

STRATEGIES

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# Same Yardstick, Different Races

As any track coach knows, a mile is nothing like a marathon. Many runners who do well over short distances lack the endurance for long ones.

Successful investing, of course, is more like a marathon than a mile. It involves a long-term commitment. Many mutual fund investors, however, do not remember that principle — and one reason for their forgetfulness is that Morningstar's ratings sometimes blur the distinction.

When comparing a fund that has been around for just three years with another that has a record of a decade or more, Morningstar assumes, in effect, that the younger fund can keep up its returns indefinitely.

That does not mean that investors should ignore Morningstar. No rating system is perfect, because aggressive and conservative investors seek different kinds of guidance. But if you understand the ins and outs of Morningstar's rating system, you

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can use it more intelligently.

Morningstar is fully aware of the problems of comparing younger and older funds. According to Don Phillips, Morningstar's managing director, these pitfalls are one reason that the firm discourages investors from automatically interpreting changes in a fund's ranking as buy or sell signals. On occasion, Morningstar has publicly bemoaned the fact that investors give its rating system more importance than it warrants. Furthermore, Morningstar has resisted pressure from investment firms to rate funds that have been around for only a year.

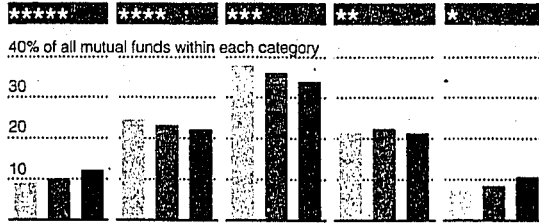
Still, many investors continue to make decisions based on changes in a fund's Morningstar ranking. According to the Financial Research Corporation, based in Boston, mutual funds that received four or five stars from Morningstar in 1999 enjoyed net inflows of \$224 billion for that year, while those rated lower suffered net outflows of \$132 billion.

Top-rated funds receive five stars from Morningstar, while those at the bottom get one. The ratings are based on Morningstar's measure of risk-adjusted performance, and grading is done on a curve. The middle 35 percent receive three stars,

## Young and Unpredictable

In mutual fund rankings by Morningstar Inc., a fund that has been around three to five years is more likely to earn an extreme five- or one-star rating than a fund that is at least 10 years old. All ratings are through September 30.

- Funds that are at least 10 years old
- Funds that are at least 5 years old but less than 10
- Funds that are at least 3 years old but less than 5



Source: Prof. Matthew Morey, Pace University, Morningstar Inc.

The New York Times

while only 10 percent get one star and 10 percent get five.

The approach is straightforward enough. But problems arise when Morningstar uses it to grade funds with records of widely varying lengths. How can these funds be fairly compared with one another?

Morningstar's solution is to calculate a separate star grade for each of three periods — the last 3, 5 and 10 years. (Funds that are less than three years old are not rated.) Morningstar then combines those grades into one overall rating. If a fund has been around for only three years, its

overall rating is the same as its three-year grade. But if a fund is at least 10 years old, Morningstar's system gives a 50 percent weighting to the 10-year grade, 30 percent to the 5-year and 20 percent to the 3-year.

Under this approach, however, a greater percentage of younger funds than veterans earn five stars. That is because luck plays a bigger role in shorter-term performance, resulting in greater extremes. So a higher percentage of 3-year-old funds than 10-year-olds earn five stars.

As a result, some investors are drawn to younger funds whose per-

formance might have come in large part from luck. The wise investor would favor a veteran fund over an upstart, even if the upstart had slightly better lifetime performance.

Some people may argue that Morningstar's approach works on balance, since a greater percentage of three-year-old funds than decade-old funds also receive just one star. But that does not discourage fund families from offering new funds in hopes of garnering five stars — and the huge influx of new capital that inevitably follows. If the upstart then turns into a loser, it can be quietly shut down and replaced.

Morningstar's favoring of younger funds was first noted in 1998 by academics including William F. Sharpe, a 1990 Nobel laureate in economics, and Marshall Blume, of the Wharton School of the University of Pennsylvania.

A new study has found a different problem in the way Morningstar compares young and old funds. The study, by Matthew Morey, a finance professor at Pace University, discovered a statistical quirk making it more likely that the overall star ratings of older funds will rise than fall. As a result, even investors who use these ratings only to assess veteran funds can go astray, by holding on to a deteriorating fund longer than they might otherwise. The study is available at [webpage.pace.edu/mmorey/mstarage11.pdf](http://webpage.pace.edu/mmorey/mstarage11.pdf).

Can Morningstar do anything to correct these problems? Mr. Phillips said there was no easy way to avoid them in combining a fund's performance over different periods into a single rating.

But two finance professors, An-

drew Metrick and Robert Stambaugh, both of the Wharton School, say Morningstar could use some statistical techniques to reflect the inherently higher risk for younger funds.

Imagine that you are choosing between two funds — one that has existed for just a few years and one for two decades. If both have average annual returns of, say, 20 percent, and their returns have been equally volatile, most of us would invest in the veteran fund. We would appreciate intuitively that investing in the younger fund carries much higher risk.

Until and unless Morningstar takes this risk into account, how should you go about picking a mutual fund? Here are three guidelines:

- Take Morningstar at its word that its ratings should not be seen as buy or sell signals. Its ratings should be where your research begins, not ends.

- Be wary of any fund that has been around less than five years. This may seem harsh, since many domestic equity funds fall into this category. But to put it bluntly, there is too much garbage among younger funds, even those whose returns seem impressive. Following this rule means missing the chance of finding a gem, but also avoids the much higher likelihood of investing in a loser. A corollary is to be wary of any fund whose manager has changed over the last five years.

- When comparing funds that are at least 10 years old, do not rely on Morningstar's overall rating but instead on its 10-year grade only. That eliminates any statistical distortion.