Do ratings have predictive value?

Relying on past performance may not be a viable investment strategy.

By Baird's Asset Manager Research

Mutual fund ratings are a common measuring stick against which fund managers are evaluated. The most common, Morningstar's star rating system, is easy to interpret and serves as a reasonable gauge of how well a fund manager has historically performed relative to peers. "Historically" is the operative word, though – by definition, these rating systems are backward-looking, focusing on past performance.

Over the 10-year period ending December 2013, there has been a $730 billion gap between the flows into funds rated five stars by Morningstar[1] and out of funds rated one star. It is clear money shifted toward better-performing options, largely based on the anticipation that past performance trends will continue into the future. The question is, does the data bear out that assumption? How much is *past* performance indicative of *future* performance? This analysis examined historical performance data to determine the predictive value of mutual fund ratings.

Note that this is not a validation or an indictment of any rating system or data provider. We often hear objections to investing in lower-rated funds and see advertisements touting higher-rated funds. There is a perception that ratings are a reflection of the skill an investment manager may or may not possess. Anything used to make a financial decision should be carefully vetted, and the purpose of this analysis is only to determine whether there is merit to concluding that a returns-based rating system has any bearing on future performance.

Methodology[2]

In our view, three years is a good approximation of the average holding period for a mutual fund investment. This analysis spans the 2005 – 2013 timeframe using three distinct three-year periods (2005 – 2007, 2008 – 2010, 2011 – 2013). These periods in particular are also representative of different market climates, which is important because prevailing market conditions tend to influence how well an investment style fares.

[1]Any reference to "ratings" or "star rating" refers to the Morningstar star rating system. See disclosures for the methodology.

[2]See disclosures for a detailed description of the methodology used.

Ratings cannot be trusted for U.S. stock funds without understanding the true drivers of performance.

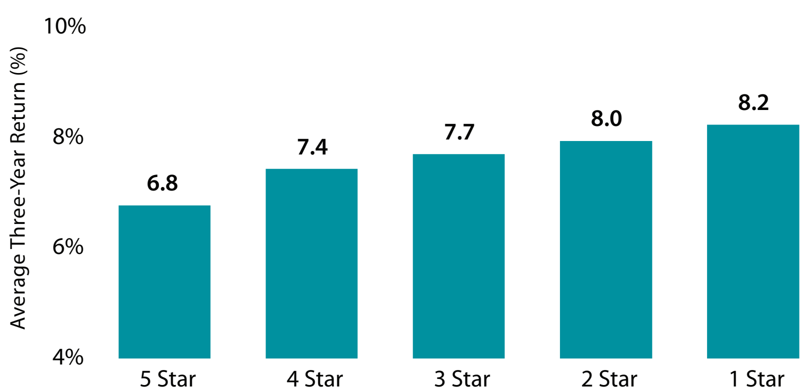
Mutual funds were grouped based on Morningstar's overall star rating at the beginning of each period, and performance was then measured over the subsequent three years. This process was repeated for major stock and bond asset classes. In total, more than 4,400 observations were collected and aggregated.

Results

U.S. Stock Funds. Our findings for U.S. stock funds were intriguing: Ratings were *negatively predictive* of future performance. In other words, funds with higher ratings generally underperformed those with lower ratings over these three-year periods. Graph 1 shows a clear trend of one-star funds outperforming five-star funds by 146 basis points (1.46 percentage points) on average. That's an additional $445 per $10,000 invested. This trend held in all three time periods and across five of the six styles evaluated. Interestingly, five-star funds not only underperformed one-star funds, they performed the worst of all categories.

GRAPH 1:

U.S. Stock Funds



Source: Morningstar Direct, Baird analysis.

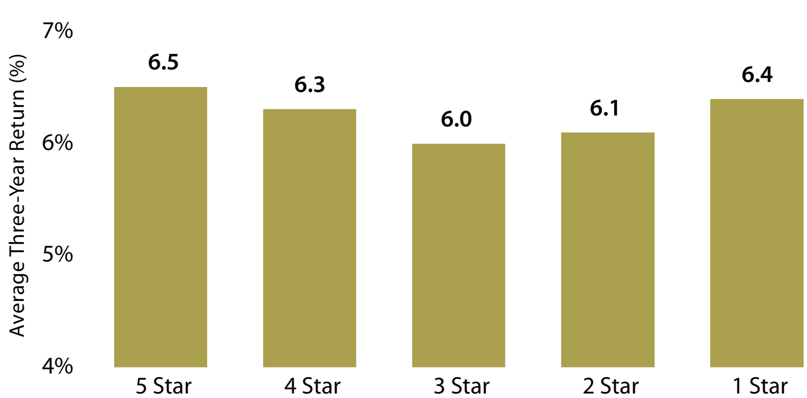
These results do *not*, however, lead us to make a blanket endorsement of all lower-rated U.S. stock funds. Strategies struggling with poor performance may also be faced with additional business risks such as declining assets. It is also very realistic that some managers simply lack skill.

