Morningstar – Is it the Silver Bullet?

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A Fiduciary is evaluated on the basis of process not results. For example, in *DeBruyne vs. Equitable Life Assurance Society*, the court was unwilling to find that a money manager had violated its duty of prudence merely because an account that it managed had lost money in the 1987 stock market crash. "The focus is whether the trustees, at *the time they engaged in the challenged transactions,* employed the appropriate methods to investigate the merits of the investment. A conclusion of mismanagement or ineptness does not automatically follow from an investment's failure to yield the anticipated return (or any return). The investment's ultimate success or failure is not the proper standard for the fulfillment of fiduciary duties. ERISA requires prudence, not prescience." *(Emphasis added)*

If process is scrutinized more closely than results, the entity that provides a proven process should succeed in attracting loyal converts to their methodology and that methodology would quickly gain the reputation as the industry's silver bullet. Again, the question at hand is, has Morningstar achieved the status of silver bullet?

Is Cost a Factor:

If popularity is a measure of silver bullet status, Morningstar's is a clear winner. Unfortunately, it seems highly unlikely that popularity could be successfully used as criteria in defense of and/or support of an investment selection process. However, one must evaluate if Morningstar's popularity is indicative of exhaustive research performed by other competent investment advisors which has unequivocally proven that Morningstar has created a superior process or if the popularity of Morningstar is driven by cost. Accordingly, our analysis reveals that Morningstar is a cost effective investment research tool deserving a place in most every investment advisor's analytical tool box, but it does not achieve silver bullet status which so many advisors and investors bestow upon it.

Advisors and investors have easy access to free Morningstar information at www.morningstar.com . However, the best information Morningstar has to offer the market is available by subscribing to Morningstar Principia Pro at a cost of approximately $1200 per year. For many investment advisors, Morningstar Principia Pro is the only analytical tool relied upon for determining investment recommendations.

At such a reasonable cost, it begs the question for investors, why not buy Morningstar rather than hire an investment advisor? First, consider that the average mutual fund 12b-1 is 25 basis points (one quarter of one percent). At that rate, fiduciaries of portfolios greater than $480,000 would be better served to buy Morningstar Principia Pro directly than pay more for the advice offered through an investment advisor all things being equal. In fact, the Employee Retirement Income Security Act of 1974 (ERISA) clearly demands a retirement plan sponsor to evaluate the reasonableness of asset based fees (see ERISA

404(a)(1)(A)(ii)) and to act in a capacity of a prudent expert as defined in ERISA 404(a)(1)(B). Although few plan sponsors can boast of investment talent equal to an investment expert, they can not deny the cost effective benefits of Morningstar's Principia Pro product if it is worthy of silver bullet status. Suffice to say, if Morningstar Principia Pro is the silver bullet, a level playing field for all investment advisors and investors has been created. Thus, ERISA 404(a)(1)(A)(ii) would compel fiduciaries to purchase Morningstar's Principia Pro or pay no more than $1200 for independent outside investment advice.

Fortunately for the investment industry, Morningstar Principia Pro does not make anyone an investment expert and to Morningstar's credit they agree. Thus the retirement plan sponsor that relies upon Morningstar Principia Pro or an advisor that uses Morningstar Principia Pro exclusively should reconsider both their process and, if applicable, their advisor relationship. Clearly, cost and popularity are in Morningstar's favor but neither justifies Morningstar's Principia Pro as the silver bullet. Instead, Principia Pro is a great beginning point, as Morningstar has acknowledged, for constructing an investment menu.

Morningstar Strengths & Weaknesses

Most in the industry rely heavily upon Morningstar's Star Rating, Commentary and Style Analytics. However, the demise of many of Morningstar's highly recommended 5 Star funds have shed a spot light on the ultimate value of Morningstar's Star Rating, Commentary and Style Analytics. Clearly, the integrity of regurgitated historical statistics i.e. Alpha, Beta, Standard Deviation and historic returns are not in question. Morningstar as a database of historical statistics has been highly effective, accurate and useful to investor and advisor alike. Thus, the value of the "rear-view mirror" provided by Morningstar is not in question. The real question is, "should an investor and/or an advisor rely on Morningstar's Commentary, Style Analytics and coveted Star Rating for investment direction?

