Morningstar's Dominance: The Good, Bad and the Ugly

No one likes to follow the herd, but almost everybody does. Following the herd feels safe… right up until the point where the herd leads you right off a cliff.

"The Morningstar Mirage," a recent article from the Wall Street Journal, shows the dangers of herd-following in the mutual fund industry. Despite the repeated warning "past performance is not an indicator of future results," investors continue to pile into funds that get a 5-star Morningstar rating, then find themselves disappointed when the funds fail to outperform.

Morningstar's (MORN) success and growth is impressive. The firm's ability to compete and take market share from other sell-side firms deserves respect. However, the growing dominance of the firm in the research business also leads to harmful inefficiencies and distortions in the market. Investors and advisors deserve other, independent sources of research that go beyond Morningstar's backward-looking methodology.

The (Hidden) Limitations of Backward Looking Ratings

"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.

Officially, Morningstar cautions investors against treating its star ratings as predictive. "We have always been very clear that it's not intended to predict future performance," the company wrote to the Wall Street Journal in response to their findings.

In practice, the media has identified several cases of the Morningstar and its officers touting the ratings as having predictive value. For example, Morningstar's official Twitter account shared a quote from columnist Matt Levine saying "Morningstar is better at picking mutual funds than I would have expected." The company conveniently ignored that he also said he expected Morningstar to have zero ability to pick mutual funds.

Nobody Ever Got Fired for Buying a 5-Star Fund… Until They Did

"Nobody ever got fired for buying IBM" was a common cliché in corporate America for decades. IBM was the safe choice. If you bought IBM machines for your company and they had issues, you wouldn't face any repercussions because it was such a conventional, safe decision. All too often, purchasing agents would go with IBM over a smaller company that might fit their needs better to avoid any risk.

The same issue has been true in the mutual fund industry for years. Morningstar ratings are a convenient safety net. Pick a 5-star rated fund that underperforms, and people will chalk it up to bad luck. Pick a lower rated fund that underperforms, and people will question your judgement. One former adviser quoted in the WSJ piece affirmed this conventional wisdom:

"Advisers get in trouble when they go against the grain. You isolate yourself more if you sell something else rather than just go with what research recommends."

However, other conversations in the article indicate that Morningstar ratings no longer provide the cover they once did. One municipal police pension fund in Illinois found itself disappointed with the return of its 5-star fund. The pension board left its Morgan Stanley (MS) broker for a local one in part due to Morgan Stanley's reliance on Morningstar ratings.

Investors increasingly understand that Morningstar's fund ratings do not constitute sufficient diligence to serve as the entire basis of an investment recommendation.

The Hidden Costs of and Forces Behind Morningstar Ratings

Morningstar rating changes have a huge impact on fund flows as investor money piles into top rated funds. As a result, fund managers will often do or spend whatever it takes to get the best rating.

Many fund managers hire executives specifically to manage relations with Morningstar. They also lobby heavily (see Financial Times: "Morningstar: A force to be reckoned with") to earn the best "Analyst Rating," the more qualitative alternative to the star ratings that Morningstar unveiled in 2011. These executive salaries and lobbying activities translate into higher fees for investors.

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.

In essence, the dominance of Morningstar's research created a situation where it was more profitable for fund managers to pursue a course that hurt investors returns.

One Dominant Voice Creates Market Inefficiencies

More broadly, Morningstar's dominant voice in the fund industry creates the potential for groupthink and market inefficiencies. 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"). When one institution can impact investor flows the way Morningstar does, you lose some of that independence, which increases the potential for instability and inefficiency.

The market needs multiple, independent voices analyzing mutual funds and their holdings to serve as alternatives to Morningstar's overly dominant and, often, backward-looking ratings.

According to the Expert: Proper Fund Research Requires Diversity of Research Providers

Fund industry expert Chuck Jaffe wrote an article a few years ago about how he picks a new fund. In the article, he writes that before settling on a fund, he checks with Morningstar, Lipper, and New Constructs. In addition to checking with analysts, Mr. Jaffe does a great deal of diligence on his own by reading fund newsletters, examining costs, and figuring out tax impacts.

The key here is that Mr. Jaffe consults several sources of research, along with his own due diligence, before making a decision on a fund. If he likes a fund, he specifically looks for research that contradicts his thesis to see if his conclusions still hold up.

Investors deserve this level of diligence. Brokers and advisors that just buy 5-star rated funds without consulting other research or performing their own diligence are not fulfilling their fiduciary duty.

This article originally published on November 2, 2017.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

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