

Success Isn't Always Written In the Five Stars

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A mutual fund's first five-star rating from Morningstar Inc. signals that its managers are among the hottest of the hot, but investors looking for long-term success would do better to steer clear of such funds, a Pace University study has found.

Finance professor Matthew R. Morey looked at 273 funds that won their first five-star rating from the Chicago-based research shop from 1993 to 2001 and determined that a fund's performance relative to that of its peers sinks dramatically in the three years after it receives the Morningstar accolade.

"The five-star funds do about as well as the three-stars," Morey said in an interview about the study, which will be published in an upcoming edition of the *Journal of Investment Management*. "Ratings are very seductive . . . but I don't think past is prologue."

Newly anointed five-star funds tended to do a poorer job of loading up on "momentum stocks" -- companies that are rapidly gaining value -- and they seemed to be investing in higher-risk companies as well, Morey found.

The problem, he said, seemed to stem from the hordes of investors who rushed into the funds after the ratings came out. The managers then seemed to struggle to find good uses for all the extra capital. "It's difficult to follow the same sorts of strategies" when a fund doubles or triples in size, he said.

If investors had the money to invest in every five-star fund, and the time and energy to revamp their portfolios every month when the Morningstar ratings come out, then they could make money, according to another study of the ratings' effect on mutual funds. That strategy beats the market indexes. But buying every new five-star fund and selling every fund that fell to four stars would require an average of 160 transactions a month, said the study's co-author, Paula A. Tkac, a financial economist at the Federal Reserve Bank of Atlanta. Choosing a few five-star funds wouldn't have the same positive results, the studies suggest.

Tkac's study of funds from 1996 to 1999 found that investors tend to rush into funds when they get new five-star ratings, and rush out of funds that fall from four stars to three, but Morey's study suggests that investors would do just as well if they stayed where they were.

"There's very little indication that an average-rated [or three-star] fund is going to do any worse than a five-star fund," Morey said. Instead, he said, investors should pick funds

rated average or above and select those that have low fees because fees don't change over time and cut directly into returns.

Morningstar research director Don Phillips took issue with the title of Morey's paper, which referred to a five-star ranking as "the kiss of death." Funds that get consistent five-star ratings are usually top performers with low fees, and investors should seriously consider them, Phillips said.

Since Morey's study was completed, Morningstar also has changed the way it doles out top rankings to make them more precise.

In the 1990s, all domestic equity funds were ranked together, so most of the funds that loaded up on technology and other growth stocks got high ratings, while managers who looked for value got low ratings. When the bubble burst, the rankings were reversed.

Now Morningstar assigns funds to more than 40 specific categories based on their strategy and ranks them only against their peers. That means funds that get five stars are beating competitors at their own game, not simply riding a market-wide wave, and their top-rated ranking should have more staying power.

But Phillips agreed that investors should heed the central message from Morey's study: Don't rush into a newly named five-star fund without doing your homework. Many small funds have had trouble coping with their new fame, he said.

"It is legitimate that if you've got a fund that's been quietly compiling a good record and gets sudden accolades, that can be a difficult period for a fund," Phillips said.