The Wall Street Journal (WSJ) published an article in January 2003 which stated, "…the prediction difficulties inherent in using popular mutual fund rating and evaluation systems namely, Morningstar, Standard & Poors and Value Line. These evaluation systems are very good about identifying Mutual funds that performed well historically, but *have been mostly unreliable* when used in an attempt to predict the outcome of the mutual fund in the future". (*Emphasis added*)

The predictability mentioned is not of a type tied to the abilities of a soothsayer. Instead, WSJ is addressing the need to provide predictability in process not results. Yet, Morningstar's Principia Pro drives the investment decisions for many with little predictability merit. In fact, according to Financial Research Corporation's 2002 analysis, funds which held the coveted 4 or 5 Star rating attracted over $144 billion dollars of new assets while mutual funds with 1, 2 or 3 Star ratings experienced an outflow of assets in excess of $79 billion dollars.

To Morningstar's credit, their disclaimer states, "The Morningstar Rating is intended for use as a first step in evaluating an investment. A high rating alone is not sufficient reason for investing in a particular mutual fund." Kudos to Morningstar for this disclosure! However, how many advisors and investors have read or are familiar with this disclaimer? Does this disclaimer show up in every presentation or on every Morningstar report presented to investors? Suffice to say, rarely are investors informed that Morningstar believes their own rating system is insufficient as the exclusive source to make prudent investment decisions.

Although Morningstar suggests their tools provide the first step in the evaluation process, most advisors and investors apparently step not further. While Morningstar's ability to provide useful historical data is not in question, research indicates an unwavering reliability by advisors and investors on Morningstar's Star Rating, Style Analytics and Commentary as the main source for investment selection decisions. Who is right? Is Morningstar just humble or is there empirical evidence that suggests additional steps in the investment selection process are necessary?

In Morningstar's Own Words

Morningstar published two articles in 2004 that should be of great interest to advisor and investor alike. Both were penned by Morningstar's own Todd Trubey. The first entitled, "Low-Quality Funds with High Star Ratings" emphasized why there are 4 and 5 Star funds that Morningstar's own analyst would not recommend to any investor. In short, the article states,

> *"Ideally, you'd like to figure out how to avoid potentially dangerous funds with high Morningstar Ratings on your own."*

Whereas, the second article, "Great Funds with Low Star Ratings", touts the advantages of considering low star rated funds as core investment holdings for an investor's portfolio. According to Todd Trubey,

> *"One of the most common queries Morningstar's fund analysts are asked is "Why would you pick funds that only got 3 (or 2) stars? This question partially stems from a common misunderstanding about the Morningstar Rating for funds and our Analyst picks. The star rating is a strictly objective measurement of a fund's historical, risk-adjusted returns versus its category peers. In contrast, Analyst picks are subjective, forward-looking judgments, often with an eye toward portfolio construction."*

The words "misunderstanding", "subjective" and "forward-looking" are three key words from the above quote that most advisors and investors ignore. To make prudent investment decisions, advisors and investors must understand the idiosyncrasies of their process. In addition, portfolio construction is a blend of both science and art where subjective decisions are made after objective quantitative and qualitative analytics are digested. Here again, most users of Morningstar relied blindly upon a Star Rating which is based upon the historic risk-adjusted returns. If one uses the Star Rating as the process for portfolio construction, the initial selection produces a recommended list of five star funds. However, history has shown that many 5-Star funds eventually end up becoming flaming stars en route to a 3 or less star rating over time. Therefore, a funds Star rating alone provides a weak defense to justify a fiduciary's prudent portfolio selection.

An Academic Response

The star rating dilemma has been evaluated by numerous members of the academic world. The most recent academic analysis was prepared by Matthew R. Morey from the Department of Finance, Pace University in New York. Mr. Morey, published a research paper entitled "The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?" in which he proves, "there is a sharp drop off in performance after a fund receives its first 5-Star Morningstar rating are very consistent with the literature that show winning performance does not persist."

