Morningstar

On October 26th the WSJ published a front page exposé of Morningstar and its rating systems. What follows is edited versions of it, 1 of Morningstar's 3 response, and our thoughts:

Mutual-Fund Ratings Are Not What They Seem

Morningstar's top-ranked funds rarely sustain high performance

By Kirsten Grind, Tom McGinty and Sarah Krouse

Millions of people trust Morningstar to help them decide where to put their money.

From pension funds to endowments to financial advisers to individuals, investors rely on Morningstar's star ratings to help divide $16 trillion among America's mutual funds, in much the way shoppers use Amazon's ratings to pick products. A lot of these investors, and the people paid to guide them, take for granted that the number of stars awarded to a mutual fund is a good guide to its future performance.

By and large, it isn't.

The Wall Street Journal tested Morningstar's ratings by examining the performance of thousands of funds dating back to 2003, shortly after the company began its current system. Funds that earned high star ratings attracted the vast majority of investor dollars. Most of them failed to perform.

Of funds awarded a coveted five-star overall rating, only 12% did well enough over the next five years to earn a top rating for that period; 10% performed so poorly they were branded with a rock-bottom one-star rating.

The falloff in performance was even more dramatic for domestic stock funds, the largest category of U.S. funds by assets.

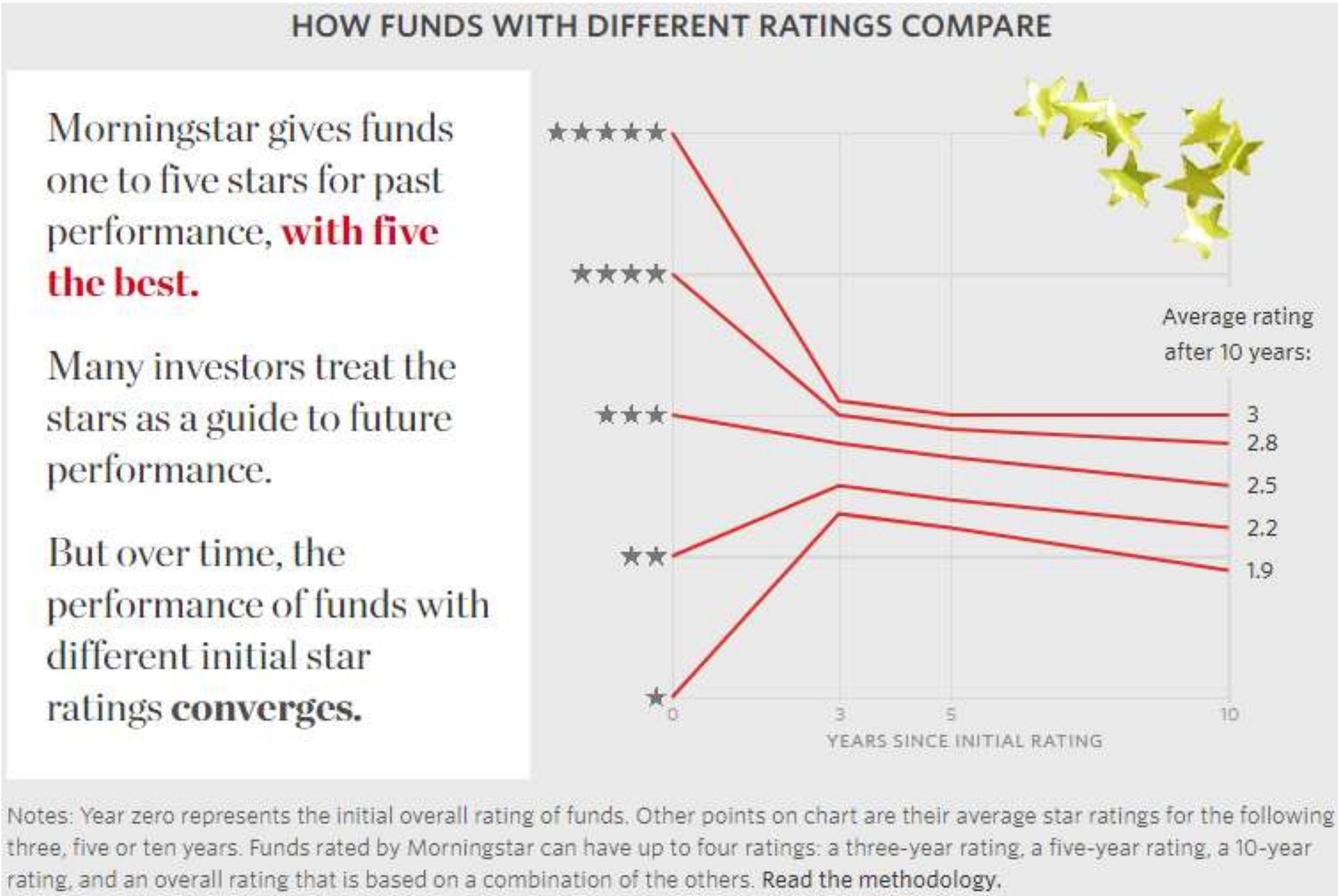
Billions of investor dollars hang in the balance. Nearly every asset manager in the world pays Morningstar for data services. Some 250,000 financial advisers rely on Morningstar's data, services or ratings, according to the firm. That means Morningstar's analysis and ratings influence investment decisions for a vast landscape of retirement plans and brokerage accounts.

