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Morningstar Star Rating System Called into Question by the Wall Street Journal

I have been analyzing mutual funds and managed accounts for over 20 years. Along the way, I have studied an immense amount of research on the subject, have performed my own studies, and have lived the experience with real client assets in real-time. I have come to realize that often, the more you know about a subject, the harder decision making becomes. A complex problem like investment management is a perfect example. To help with decision making, people often seek out simple, understandable, data-backed shortcuts to help guide them. We are comforted by data and simplicity, and when we don't understand something, we simply don't trust it. The investment approaches of indexing, "perfect" strategic pie charts, and smart beta, all sound like simple answers to a complex problem where data can be presented to show an advantage. However, the most prevalent simple shortcut is to evaluate an investment manager based on their historic returns as a measure of their future success. It simply feels right to invest based on past performance, and it beats the alternative – looking for investments with poor past performance. The industry knows this linear mental leap that investors make and has been constantly looking for one clean, simple, easy formula that will lead to manager selection success, or outperformance, after the fact. However, just like evaluating any other complex problems where humans, processes, and an ever-changing environment are involved, a simple formula or shortcut often falls short.

Imagine a simple formula that predicts the success of an engineer, a surgeon, or an attorney. This would be a complex problem; variables are constantly changing. And then there are humans involved! Each outcome could be different for a variety of reasons and some unrepeatable. We could study their past successes or failures, but this still doesn't comfort us enough to be certain that next time they will be successful. Such is the case with analyzing mutual funds or investment managers. It is not enough to say that "well, they did a good job over the last 5 years". We are not time travelers, we do not get to go back in time and achieve those historic results. Further, and more importantly, maybe the investment manager was just lucky.

Nowadays most services have peer group ratings or some form of customer reviews that judge past performance. In the investment world, this measure is return. Through technology, the returns of almost all investment managers are readily available, and by boxing strategies among "similar products", everyone can easily compare track records. I don't think there is an investment advisor reading this article that would make an investment without a 10-year minimum real track record and where this performance hasn't been compared to "similar products".

As a generation, we are data dependent. Data helps us make decisions and often, it is all we have to go on. The more data the better. Longer track records and more thin slices of the same track record foster a sense of ease because our brains are trying to become comfortable with what we know will be a relative unknown outcome of the decision. Contrast this to where our brains are comfortable making decisions: the product world. When evaluating a physical product, like a Porsche for example, it is far easier to rely on the past history of Porsches and current performance data to feel comfortable with what future results will be. This is because we can experience the outcome before we make the purchase. We can touch, feel and drive the result, and, the same awesome result occurs every time we use it. We can compare it to similar cars; we know what the comparables are and we can drive them all. This simply cannot be said for services, and especially services like investment management where investment managers and future results can vary greatly.

Unlike Porsche, an investment manager's positive results could have occurred because a manager was lucky. A manager's positive results could be attributable to an overall positive market environment, maybe a manager's investment style was in favor at the time, or maybe they just guessed right. Scary, I know. Or, maybe the manager was skillful and deftly navigated the changing market environment. Just like anything else in life, the truth is somewhere in the middle, and that's the rub.

The Morningstar star rating is a past performance measure. The essence of the star rating system is to box up mutual funds into similar categories (styles) and then compare and rank their returns, scaled for risk, over common historic time periods, and then apply a star rating of 1 to 5 to a fund. The implication that the marketplace has accepted is that mutual funds with a 5-star rating are the best at what they do, and mutual funds with a 1-star rating are the worst. At first blush, this feels right. It is a commonly accepted approach, it includes data and formulas, and it is produced by Morningstar – a widely known industry brand. However, our experience tells us that this approach is flawed, and we are not the only skeptics.

The Wall Street Journal published a well-researched independent critique of the Morningstar star rating classification (*The Morningstar Mirage*) and came up with some clear evidence that the system is unreliable. From a future performance standpoint, the evidence suggests that most 5-star rated, and 1-star rated funds for that matter, gravitated towards being 3-star funds in the future. The implication is that most top and bottom performing funds from the past became average performers in the future. The future performance of 5 star rated funds, after the fact, was probably no better than random selection.

An important reason why the Morningstar star rating system has been shown to be an unreliable indicator of future returns is that investment management is not a "product". Sure, maybe if a mutual fund is highly structured as an index or index-plus type portfolio, then it could be construed as a product with similar alternatives. But, we at Frontier are not interested in investing in "products". We believe the mutual funds that offer the most potential for added value are those that do not fit into an industry standard box. We seek to invest in mutual funds managed by experienced management teams using their independent judgement to provide our clients with value added return for risk outcomes. In this, less fungible, universe of actively managed mutual funds, not many management teams, processes, or investment approaches are similar or comparable. Moreover, return achieved in one specific historic time period is certainly not indicative of all possible future outcomes for a manager, and these returns could be attributable to either, or both, luck and skill.

This all sounds like common sense, yet the industry still focuses on making decisions based on boxing mutual funds, managed accounts, and even asset managers into like categories and ranking their past performance. Contrary to this perspective, evidence shows that skilled investment managers are unique and not comparable, and that past performance is not indicative of future returns.

Parsing out luck from skill from a manager's track record, or thousands of mutual fund managers' track records for that matter, is not easy. Many have simply given up and taken the easy way out and turned to indexing. But for those that are committed to the work, added value from mutual fund selection can deliver excess returns, reduced risk, and a more consistent return experience. Frontier has provided these attributes to our investors over the past 18 years through our endless efforts to pursue the best investments we can for our clients and avoiding shortcuts.

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Grind, McGinty and Krouse, *The Morningstar Mirage*. The Wall Street Journal (25 October 2017). Retrieved from https://www.wsj.com/articles/the-morningstar-mirage-1508946687.

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