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."
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> 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.

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