Morningstar's reach is so pervasive that the ecosystem for buying and selling mutual funds revolves around it. Fund companies heavily advertise their star ratings. Money typically pours into funds after they receive a five-star rating from Morningstar, the Journal found. It flows out if they lose stars.

There is no question that Morningstar has greatly improved the transparency and rigor of data on mutual funds' holdings and performance, making it easier for individual investors to compare funds.

Morningstar says it has never claimed its star ratings suggest how funds will perform in the future. The star system is strictly backward-looking, assessing past performance, the firm says. "We have always been very clear that it's not intended to predict future performance," the company said in a written statement.

"The star rating works well when it's used as intended: as a first-stage screen that helps identify lower-cost, lower-risk funds with good long-term performance," Morningstar said. "It is not meant to be used in isolation or as a predictive measure. Reversion to the mean is a powerful force that can affect any investment vehicle."



The firm sends conflicting signals about the star ratings' predictiveness. A study published by Morningstar last month said the stars point investors to funds "likelier to outperform in the future."

Morningstar founder Joe Mansueto said in an interview that the firm's analysis of past ratings found "some modest predictive value." Chief Executive Kunal Kapoor, in another interview, called the star system "a better predictor than it ever has been."

In its written statement to the Journal, Morningstar said its analysis has found "the Star Rating is moderately predictive," which "conforms to what we'd expect of a backward-looking, entirely quantitative measure."

The Journal's analysis found that most five-star funds perform somewhat better than lower-rated ones, yet on the average, five-star funds eventually turn into merely ordinary performers.

Inside Morningstar, some employees have expressed discomfort about how much investors rely on the ratings. Stephen Wendel, head of behavioral science at the Chicago-based firm, wrote in the June/July issue of Morningstar magazine that part of his job was "examining whether we are contributing to abuses in the industry," and said: "Morningstar's star ratings for funds are clearly used in the industry to imply that funds that performed well in the past will do so in the future."

He added, "That needs to change."

Morningstar's Mr. Mansueto, 61 years old, said the star rating system "is a way to whittle down a big universe into something more manageable." The firm said it has worked to make investors understand the star ratings should be just a starting point for their research.

Since 2011, Morningstar has had a second rating system, lesser known and of limited scope, that includes analysts' opinions. Unlike the star ratings, it is designed to be forward-looking, Morningstar says. In this system, too, the Journal found the performance of funds rated high, low and in between tended to converge after several years. ...

Morningstar groups funds into categories based on their investing style or area, more than 100 groups in all. It compares funds not to all other funds, nor to the overall market, but to other funds with the same investment focus. The top 10% of funds in each group receive five stars, the bottom 10% get one, and the rest get two, three or four.

The ratings don't reflect raw performance, but performance adjusted for funds' degree of risk. To make that calculation, Morningstar uses an algorithm Mr. Mansueto devised that reflects the variation in funds' month-to-month returns.

The firm rates funds on how they did over three years—plus over five years and 10 years if they're old enough—and assigns them an overall rating based on the others. A fund thus could have as many as four ratings from Morningstar, though most investors see only the overall one. New star ratings come out each month.

Most mutual funds have multiple "classes," each charging a different expense fee. Since varying expenses spell varying returns, Morningstar rates each class of each fund separately.

Its star ratings covered more than 10,800 mutual funds—and almost 39,000 share classes—during the 14 years studied by the Journal. The only qualification to be rated is being in business three years. The ratings include index funds, which try to mimic the performance of markets.

(The Journal's analysis didn't include exchange-traded funds, or ETFs, which trade throughout the day like a stock and usually mirror an index. Morningstar began rating ETFs alongside ordinary mutual funds late last year, after the period covered by the Journal's analysis.)

