

SundayBusiness

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Text:

VALUE LINE is best known for its stock ranking system, which has been so successful since it started in 1965 that it has caused some skeptical finance professors to make an exception to the rule that it is impossible to beat the market over the long term.

The company has also rated mutual funds since 1993. While this ranking system is not as successful or well known, it merits a closer look.

Because Value Line has not changed its method since it started rating funds, it has a longer track record than the current systems of its competitors. The method used by Morningstar, for example, dates back to just mid-2002. Lipper Inc. inaugurated its fund rating system, known as Lipper Leaders, in late 2001. Standard & Poor's introduced its fund ratings in 1996.

Value Line's rating of a fund is a composite of three factors. The first two are based on the fund's relative strength, or momentum. One measures the number of times over the trailing 12 months that the fund has increased its performance ranking relative to other funds; the second measures how often it has done so over the trailing 60 months. The third factor is the Sharpe Ratio of the fund's performance over the trailing 36 months; this ratio, calculated by dividing performance by volatility of returns, measures performance adjusted for risk.

Value Line assigns a grade of one, its highest, to the 10 percent of funds with the highest composite scores. Its worst rating, a five, goes to the 10 percent with the lowest scores.

A funds typically keeps its Value Line ranking less than a year. A study by The Hulbert Financial Digest found that the average fund that gets a top rating typically loses it after five months. Because of that small window, investors who want to own only top-rated Value Line funds must trade often, so they should buy no-load funds to keep costs low, said Samuel Eisenstadt, Value Line's research chairman emeritus.

In pure performance, how have the ratings fared? Consider a hypothetical portfolio that was always invested in Value Line's top-ranked no-load equity funds. The portfolio would sell any fund as soon as Value Line notified subscribers that it had been downgraded, and would immediately buy any fund that Value Line added to its top category. From the end of 1993 through September this year, The Hulbert Financial Digest reported, this portfolio would have had a return of 9.6 percent, annualized. The overall market, measured by the Dow Jones/Wilshire 5000 Composite Index, did slightly better, gaining 10 percent, annualized.

But the market-lagging performance of Value Line's top-ranked funds does not mean its ranking system is useless to investors, because the average no-load fund has fared worse. According to Value Line's calculations, the average no-load United States equity fund had a return of 8.1 percent, annualized, over the period. That was one and a half percentage points a year less than Value Line's top-rated funds.

The Value Line results can be traced in part to the disproportionate number of small-cap value funds that have made it to its top category. Although this sector did relatively well in the bear market of 2000 to 2002, it lagged behind the overall market in the 1990's, pulling down the performance of Value Line's top picks over the last decade.

Matthew R. Morey, a finance professor at Pace University, said that there appears to be nothing inherent in the system that would make it favor small-cap value stocks over the long term. The tilt in that direction, he said, seems temporary.

In his research, Professor Morey has concluded that Value Line's system has some ability to predict the relative performance of mutual funds. He analyzed Value Line's fund ratings from 1995 through 2000 and found that the average fund in its bottom two rating categories did significantly worse than Value Line's higher ranked funds -- in other words, that the lower-ranked funds lagged further behind the market.

How does Value Line's fund rating system compare with Morningstar's? There are broad similarities, since both place significant weight on risk-adjusted performance. But there are also big differences.

Perhaps the biggest is that Morningstar does not rate a fund any higher for showing momentum. Consider two funds that are identical, except that one had its best year three years ago, while the other had its best performance over the last 12 months. According to Professor Morey, Morningstar would give the same rating to both funds; Value Line would give a higher rating to the one with the better recent performance.

THESE differences are apparent in the top 25 domestic equity funds in the Value Line rankings. Just nine of the 25 also receive Morningstar's highest rating, five stars. Twelve get four stars, while four funds get three stars.

Comparing the performances of Value Line's and Morningstar's rating systems is difficult. Professor Morey says there is not enough data for Morningstar's current method to form a firm conclusion about its ability to pick winning funds. Morningstar made major modifications to its ranking system in mid-2002, changing the composition of the peer group against which each fund would be judged. So the track record for Morningstar's current approach is only slightly more than two years old.

And it may not be entirely fair to compare Value Line's top-rated funds with Morningstar's. Since mid-2002, Morningstar has played down the role that its star ratings should have in investors' fund choices; instead, it has emphasized a number of other factors. Before the change, a page of each issue of the Morningstar Mutual Funds newsletter was devoted to lists of funds with the highest star ratings. That page no longer appears.

In place of that page is a section called "Fund Analyst Picks," in which Morningstar's analysts highlight their "favorite funds based on superior track records, compelling strategies and impressive managers." A majority of those highlighted funds typically do not have the highest star rating. Only 8 of the 32 domestic equity funds now on the list get five stars, for example, while five funds get only two stars.

The fairest comparison may be between Value Line's top-ranked funds and Morningstar's "Fund Analyst Picks." Since Morningstar's method change in mid-2002, Value Line's top-rated funds have outperformed those Morningstar picks in the domestic equity category. The Hulbert Financial Digest reported that Value Line's top-rated no-load domestic equity funds had an

annualized return of 15.6 percent from mid-2002 through September this year, versus 15.4 percent for the Morningstar picks and 13.3 percent for the Wilshire 5000. And Value Line's top funds were more than 10 percent less risky than the Morningstar choices, as measured by volatility of returns.

Keep in mind, though, that Value Line -- like Morningstar -- does not recommend that investors choose funds solely because of their ratings. Investors are advised to use the rating systems as a starting point, to narrow the field of funds that should be researched in greater depth.

CAPTION(S):

Graph: "Better Than Average"

A \$10,000 investment in the no-load domestic equity funds rated highest by Value Line would have slightly trailed the broad market over the last decade, but would have beaten the average fund.

Graph tracks the Wilshire 5000, top-rated Value Line funds, and average no-load fund from 1994-2004.

(Sources by Value Line; Hulbert Financial Digest; Wilshire Associates)

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