



Morningstar's Attempt to Predict Performance

By Robert Huebscher

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Few question that skillful mutual fund managers exist, but virtually all attempts to identify them *ex ante* have failed. Last week, Morningstar took up the challenge with its Analyst Ratings, which aim to identify funds with the “long-term potential for superior risk-adjusted performance.” Given the futility of such efforts over the last several decades, advisors should approach this new effort with skepticism.

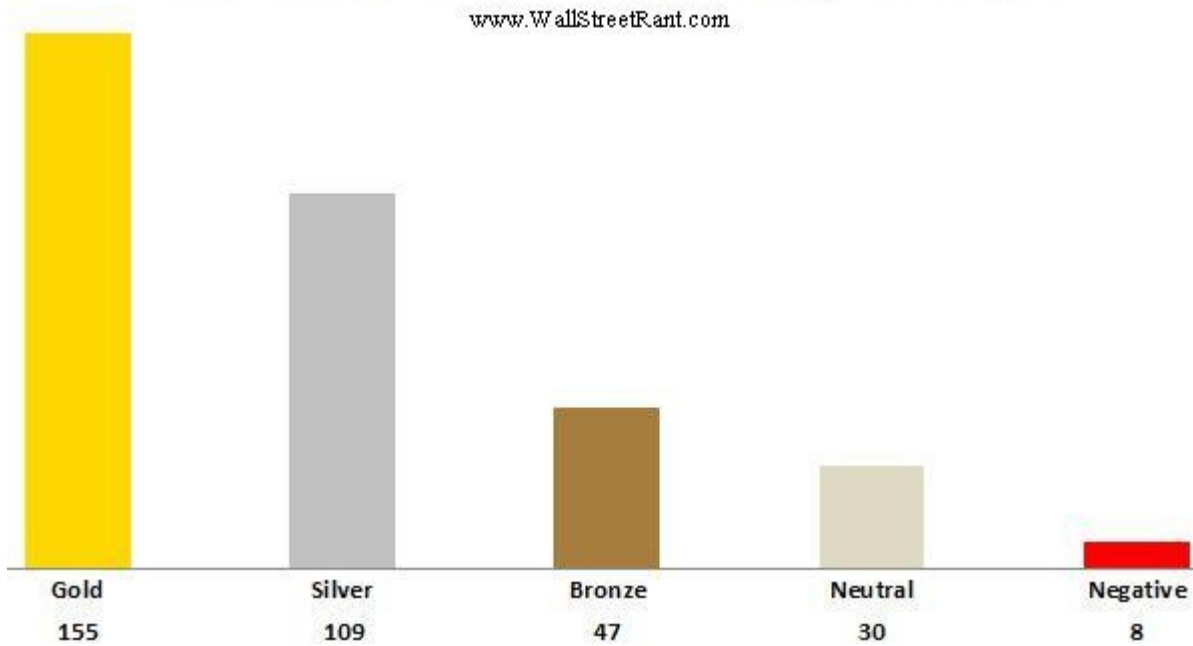
The measure of whether Morningstar will succeed is quite simple, since a relatively straightforward calculation will provide risk-adjusted performance. But that test can only be applied after a complete market cycle. We need to know how well a fund and its manager performs in both up and down markets, so it will be at least a few years before we have any meaningful data to examine.

We already know that a naïve strategy of selecting low-cost funds will improve investor outcomes (and this week we learned that following the investment decisions of members of Congress might offer further benefits). We need to see whether the Analyst Ratings will do better.

A [blog](#) noted that Morningstar chose to rate some of the “bigger and best” funds first, and as a result its ratings are highly skewed:

Breakdown of Morningstar Analyst Ratings

www.WallStreetRant.com

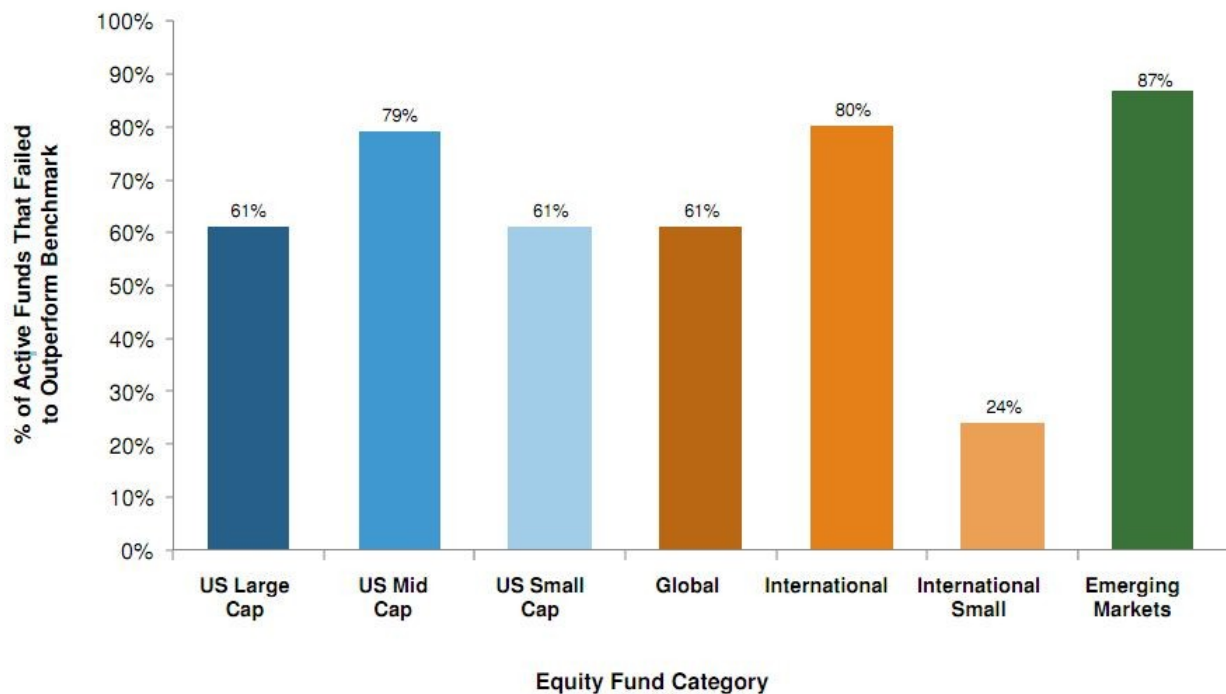


Let's hope this is not the distribution at which Morningstar ultimately arrives for the full fund universe, since studies (such as S&P's below) have shown that less than half of actively managed funds outperform the market, as dictated by Sharpe's [law of active management](#).

The Failure of Active Management

Percentage of Active Public Equity Funds That Failed to Beat the Index

Five Years as of June 2011



Once Morningstar rates the full universe of funds, we will need to verify that the distribution of its ratings conforms to the distribution of funds and managers based on risk-adjusted performance. Until then, advisors should be justifiably wary, based first and foremost on the funds it chose to rate.

Surprisingly – and without explanation – Morningstar chose to rate index funds. Moreover, all the index funds it rated were given gold, silver or bronze status, as shown in the appendix to this article.

The fact that no index funds drew neutral or negative ratings raises grave concerns about Morningstar's standards. An index fund, by definition, should underperform its index by its expense ratio, tracking errors aside. Passive management proponents may deem it laudable that Morningstar chose to assign such high ratings to index funds, but those in search of skillful active managers can and should cite this glaring incongruence with the stated goals of the Analyst Ratings.

Morningstar has parlayed its star-based ratings into a multi-million dollar business. As we and others have [shown](#), those ratings are not predictive of future performance. Indeed,



Morningstar has admitted as much, asserting that those ratings encapsulate the historical returns of a fund relative to its peers and are not indicative of future performance.

Investors, however, continue to rely on the star ratings, and studies have shown that money flows into higher-rated funds and out of lower-rated funds. Let's hope that, if investors behave similarly with respect to Analyst Ratings, it will be because Morningstar has been able to succeed where countless others have failed – finding those managers who will achieve risk-adjusted outperformance. We will answer that question in a few years but, in the meantime, be skeptical – very skeptical.

Appendix – Index funds with Analyst Ratings

The following index funds were rated "Gold"

Fidelity Spartan Extended Mkt Index Inv FSEMXX US Dow Jones Complete Stock Market Index
Vanguard 500 Index Admiral VFIAX S&P 500
Vanguard Developed Markets Index Admiral VDMAX MSCI EAFE
Vanguard Developed Markets Index Inv VDMIX MSCI EAFE
Vanguard European Stock Index Adm VEUSX MCSI Europe
Vanguard Institutional Index Instl VINIX S&P 500
Vanguard Mid Cap Index Adm VIMAX MSCI US Midcap 450
Vanguard Short-Term Bond Index Adm VBIRX Barclays Capital US 1-5yr Govt/Credit
Vanguard Small Cap Index Adm VSMAX MSCI US Small Cap 1750
Vanguard Total Bond Market Index Adm VBTLX Barclays Capital US Agg
Vanguard Total Intl Stock Index Admiral VTIX MCSI All Country World Ex US
Vanguard Total Stock Mkt Idx Adm VTSAX MCSI US Broad Market

The following were rated "Silver"

Fidelity Spartan International Index Inv FSIIX MSCI EAFE
Vanguard 500 Index Investor VFINX S&P 500
Vanguard Balanced Index Adm VBIAX 60% MCSI Broad Market / 40% Barclays Capital US Agg
Vanguard REIT Index Inv VGSIX MCSI US REIT

The following were rated "Bronze"

Spartan U.S. Bond Index Investor FBIDX
Vanguard Small Cap Value Index Instl VSIIX



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