Why Top Returns Are Not in the Stars
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STRATEGIES

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WHEN it comes to picking among the thousands of mutual funds out there, investors want a rating system that separates the wheat from the chaff. Unfortunately, the most popular rating services get only half of the equation. They do a good job of pinpointing the chaff of the investing arena, but are not much help in identifying the wheat.

Consider **Morningstar**, the Chicago financial publisher that provides the most widely used fund rating system. Morningstar ranks funds on a scale of one to five stars, according to their historical, risk-adjusted performance. While the ratings thus look backward at performance, Morningstar advises that they be used as a first tool — though not the only one — in selecting a fund. And individual investors overwhelmingly choose four- or five-star funds when investing.

Funds in the bottom 10 percent of their universe receive one star, while those in the top 10 percent receive five. When calculating the stars, Morningstar ranks on the same curve all funds in a particular universe, say domestic equity funds, regardless of their investing style, their objective or their holdings' market capitalizations.

Yet while one-star funds significantly underperform the market, five-star funds, on average, do not outperform it, according to a recent study.

Let's look first at the one-star funds. The study, by Christopher R. Blake, associate professor of finance at Fordham University's Graduate School of Business, and Matthew Morey, assistant professor of economics at Fordham, found that those funds, on average, trailed the market by a large margin. The average fund that had a one-star rating on Jan. 1, 1993, lagged behind the Standard & Poor's 500-stock index by 8.4 percentage points a year for the five years ending Dec. 31, 1997. (That five-year period was one of many studied, but the results are representative of the professors' findings.)

That performance difference is substantial, and Morningstar can be proud that its one-star rating was so effective at identifying such likely underperformers.

Impressive as that may be from an academic viewpoint, it is of limited real-world value in helping you outperform the market: All you can do with Morningstar's list of one-star funds is avoid them.

Jack Manning/The New York Times

When Mark Carhart studied fund rankings, he found some nasty surprises.

Unfortunately, at the other end of the spectrum, Morningstar's five-star funds, as a group, do not beat the market, even if they clearly do better than the average one-star fund. For example, the average fund with a five-star rating on Jan. 1, 1993, underperformed the market by 3.8 percentage points for the five years through Dec. 31, 1997.

But that is not the only difficulty in the rankings. According to Professors Blake and Morey, the differences between the performances of the average five-, four-, and three-star funds are so small as to have very little statistical significance.

NONE of the other rating services monitored by the Hulbert Financial Digest have done any better than Morningstar in identifying funds that will outperform. For example, the **Value Line Mutual Fund Survey**, created several years ago to compete with Morningstar, also bases its ranking on historical risk-adjusted performance, though it looks at performance over different periods than Morningstar does and defines risk differently. Yet, on average, its group of highest-ranked equity funds have performed more than one percentage point a year worse than Morningstar's.

One of the fund-picking approaches that most profitably uses past performance data is remarkably simple, involving no complicated risk-adjustment or long-term historical comparisons. This system calls for the purchase each Jan. 1 of the best-performing diversified no-load equity fund of the previous year. According to Sheldon Jacobs, editor of the **No-Load Fund Investor** in Irvington, N.Y., such an approach would have produced a 20.2 percent return, annualized, since the beginning of 1975, beating the Wilshire 5000 by an average of 3.2 percentage points a year and far outpacing any competing fund selection method I know.

But there may be less here than meets the eye. For starters, investing in last year's winners is risky. When the approach works, it is because the stock market exhibits short-term momentum; one year's wave often continues into the next year. But when that wave crashes, sooner rather than later, the funds at its crest can sometimes be the biggest casualties.

One measure of the heightened risk comes from Mark Carhart, formerly an assistant professor of finance and business economics at the University of Southern California. Mr. Carhart, now co-head of quantitative research at Goldman Sachs Asset Management, has studied fund performance year to year back to 1962. If fund performance were all a matter of luck, one would expect that just 10 percent of all funds in the top performing decile one year would repeat that performance the next year. But Mr. Carhart has found that a greater percentage of those top performers manage to do so. Here's the catch: He has also found that the top decile performers in any one year are more likely to end up the next year in the *bottom* 10 percent.

In other words, investing in last year's top performers is a crap shoot. You might be lucky. But there also a significant chance that you'll invest in a real clunker.

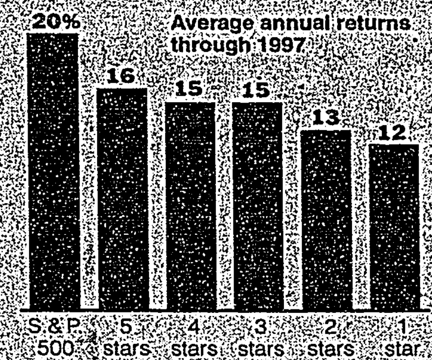
Mr. Jacobs began using the strategy in late 1991 and, though it is not his only strategy, has been recommending it to subscribers ever since. Over the next seven years, his portfolio that uses the strategy lagged behind the broad market by an average of 2.2 percentage points a year. Worse yet, it was also 31 percent more volatile.

The problem with the popular rating systems is that they do a poor job of distinguishing between adviser skill and mere luck. And so it is no surprise that the top-rated funds do not meet expectations.

Consider how funds have performed over the last five years, a period dominated by large-capitalization stocks and by growth investing instead of a value approach. A fund manager whose focus over these years was small-cap value would probably look awful, even if he outperformed the average small-cap value stock. By the same token, the manager of a large-cap growth fund could still look good, even if his fund has trailed the average large-cap growth stock. The real measure of an adviser's skill is outperforming a benchmark constructed to match all relevant aspects of his approach.

Morningstar is aware of this criticism and has taken some steps toward addressing it. For example, it no longer compares international equity funds with domestic equity funds when awarding stars. But it still puts all domestic equity funds into the same pot, regardless of whether they are large- or small-cap, value or growth.

How can investors identify which funds have truly outperformed their peers, taking into consideration the different market caps or investing styles? I know of no service that regularly provides such rankings, even though several, including Morningstar and Value Line, provide much of the data necessary to do so. In the meantime, unless they're willing to just go with the roll of the dice, investors should judge a fund's performance only by comparing it to others that focus on the same kinds of securities and pursue a similar investing style. □



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