

## Positive Ratings for a Ratings Makeover

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### Abstract (Document Summary)

The results are in -- and they are quite positive. On average, funds rated highly by Morningstar have outperformed those that are rated poorly. Yet Morningstar continues to recommend that investors not place undue weight on these ratings when they choose funds.

Morningstar's words of caution notwithstanding, investors have for years placed great weight on those ratings. This was true before Morningstar's 2002 methodological changes, and it remains true today. Researchers have found that a five-star rating, Morningstar's highest, typically leads to outsized inflows of new money, and that a one-star rating leads to a lopsided number of redemptions.

Morningstar recently completed a study, published in its Morningstar Mutual Funds newsletter, of how its rating system has worked. It found that the average domestic equity fund earning five stars on June 30, 2002, for example, produced a 10.1 percent annualized return over the three years through June 2005, slightly beating the 10.0 percent of the Dow Jones Wilshire 5000 index. Progressively lower returns were

produced by the other four rating categories, with the average one-star fund having an annualized return of 8.1 percent.

**Full Text** (972 words)

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IN 2002, Morningstar completed a major overhaul of its mutual fund rating system, significantly narrowing the categories in which individual funds were placed and evaluated. Enough time has elapsed to allow a meaningful test of how well the new system works as a tool for fund investors.

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Morningstar's words of caution notwithstanding, investors have for years placed great weight on those ratings. This was true before Morningstar's 2002 methodological changes, and it remains true today. Researchers have found that a five-star rating, Morningstar's highest, typically leads to outsized inflows of new money, and that a one-star rating leads to a lopsided number of redemptions.

In several important respects, Morningstar's approach to rating funds did not change in 2002. The firm has always graded funds on a curve, for example, giving its highest grades to the best performers. The 10 percent of funds at the top of a ranking of recent risk-adjusted performance, for example, are given five stars. The next 22.5 percent get four stars, the middle 35 percent get three, the 22.5 percent below that get two and the bottom 10 percent get one.

The biggest change was to alter the group of funds against which a given fund is compared. Before June 2002, a domestic equity fund essentially was compared with all other domestic equity funds. As a result, a fund whose manager had inferior stock-picking skills could nevertheless earn five stars if his investment style happened to be in fashion. In a time when small-cap growth stocks were leading the market, for example, a mediocre small-cap growth fund would still get a high rating.

Morningstar corrected this defect, dividing funds into 48 groups. A fund's rating is now based on how its return compares with that of just the other funds in its category. Small-cap growth funds, for example, are now compared only with other small-cap growth

funds.

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In a separate study completed in December, this result was confirmed by two **Pace University** finance professors, Matthew R. **Morey** and Aron Gottesman. A copy is at <http://webpage.pace.edu/mmorey/MoreyGottesman.pdf>.

Despite these findings, Morningstar does not recommend that investors automatically buy only those funds with five stars and sell those with just one. In fact, Russell Kinnel, its director of fund research, emphasizes that its system "is not a magic bullet by any stretch." Its performance is "certainly encouraging," he says, adding that it can be "somewhat helpful" to investors when choosing funds to buy and sell. But in his opinion, an even more important consideration than a fund's star rating is a rigorous fundamental analysis of its strategy and its manager's approach.

In deciding which investment styles should be emphasized in your portfolio, for example, Morningstar's ratings are of no use. That's because its five-star list, as well as its one-star list, always contain funds from each of its style categories. In deciding whether to concentrate a portfolio in, say, small-cap value funds, you will need advice and analysis from other sources.

There is another reason to view the ratings as just one piece of the fund selection puzzle: in some respects, the system is a work in progress. In October 2003, for example, Morningstar introduced additional changes in how it rates international funds. It is continuing to adjust the ratings system.

MORNINGSTAR'S caution about its system is reflected in the funds that its analysts choose as their favorites. (A list appears every two weeks in the Morningstar Mutual Funds newsletter.) Of the 47 equity funds now on the list, five have ratings of only two stars and 12 have three stars. Only five favorites have five-star ratings. Of course, an analyst may like a low-rated fund for various reasons: it may have a new manager, for example, or the market may be starting to favor its investment style.

On a more basic philosophical level, Morningstar's attitude toward its rating system reflects a belief that statistics play a limited role in investing. As Mr. Kinnel puts it, "investing is much too complex for any single measure to sum up the entire merit of a security."

[Chart]

## "Counting the Stars"

In the three years after Morningstar overhauled its rating system, mutual funds with higher rankings outperformed other funds, on average. The top-ranked equity funds beat the overall stock market, but barely.

Morningstar rating -- On June 30, '02: \*\*\*\*\*

3-year returns -- Domestic equity funds, annualized through June 30, '05: 10.1%

Morningstar rating -- On June 30, '02: \*\*\*\*

3-year returns -- Domestic equity funds, annualized through June 30, '05: 9.3

Morningstar rating -- On June 30, '02: \*\*\*

3-year returns -- Domestic equity funds, annualized through June 30, '05: 9.2

Morningstar rating -- On June 30, '02: \*\*

3-year returns -- Domestic equity funds, annualized through June 30, '05: 9.0

Morningstar rating -- On June 30, '02: \*

3-year returns -- Domestic equity funds, annualized through June 30, '05: 8.1

Dow Jones Wilshire 5000 index

3-year returns -- Domestic equity funds, annualized through June 30, '05: 10.0%

(Source by Morningstar Inc.)