The more important takeaway is that ratings cannot be trusted for U.S. stock funds without understanding the true drivers of performance, including reconciling the management team's selection process against what has or hasn't been rewarded by the stock market. Investors relying too heavily on past out-performance may be setting themselves up for future under-performance.

International Stock Funds. It is important to examine if similar trends hold across major asset classes. We used the same methodology to evaluate international stock funds and interestingly found no discernible trend between ratings and future performance. In fact, an investor could have selected a fund regardless of rating and found similar results, on average (see Graph 2). The patterns between ratings and returns varied greatly based on time period and investment style. Some investors could have found success in letting ratings dictate investment opportunities, while it would have been to the detriment of others. Either way, ratings offered little use to investors in this asset class.

GRAPH 2:

International Stock Funds



Source: Morningstar Direct, Baird analysis.

No one knows what the future holds. Rather than relying solely on past performance, investors may be better served by applying a more comprehensive fund evaluation system designed to provide durability and flexibility, and supported by a team of professionals who act as valuable stewards of capital.

Bond Funds. Turning our attention to bond funds led to a third conclusion: Ratings and performance actually did exhibit a positive relationship. As depicted in Graph 3, funds rated five stars outperformed one star-rated funds by a full percentage point, on average. That being said, similar to our advice regarding the trends found with U.S. stock funds, we would avoid drawing the conclusion that a five-star bond fund is automatically superior. The 2005–2013 timeframe for this study doesn't capture as diverse a range of market climates for bonds as it does for stocks. For example, taking credit and interest rate risks worked well for most of this period.

Putting it All Together

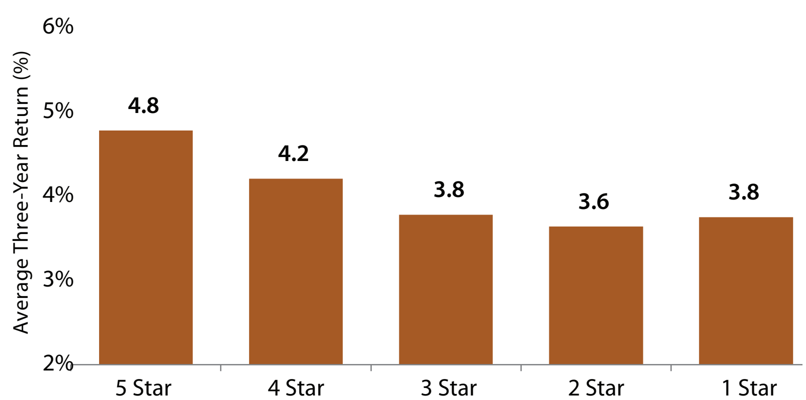
Positive trends, negative trends, no trends – how is anyone supposed to interpret these results? In our view, there is no substitute for a thorough analysis of any investment opportunity. Relying solely on mutual fund ratings (or any indicator of past results) can give investors a false sense of security.

This is not to say that ratings and past performance aren't useful. Historical performance can be a fine litmus test of whether an investment has behaved as expected during various market conditions, and such information should not be discounted. Ratings can provide directional guidance, but they offer little in terms of predictive ability.

No one knows what the future holds. Rather than relying solely on past performance, investors may be better served by applying a more comprehensive fund evaluation system designed to provide durability and flexibility, and supported by a team of professionals who act as valuable stewards of capital.

GRAPH 3:

Bond Funds



Source: Morningstar Direct, Baird analysis.

If you have questions or need more information, please contact your Financial Advisor.

Please consider the investment objectives, risks, charges and expenses of a fund carefully before investing. This and other information is found in the prospectus or summary prospectus. For a prospectus or summary prospectus, contact your financial advisor. Please read these materials carefully before investing. Past performance is no guarantee of future results.

Methodology

The Morningstar Rating™ for funds methodology rates funds based on an enhanced Morningstar Risk-Adjusted Return measure, which also accounts for the effects of all sales charges, loads, or redemption fees. Funds are ranked by their Morningstar Risk-Adjusted Return scores and stars are assigned using a one- to five-star scale. Funds are rated for up to three periods – trailing three, five and 10 years – depending on the life of the fund.

The Overall Morningstar Rating for a mutual fund is derived from a weighted average of the performance figures associated with its three-, five and 10-year (if applicable) Morningstar Rating metrics.

The asset classes (as defined by Morningstar) for each investment group are as follows: U.S. Stocks (Large Value, Large Blend, Large Growth, Small Value, Small Blend, Small Growth), International Stocks (Foreign Large Value, Foreign Large Blend, Foreign Large Growth), and Bonds (Short-Term Bond, Intermediate-Term Bond, Muni National Short, Muni National Intermediate). These mutual fund universes were limited to the share class with the longest performance history and excluded index funds, asset allocation funds and fund of funds. Mutual funds in each asset class were grouped based on the Morningstar Rating at the beginning of each period. For example, all funds rated 5 stars at the beginning of 2005 were identified and then performance was measured through 2008. The average of the three-year performance for each rating group was measured and a weighted-average calculation was used to report the aggregate results.

For each fund with at least a three year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star.