Going back to 2003, the Journal examined the rating of every investment class of every fund, in every month, and how these changed over time—some three million records in all. ...

For funds that had an overall five-star rating at any point, the Journal found that their average Morningstar rating for the following five years was three stars—in other words, halfway between the top and the bottom.

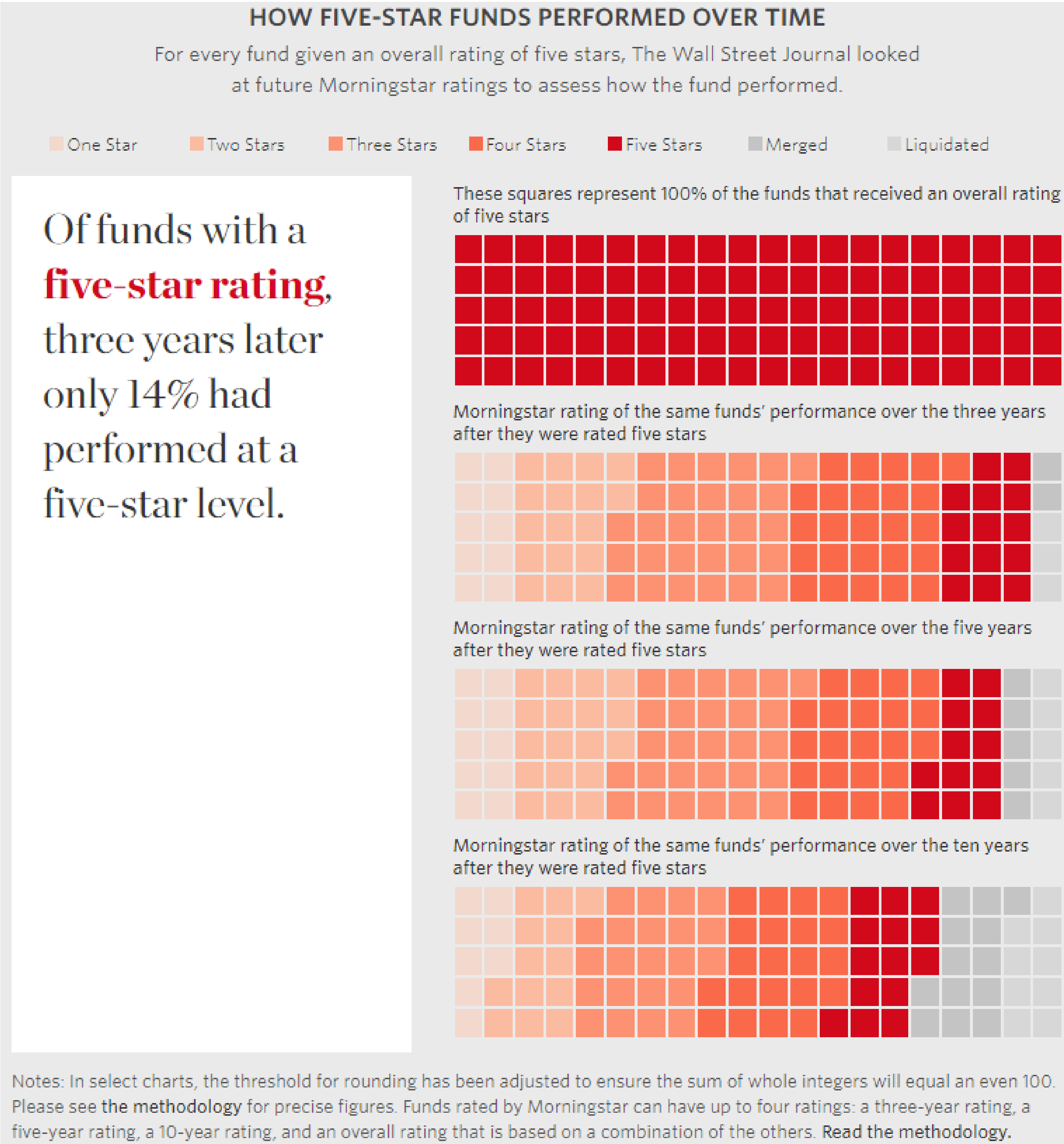
When funds picked up a fifth star for the first time during the period included in the Journal's analysis, half of them held on to it for just three months before their performance and rating weakened.

