MarketWatch

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Be wary of predictive mutual-fund ratings

Commentary: No research firm has a crystal ball on the future

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — The problem with building a better mousetrap is convincing people they need it. Then you have to stave off the competition.

That's what is happening to Morningstar Inc. (NASDAQ:MORN) , which last year introduced its new "analyst ratings," marking a significant change in how its analysis system worked because it purports to tell investors which funds the firm believes will be best in the future.

Morningstar's long-established star-rating system looks at risk-adjusted past performance, and was designed to be descriptive of a fund and its results, even though investors used it as if it were the Good Housekeeping Seal of Approval.

For years, more than 90% of all money flowing into funds has gone into issues carrying Morningstar's top two star ratings; while stars are still awarded on the same criteria, they are now supplemented by the forward-looking, predictive gold, silver, bronze (or neutral/negative) of the analyst ratings.

Warren Buffett's successor picked

Warren Buffett published his annual letter to Berkshire Hathaway Inc. shareholders on Saturday. In it the billionaire investor says the company has identified a successor to him as chief executive. WSJ's Colin Barr and David Benoit discuss the letter.

If investors are going to look at more than past performance measures — whether those come from Morningstar, Lipper Inc. or simple raw performance — they should also consider the competition, a pack that is heating up in pursuit of the industry leaders.

While investors have long been able to choose from newsletters like No-Load FundX or No-Load Mutual Fund Selections & Timing, they now also have services such as FundReveal.com and analysis from New Constructs and others.

Telling fortunes

As a general rule, predicting fund performance is based on drilling into the portfolio to see the kind of issues it holds, or looking at the performance pattern of the portfolio.

New Constructs' ratings, for example, are based on the firm's stock analysis; a fund that holds many of the securities that the Nashville firm considers "most dangerous" is going to be a dangerous fund.

By comparison, FundReveal uses risk and return measures to size up "persistence"; the fund's measure on that scale indicates the decision-making ability of the fund manager.

The newsletters, meanwhile typically don't just rate funds, but also come up with portfolios for investors to follow. Still, it's a similar idea — finding the best funds for tomorrow — with a bit more guidance on when the status of those funds changes. No-Load Mutual Fund Selections & Timing uses "comets" instead of stars, tilting towards the hot sectors; similarly, No-Load FundX — which has been published since the mid-1970s — ranks funds based on recent measures of performance, buys the hot ones and holds them for as long as they outperform the competition.

Whether it is the ratings firms, websites or newsletters, David Snowball of MutualFundObserver.com noted that few "share anything about their methodology beyond the utterly vacuous. Some of the phrases come close to 'and then the magic happens.'"

That's why investors have to be wary.

"My problem with all of these prognostications is that you have no real idea how good their system is or how reliable they are, certainly not now while they are new," said industry consultant Geoff Bobroff of East Greenwich, R.I. "They're dealing with stale information on what is in the fund's portfolio, and they are dealing with the influx of derivatives and strategies for using those derivatives that I'm not sure any outsider has a hope of analyzing accurately, at least not without information on strategy that the funds don't have to give, even to the ratings firms."

What's more, just as there are thousands of patents filed on mousetraps (really), there's no guarantee that any of the newcomers will succeed. If they do, they might go the way of RiskGrades.com, a portfolio-assessment service that was building a following when it basically went away, part of MSCI's purchase of RiskMetrics that put the data off-limits to Joe Average.

"Forward-looking exercises are about as valuable as forecasting in general … not very," said Michael Falk of Focus Consulting Group in Chicago.

Time will tell whether that's true; in the meantime, fund investors should look at these exercises as interesting and intriguing, but they will want to learn a lot about how a system works before trusting any firm's ability to predict which funds will do the best in the future.

Said Bobroff: "The marketplace wants this, investors have demanded it, but that doesn't mean it works. It's just too early to tell, though it's tempting to look … and if you are going to look, then you should evaluate everyone who is doing it to see whose system you are most comfortable with. But until there's enough history to test a system's veracity and validity, you should follow these recommendations very cautiously."