One must question, that if a 5-Star fund does not persist as a 5-Star fund, is the 5-Star rating a recommendation to buy high and sell low? Assuming advisors and investors make logical decisions, it would seem reasonable to assume that the 5-Star rating is a buy signal since the star rating is a measurement of a fund's historical, risk-adjusted returns versus its category peers. If an investment's historical performance is the only criteria used in portfolio construction it stands to reason that many falling stars will be replaced by new shooting stars over time. Unfortunately, the consequence of this process is a continual repetition of bad decision making followed by bad investment results. Morey's thesis supports the fact that Morningstar should not be relied upon as the process but as a tool within a more comprehensive and prudent investment selection process.

Three Reasons Morningstar is not the Silver Bullet

While a plethora of additional evidence to support this position is widely available the following is a summary of three examples which suggest Morningstar is not the silver bullet.

1. Revisions to Style Analytics:

While the most recent style revisions occurred in 2003, these enhancements cause concern that past style analytics where not be as reliable as one had expected. In fact, it is reasonable to argue that the recent changes emphasize the shortcomings and lack of reliability of past style analytics. Morningstar's style analysis starts with a holding report they receive once or, at most, twice a year. This one day snapshot of portfolio holdings supplied by the fund manager is assumed to be a reflection of a years trading activity. While, this may be an applicable and useful analysis for style reliability where the fund manager has a history of buy and hold, few actively traded funds adhere to a buy and hold strategy. Instead, most fund options experience significant portfolio turnover making a holdings based analysis unreliable in its conclusion. Again, how reliable is any style analytic tool that provides a style snapshot based upon a single day's holdings analysis? Obviously, Morningstar's style is accurate as of the date of the holdings report but that information is misleading to advisors and investors who rely on it as a reflection of a consistent investment process.

Investment research provides evidence that supports a higher probability of accuracy when more data is considered and true to an investment advisor's and investor's fiduciary obligation to plan participants, investment analysis should be exhaustive…short cuts are not acceptable! Thus, a holdings based analysis provides a starting point for testing style results using returns based analytical tools which Morningstar is not. In conclusion, advisors and investors who rely exclusively on Morningstar's style analytics have excluded an important half of the quantitative story to their own detriment. Therefore, reliance on holdings alone is a shortcoming in the investment process of fund selection and monitoring with severe financial repercussions.

2. Conflicts of Interest:

Ian McDonald, of The Wall Street Journal Online, was the first to break the story "Morningstar's Deal With Fidelity for 'Favorites' Earns Jeers, Fears," February 4, 2003. The article announces an alliance between Morningstar and Fidelity to produce a list of Fidelity Favorites. In addition to Ian McDonald's article, Roy Weitz published the following commentary on his free website www.fundalarm.com**,** on March 31, 2003:

> *Here's the theory: Fund giant Fidelity hires fund tracker Morningstar to come up with a list of "favorite" Fidelity funds......Morningstar carefully analyzes 150 Fidelity funds, using both objective and subjective criteria, and presents its list of up to 30 favorites to Fidelity.....Then, Fidelity responsibly presents Morningstar's conclusions to a confused public that is eager for independent, third-party fund advice.....Now, here's the reality,*

from a recent Fidelity print ad:

> *"Fidelity Fund Favorites: If they are good enough to be Morningstar's, chances are they'll be yours too."*

Morningstar did, indeed, come up with its list of "favorite" Fidelity funds, for an undisclosed fee, and Fidelity is, indeed, running with that list like a dog with a stolen bone.....And, contrary to our theory, Fidelity's ad does everything it can to make Morningstar's list look like a ringing endorsement.....It's only in the incredibly small print (not shown above) that some of the interesting details of the Fidelity/Morningstar relationship are revealed.....(For example: The list has been prepared by a subsidiary of Morningstar that was formed to work with institutional clients, and not by Morningstar's regular team of fund analysts.....Also, Morningstar agreed to classify Fidelity's funds into several non-standard categories, presumably with Fidelity's consent, and presumably because it achieved a result that Fidelity was satisfied with).....Meanwhile, Morningstar seems determined to push the limits of its public identity: Is it the champion of individual fund investors, or a hired gun for deep-pocketed financial services firms?.....And you know what?.....Without any serious competition, Morningstar just might be able to have it both ways.

