

**Title:** *THE RATINGS GAME* , By: Updegrave, Walter, Money, 01494953, Jan2001, Vol. 30, Issue 1

**Database:** *Academic Search Premier*

Section: Investing 101

## THE RATINGS GAME

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#### **How much stock should you put in stock, bond and fund rankings?**

You can get ratings on just about anything these days--movies, wine, vacuum cleaners. Last March, Consumer Reports even rated supermarket taco dinners on the basis of "flavor and texture" scores assigned by the magazine's "trained taste panel." (Taco Bell took the numero uno spot, despite the "jarred garlic" taste of its taco sauce.) So it's not surprising that when it comes to something really important--like investing our money--we gravitate toward some expert's seal of approval.

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Which is why this month I thought we'd turn our attention to the ratings that hold the most sway with individual investors: the star ratings Morningstar bestows on mutual funds; the buy, sell or hold recommendations analysts place on stocks; and Standard & Poor's bond ratings. We'll start by looking at what goes into these ratings. But the key issue, of course, is whether following these rating systems can improve your investing results.

### **The star system**

Eat at a restaurant with a top rating from the famed Michelin Guide, and you're virtually assured a fine dining experience. Buy a fund with a top five-star ranking from Morningstar and, well, you could end up with a case of financial heartburn.

To understand why, you've got to know how Morningstar's star system works. The company begins by divvying up its database of nearly 5,600 funds into four large categories: U.S. and international stocks, and taxable and municipal bonds. Next, Morningstar grades each fund based on its risk-adjusted total return after expenses for the past three and, if available, five and 10 years. The funds are then ranked by their scores within their categories. The highest scoring 10% in each category are awarded five stars, the next 22.5% merit four, the following 35% receive three, the next 22.5% get two stars and the 10% with the lowest scores receive one lone star. The ratings are updated every month.

As mathematically precise and soothingly symmetrical as this process is, it's not particularly good at identifying future superior performers. My biggest beef: The four categories are so broad that the rankings tell you more about which investing style is hot than which managers are doing a great job.

In October 1996, for example, 19% of domestic-stock funds with five-star ratings were growth funds. By this past September, however, growth funds had taken over 66% of the five-star slots. Had growth fund managers become far better investors than their value-oriented counterparts? Of course not. The surge in five-star growth funds had nothing to do with the relative prowess of growth and value managers. It simply reflected the fact that growth stocks like Intel and Cisco Systems have been all the rage the past few years.

Recent research takes a dim view of stargazing. When researchers at the TIAA-CREF Institute tracked the performance of funds with four or five stars as of January 1998, they found that less than a third of those funds maintained a four- or five-star rating continuously over the following two years. Finance professors Christopher Blake and *Matthew Morey* also found that a high Morningstar rating is not a good predictor of future superior performance, although their research does suggest that funds with low rankings--one or two stars--tend to keep them. "If you want to predict the turkeys, the star ratings are good," says Blake. "But if you want to predict the winners, don't look to the stars."

So where should you look? As a starting point I'd be more apt to use Morningstar's category ratings, which aren't as well known as the stars but are also available at Morningstar's website ([www.morningstar.com](http://www.morningstar.com)). The category ratings aren't perfect, but at least the funds are stacked up against their true peers--large growth vs. large growth, small value vs. small value and so forth. So you get a sense of how a manager has performed vs. managers of similar funds, which is important to know if you're building a portfolio of funds with a variety of investing styles.

### Stock answers

Each year an army of securities analysts assesses the future prospects of some 6,000 publicly traded stocks to issue buy, sell or hold recommendations. In theory, this should make stock picking a breeze. Just follow the picks and pans of these highly paid stock scouts, then sit back and savor the gains. But in reality these recommendations come with some rather large shortcomings.

Probably the biggest knock against them is that they're, shall we say, irrationally exuberant. Most analysts rank stocks on a five-tier scale, where 1 stands for a strong buy; 2, a buy; 3, a hold; 4, a sell; and 5, a strong sell. Since ratings are supposed to gauge how a stock will perform relative to the market, you would expect a roughly equal number of buys and sells. After all, the stock market isn't Garrison Keillor's fictional town of Lake Wobegon, where "all the children are above average."

