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HEADLINE: Study finds high ratings a 'kiss of death' for mutual funds: Star performance usually can't be maintained

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BODY:

In Malcolm Gladwell's bestseller *Blink: The Power of Thinking Without Thinking*, the author attaches great value to "thin-slicing," the powerful insights sometimes gained from first impressions.

In picking a mutual fund, the opposite is true: We court trouble when we buy based on a quick glance at recent returns or fund ratings.

Matthew Morey, a finance professor at Pace University in New York, who has studied fund-rating systems, finds them to be "really seductive."

"People will look at 'star' ratings like restaurant and movie rankings," he said. "They think they may be buying a great fund, but that may not be true at all."

In a research paper entitled "Kiss of Death: A 5-Star Morningstar Rating," Mr. Morey studied a sample of diversified five-star stock funds, which received the highest ranking from Morningstar Inc., the Chicago-based investment research firm.

"Three years after a fund received its initial five-star rating, fund performance severely falls off," Mr. Morey said. Attempting to duplicate their success, fund managers of the top funds often took on more risk.

It's rare for a fund with one stellar year to be able to continue its winning ways. Unfortunately, we're hard-wired to believe that those returns will continue indefinitely. (Attention real estate investors!). That's one reason why the US\$8-trillion U.S. fund industry keeps growing.

As a result of our inclination to place higher value on recent returns -- and to ignore risk -
- we're often led astray.

Neither fund performance nor high rankings always translate into consistent returns in the unforgiving world of investment statistics.

Mr. Morey has found that highly rated funds almost never match their best years, although the low-rated funds seem to continue their lacklustre ways.

Even when managers have a good year, they often make mistakes in attempting to replicate past performance. There's some evidence to suggest that there's a winner's curse, since successful managers often trade more and needlessly run up costs, hurting returns.

Over the years, there's been considerable pressure on managers to trade more to match their best years.

John Bogle, founder of the Vanguard Group, the second-largest U.S. fund company, found that stock-fund turnover rose to 112% at the end of last year from 24% in 1945. Turnover is the percentage of a fund that is bought and sold in a year (100% means the entire portfolio has changed).

Returns and ratings tell you almost nothing about whether a fund will match or surpass its best year. If managers feel compelled to trade aggressively to try to match or beat their halcyon years, escalated expenses and poor timing alone will defeat them.

"Investors should be very wary about using the five-star rating as a signal of future three-year performance," Mr. Morey concludes.

Russel Kinnel, director of fund research for Morningstar, disputes Mr. Morey's assessment on his company's rating system.

He called the study's findings "irrelevant" because they were based on a system that Morningstar changed almost three years ago.

Morningstar ratings evaluate returns as far back as 10 years and weigh risk and adjust for the costs of sales commissions, Mr. Kinnel says.

"The ratings are a helpful measure of how funds did on a risk-adjusted basis," he said.

"Star ratings are useful, but they are part of a matrix of investment research."

A shift from concentrating on individual funds and managers to an allocation based on risk tolerance would be a good place to start if you want to tune up your investments.

Diversification works because it's like betting on all the horses in a race. You're guaranteed a win, place and show.

The best advice for fund investors would be to ignore "top 50 funds" lists and rankings based on recent returns. Diversify according to your age, occupation risk (longevity in your job), and risk tolerance (how much can you stomach to lose).

Then keep your investing simple. Stop researching managers, chasing returns and concentrate on finding the lowest-cost mutual or exchange-traded funds that represent the greatest number of securities in the asset classes mentioned above.

Mr. Morey advises investors to pay more attention to fund costs such as sales charges, management expense ratios and turnover from trading. "They really drive long-term performance," he says.

To win at investing, it helps to stop listening to the relentless pitches of Wall Street, the fund industry and advisers who rely solely on past returns. It's mostly just noise.

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