BURNS ADVISORY GROUP
private wealth management

From Stars to Olympic Medals
Morningstar attempts to solve a problem that does not exist, again
December 2011
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"The performance data given represents past performance and should not be considered indicative of future results."

Fund analysis giant Morningstar includes this sentence as part of their Important Disclosures on all of their research. It represents perhaps the most common disclosure in the investment analysis universe because investors must be reminded of the dangers inherent to chasing performance. The impulse to buy high-flying investments is trumped only by the irrational tendency to take stock tips, calendar cycle strategies, or unsubstantiated rankings at face value.

And now the firm most notable for its star rating system, which until last summer went virtually unquestioned as the fund industry's de facto seal of approval, has emerged from the research lab with a new, separate rating scheme. This time Morningstar's analysts will assign Olympic medal rankings to funds they "believe have sustainable advantages that position them well versus peers or the relevant benchmark on a risk-adjusted basis over a full market cycle."

The Morningstar Analyst Rating, in short, intends to forecast future performance. To acknowledge it now claims to possess this ability should trigger two questions. First, does this represent a new level of ambition in the realm of investment research or just the most recent?

Last August, Morningstar released study findings supporting the long-standing belief that the single greatest determinant of future investment returns is expenses. That is, the lower a fund's expense ratio and other costs like trading fees, the more likely it will perform well relative to its benchmark. A clever observer might be inclined, given Morningstar's own findings, to expect the weight of fund expenses in its new ratings would be large. Better yet, an enterprising investor might just reference expenses directly and disregard the new ratings altogether.

The second consideration that probably occurred to the folks at Morningstar is how the new ratings will square with investors who have relied on the original star system.

A thoughtful answer here requires a deeper dive into the reasons that drive an organization to provide new services. As long ago as 2005, Morningstar required mutual funds to pay at least $8,000 per year if they desired to use their star rating in client communications or advertisements. There are over 6,000 funds with either a four or five star rating, although granted some of these are probably different share classes of the same fund. Still, this represents a vast prospect base.

To their credit, the company maintains, and there seems no reason to believe otherwise, that they neither seek nor receive direct payment for issuing ratings or research. However, the incentive to update, change or add to their stable of ratings for anticipated future licensing revenues from funds that receive favorable analysis exists without question. The motivations for establishing a new rating scheme extend in many directions and could quickly outweigh the blowback from diluting earlier ones.

Backward-looking data like performance and Morningstar's original star rating system are imperfect because their consistency in the future cannot be guaranteed. Recent performance, in particular, often leads investors astray. Forward-looking indicators like earnings expectations and Morningstar's new rating system are even less perfect since they're often based on assumptions and estimates.

Investors have a long track record of using imperfect information to make regrettable decisions. Our Investor Returns formula does a nice job of explaining how investor behavior, and expenses for that matter, can have a negative effect on overall investor returns:

Investor Returns = Investment Returns – costs +/- Investor Behavior

Ongoing findings demonstrate that investors fail to capture a lot of the returns generated by their investments. If the only two variables are cost, which is controllable, and investor behavior, then it's clear the investor tends to be his or her own worst enemy. The best advice an investor can take is to keep costs low, avoid making decisions based on emotions like greed or fear, and give backward-looking data, forward-looking estimates, and analyst ratings the credit they deserve.