But in the fantasy land of Wall Street analysis, cockeyed optimism rules. According to research firm First Call, more than 70% of the 27,000-plus recommendations outstanding in early November were strong buys or buys, while fewer than 1% were sells or strong sells. (The chart above gives a detailed breakdown.) First Call research director Chuck Hill attributes much of this preternaturally upbeat stance to the fact that brokerage analysts don't want to offend companies that may be (or could become) lucrative clients in the brokerage's investment banking division. Some analysts go to absurd lengths to avoid uttering that four-letter word sell, resorting to euphemisms like "least attractive," "underperform" or, my personal favorite, "reduce." (Can you reduce without selling?)

Still, there is some evidence that analysts can be decent stock pickers. After slogging through more than 360,000 recommendations analysts made at 269 brokerage houses between 1986 and 1996, finance professors from the University of California and Stanford University concluded that a strategy of holding the most highly recommended stocks would have beaten the market by about four percentage points a year. The operative words here are would have. You see, to keep up with the constantly changing recommendations, you would have had to turn over your portfolio four times a year, which would have generated transaction costs that would have wiped out any excess gain.

Nonetheless, it makes sense to check a site like [BulldogResearch.com](http://BulldogResearch.com) ([www.bulldogresearch.com](http://www.bulldogresearch.com)) to see what analysts think of stocks you're considering buying or selling. But I would never base my decision to buy or sell primarily on analysts' ratings.

### **Strong bonds**

Unlike stock recommendations, the ratings that Standard & Poor's assigns each year to billions of dollars of corporate and municipal bonds make absolutely no prediction about rates of return. S&P's grades measure the likelihood that a bond issuer will repay interest and principal on time. Of course, collecting interest payments and getting your principal back are major concerns if you own a bond. So despite their limited scope, these ratings attract mucho attention in the bond world.

To arrive at its ratings, S&P examines the financial strength of bond issuers. For corporate bonds, that means assessing revenue and expenses to make sure the company has enough cash flow to cover its borrowings. In the case of munis, it's ensuring that a municipality's tax base can generate the required payments or that revenue from a project such as a bridge is sufficient to repay the bond.

After performing this analysis, S&P grades the bonds on a 10-tier scale that starts at AAA ("extremely strong" ability to repay), goes to AA (very strong), A (strong), BBB (adequate) and so on, down to D (in default). Issues rated below the investment-grade cutoff of BBB are considered "junk" bonds, although bond salesmen prefer the more sanitized "high yield" label. (For more on the grading system and ratings on specific bonds, check the Ratings Services section of S&P's site, [www.standardandpoors.com](http://www.standardandpoors.com)).

So how good are the ratings at predicting whether a bond will pay as promised? Well, not perfect, but they're pretty damn good. Based on an analysis of 8,693 corporate bonds, S&P estimates that during a period of 15 years only about 2% of corporate bonds originally rated investment grade default.

Defaults for highly rated munis are even rarer. What's more, defaults typically occur only after a bond has been downgraded to a lower rating several times. This process usually takes more than six years with investment-grade issues, so you should have plenty of time to bail out before a bond is slapped with the dreaded D rating.

As comforting as that may be, these ratings do have limitations. A lofty rating will do nothing to prevent the price of your bond from getting clobbered if interest rates spike up. And while sticking to highly rated issues may help you sleep at night, it doesn't assure top returns. In fact, low-rated junk bonds have outperformed investment-grade issues by an annualized two to three percentage points over the past 10 years. In short, if you're looking for peace of mind, the S&P

ratings can definitely help. But if you're hoping to spice up performance, well, a Taco Bell dinner might do a better job.

### **Falling stars**

As the chart shows, a prestigious ranking from Morningstar hardly assures superior future performance. Only 49% of the 1,897 mutual funds with a four- or five-star rating in January 1998 were able to maintain that rating for even one year, and a mere 32% managed to hold onto four or five stars for two years.

Percentage of mutual funds that maintained a four- or five-star rating during the two-year period

Note: Figures exclude muni bond funds.

Source: "The Persistence of Morningstar Ratings" by Mark Warshawsky, Mary DiCarlantonio and Lisa Mullan, Journal of Financial Planning, September 2000.

### **Sell is a four-letter word**

With buy recommendations outnumbering sells by more than 80 to 1, stock analysts are obviously reluctant to tell investors to dump any stock.

|                  |       |
|------------------|-------|
| Strong buy       | 35.7% |
| Buy              | 36.8% |
| Hold             | 26.6% |
| Strong sell/sell | 0.9%  |

Note: Based on more than 27,000 recommendations on some 6,000 stocks as of Nov. 1. Source: First Call.

PHOTO (COLOR): Walter Updegrave

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