bubble burst, many five-star funds went from supernovas to black holes. In 2000, the five-star class of '99 lost 15.7%, while funds that had one star in 1999 gained 6.9%.

Star-ting over

To its credit, Morningstar overhauled the star system in 2002. The biggest change: All funds now get rated from best to worst within narrower categories like real estate, technology, small growth stocks or large value stocks. This way, funds must earn their stars relative to other portfolios with the same goals. "Now," says Morningstar managing director Don Phillips, "quality funds in out-of-favor sectors get better ratings."

With the hot-sector effect taken out, stars are awarded on the basis of performance, risk and cost. And the reforms seem to be working. Morey, the finance professor, did a study critical of the old system. But he has found that under the new one, funds with more stars went on to outperform those with fewer between 2002 and 2005. Morey's not sure why but suggests that given the short time period he's studied, the outperforming managers may just be on a hot streak.

My view, however, is that it's largely due to the one component of the star rating that really matters in the long run: costs. Performance and risk will vary. But the advantage of low expenses stays with a fund forever. The star rating adjusts fund returns for sales charges, and their other expenses are already included in net return. Result: Cheap funds now dominate the five-star galaxy. Five stars will not always beat four or three-- but over time, on average, low-cost funds must prevail over high-cost funds.

So check the ratings, by all means. But don't stop there. Here's what else to do.

BE A CHEAPSKATE

No matter how many stars a fund has, if its costs are above average (check them at cnnmoney.com or morningstar.com), skip it.

STICK WITH THE OLDSTERS

Newer funds tend to perform unpredictably as they get bigger. Favoring established ones lessens your chances of flameouts.

REMEMBER, CHARACTER COUNTS

After you tally stars, suggests Morningstar's Phillips, "Ask whether the people and practices that put these returns together are likely to remain in place." To size up the character of the manager, consult Morningstar's "stewardship" grades, then read the fund's prospectus and proxy statement, plus the annual report from this year and from a year when returns were terrible. Does the manager take responsibility when times are tough? Does he seem to care more about earning high returns (good for you) or luring more dollars into the fund (good for him)? How much of his own money does he have in the fund? If you don't like the answers, chances are you won't like owning the fund either.

% OF FIVE-STAR FUNDS WITH LOWER-THAN-AVERAGE EXPENSES

65%

International stock

69%

U.S. stock

82%

Taxable bond

Stardom Goes to the Cheap

Morningstar's rating system gives an edge to low-cost funds. Good idea. Over the long run, expenses are the single most important factor in performance.

NOTE: As of Dec. 31, 2006

SOURCE: Morningstar.