Such information begs the question, is Morningstar producing reliable objective and unbiased research at all times? Clearly, an advisor or investor can not rely exclusively upon Morningstar's recommendations when making an investment selection decision without cross testing that recommendation against other independent sources.

3. Commentary is Flawed:

If you have access to Morningstar Principia Pro, take a gander at Morningstar's historical commentary for Fidelity Advisor Growth Opportunities. This fund was run successfully by George Vanderheiden, a large value manager, until January 2000 when the reins were turned over to the very capable Bettina Doulton, a large growth manager. The following represents selective cuts from the commentary by Morningstar:

1-18-2000 Although the loss of a manager of Vanderheiden's stature is never a plus, there is ***little reason to consider selling*** the fund.

4-28-2000 Bettina Doulton had completely revamped Fidelity Advisor Growth Opportunities Fund….Doulton hiked the Fund's ***tech stake to 46%*** assets…Doulton got the fund fully invested…It is way, way ***too early to hit the panic button*** Though…***Put simply, this fund's shareholders are in good hands***.

10-10-2000 *Giving up* on Fidelity Advisor Growth Opportunities Fund now ***is premature***, at least, ***and probably just plain Wrong***….not much has gone right here during the past couple of years…Significant bet on wireless-related issues such as Nokia and Sprint PCS, which got crushed in the third quarter…***Fund's returns is one of the worst in the large-blend*** category…

But a ***few things can be said in Doulton's favor***…Doulton's ***record gives reason to believe that this will be a solid growth-oriented core holding***. The fund's recently rotten returns are tough to stomach, but it's likely that better things lie ahead.

> **6-23-2003** ***Despite…strong recent showing, we think investors have better options***. The strong showing owes in part to the ***fine performance of blue-chip holdings***. ***Fidelity hasn't released a full portfolio for the fund since November 2002***…Since manager Bettina Doulton took the reins more than three years ago, the fund has mostly struggled. Her affinity for growth stocks is certainly paying off right now. (***emphasis added)***

If you had followed Morningstar's advice you would have violated the first guiding principle of investing…i.e. buy low and sell high. According to Morningstar you would have kept a fund that significantly changed it's investment approach from Large Value to Large Growth at the pique of the market only to sell it at the bottom of the market when the investment style was beginning to come back in favor. Although this analysis is not applicable to every fund's commentary, it is not an isolated case. Therefore, Morningstar's commentary should be scrutinized thoroughly and cross tested against other sources and personal research versus blind reliance.

Again, Morningstar provides a great rear view mirror look at a fund manager's historical statistical data. Based upon this analysis, the Star Rating, Commentary and Style Analytics have flaws. Thus we agree with Morningstar, that Principia Pro provides advisors and investors a great beginning point for fund research. However, Morningstar is not the silver bullet which should cause a thunderous applause by advisors everywhere. If Morningstar were the silver bullet, there would be no need to hire an investment advisor for their expertise. Or, if Morningstar's Principia Pro was dubbed the silver bullet, an advisor, at best, would find the market could bear a fee of $1200 for their expertise and no more.

Fortunately, investors, particularly retirement plan fiduciaries, are obligated to retain investment expertise when the investment expertise does not reside within the investment committee structure. A fiduciary who relies on Morningstar analytics alone makes a terrible judgment call, exposing both personal and corporate assets to potential legal pillaging with imprudence and fiduciary negligence as the cause of action. Of course, the same applies to the advisor who relies exclusively on Morningstar to justify their investment selection process. For the fiduciary who has hired an advisor whose investment process relies exclusively on Morningstar caveat emptor.

In conclusion, Morningstar provides a cost effective investment analytics tool that provides valuable historical data for advisors and sophisticated investors to evaluate portfolio holdings within a comprehensive investment process. However, Morningstar is not the silver bullet and should not be relied upon exclusively to defend a prudent and comprehensive investment process. According to the court's decision in *Katsaros vs. Cody,* "The test of prudence is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment." Clearly, the advisor or investor/fiduciary that can document a prudent and comprehensive process to investigating the merits of the investments selected will successfully mitigate both personal and corporate fiduciary risk, which remains the ultimate objective.

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