Has the Morningstar Rating System Become a Costly Prophecy for Mutual Fund Investors?

Ignoring something new because something old is familiar makes you comfortable. Because you are comfortable that doesn’t mean you are safe. Following the herd can leave you without choice.

For ages, certain advisors have bemoaned that too many clients insist on putting their money only into four or five-star rated funds despite admonitions that the ratings are backward-looking.

“History is strewn with examples where star fund managers have fallen to earth when their luck or skill deserted them, but the Morningstar ranking adjusted only slowly downwards, with Legg Mason’s Bill Miller perhaps being the most prominent example.”

Source: "Morningstar: A force to be reckoned with" By Stephen Foley.

Despite the evidence, investors routinely follow Morningstar’s (MORN: $68/share) ratings because they know the firm’s influence on money flows is unmatched. From the same Financial Times article above:

“Repeated academic studies have shown that, when the Morningstar algorithm spits out a change to a fund’s performance ranking, money will pour in or out.” Money talks right? And Morningstar has by far the loudest voice when it comes to mutual fund flows.

Investors see this self-fulfilling cycle as a safety net for their investment strategy. I would argue that Morningstar’s influence has reached a point where they are right even if they are wrong. In other words, no matter how good the fund, its manager or its securities selection, if Morningstar says it is good, then so much money pours in to the fund that the underlying holdings of the fund can get a short-term boost as the manager puts the new money to work. On the other side of the coin, a poor rating from Morningstar can lead to serious outflows and, in the worst case, the fund shutting down.

It’s a self-fulfilling prophecy, and one with costly consequences.

The Hidden Costs We Ultimately Pay

Morningstar’s influence on fund flows carries several hidden costs for investors. For example, the Financial Times article referenced above also mentions that many mutual fund managers hire executives specifically to manage relations with Morningstar. Who do you think pays those executives salaries? Investors do, usually in the form of higher fund fees.

In addition, fund managers sometimes pursue suboptimal strategies in order to cater to the Morningstar ratings system. David Blanchett offers a great analysis of one of these distortions in his paper “Gaming the system: the impact of Morningstar category changes on peer rankings” in the Journal of Investing.

Blanchett discovered that underperforming fund managers in one category will sometimes “drift” into different categories where their relative ranking looks better. Funds that engaged in this style drift saw significant fund inflows after making the switch, but they went on to underperform their new peers. Even worse, fund managers pursuing this strategy typically saw their new category underperform their old one, further hurting returns for shareholders.

Blanchett sums up the issue perfectly at the end of his paper: “In the aggregate, changing Morningstar category benefited the portfolio manager through an equivalent [relative] performance boost of 50 bps and higher fund inflows yet provided little or no future performance benefit to the shareholders.”

This paper and others show that the dominant influence of Morningstar on fund flows has the potential to create these kinds of backwards incentives for fund managers, where a move that hurts investors benefits the manager’s salary. Imagine investing in a small-cap value fund only to find out a few months later that it has transformed into a mid-cap blend fund in order to improve its ranking versus peers.

Too Big To Fail

I’ve already discussed why investors need independent fund research. I believe the market as a whole needs more independent research as well. One institution having too much influence on the rating of
securities can have damaging effects. Remember how the major ratings agencies all gave sub-prime mortgage backed securities AAA ratings in 2007?

Morningstar has become “too big to fail” in the sense that issues with their ratings can reverberate throughout the industry. If Morningstar gives positive ratings to risky funds, millions of dollars in investor assets could flow into dangerous funds and their holdings.

Markets with a large number of independent estimates of value are likely to be more efficient, even if those estimates are all individually flawed (See "Market Efficiency and the Bean Jar Experiment"). It’s only when investors start succumbing to groupthink, as they do at the peak of bubbles, that markets become inefficient.

A dominant voice increases the chance of investor groupthink. And I think it is fair to say that Morningstar’s voice is the most dominant in all of research as their ratings have the ability to move billions of dollars in investor assets. When one voice can move the market to that extent, the potential for instability and inefficiency increases.

The market not only needs multiple voices analyzing mutual funds, but also holdings-based research that offers an alternative to Morningstar’s backward-looking ratings. The more voices we have in the market, the healthier it will be.

Sam McBride contributed to this report
Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector or theme.
New Constructs® – Profile

How New Constructs Creates Value for Clients

1. Superior Recommendations – Our stock picks consistently outperform. See our track record in our stock-picking accolades and Proof Is In Performance reports.


3. Time Savings – We check the fine print in thousands of corporate filings so you don't have to. As reported by Barron’s, our expertise in analyzing SEC filings delivers Hidden Gems and Red Flags that drive long-term stock-picking success.

4. Transparency – We are proud to share the results of our analysis of over 50,000 10Ks. Request the Corporate Disclosure Transgressions report we provided the SEC. Our reports detail all data and assumptions. Company Models enable users to change them.

5. Objectivity – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our presentation to the Senate Banking Committee, the SEC and many others in DC.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting, advisory and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.
DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs’ research recommendations may not coincide with the hedge fund’s holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk. All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs. Copyright New Constructs, LLC 2003 through the present date. All rights reserved.