The findings were especially stark among U.S.-based domestic equity funds. Of those that merited the five-star badge, a mere 10% earned five stars for their performance over the following three years. Only 7% merited five stars for the following five years, and 6% did for 10 years.

For all of the measured periods—three, five and 10 years—five-star domestic equity funds were more likely to turn in a one-star performance than a top one.

That means a five-star rating for the equity funds was no more an omen of success than it was one of failure. ...

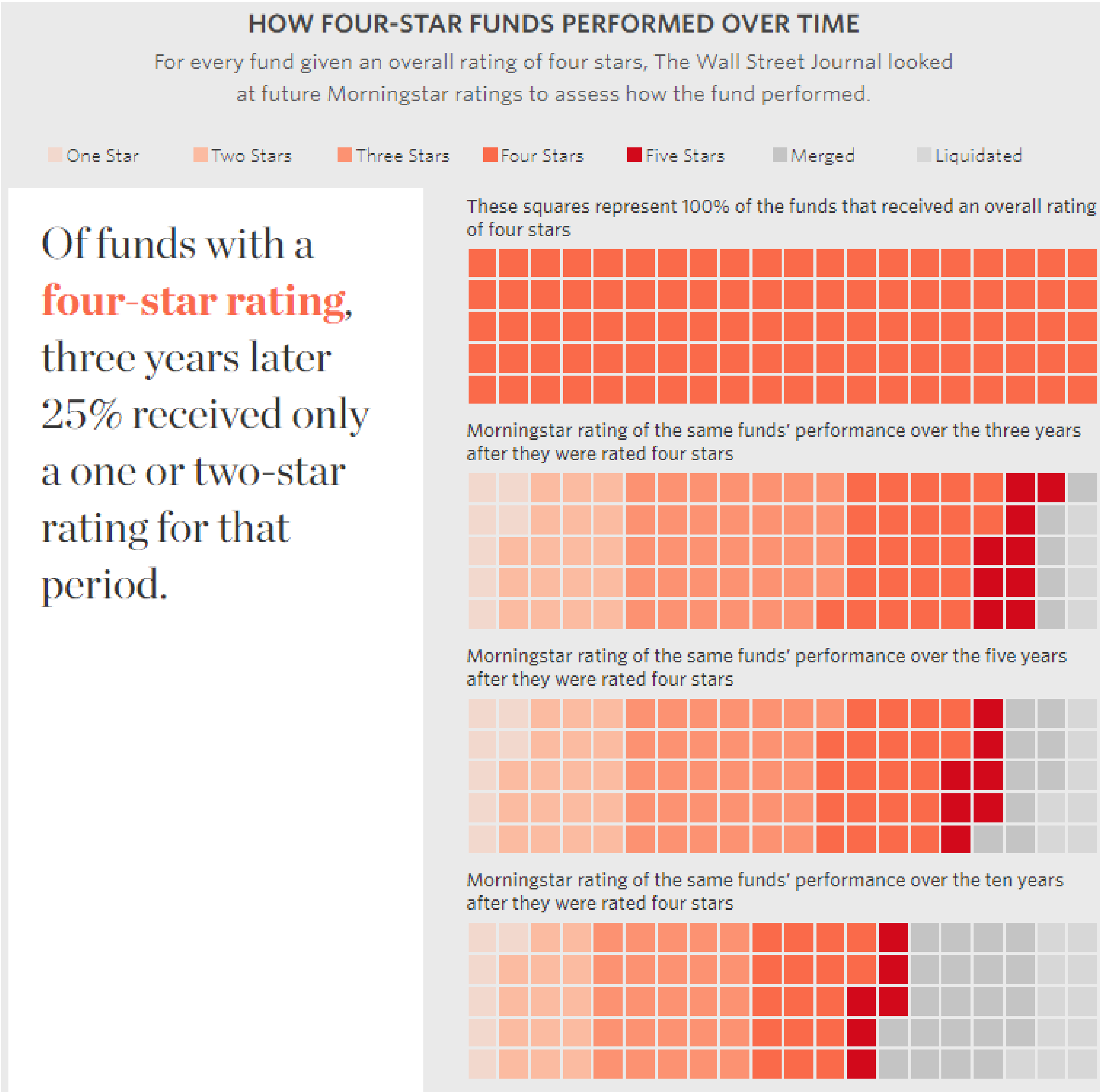
The Journal's analysis found that investors put new money into five-star-rated funds in 69% of the months they held that rating, compared with 29% for one-star funds. The Hickory Hills investment was part of $184 million investors put in the Santa Barbara fund in 2011 when it had five stars.



Morningstar acknowledged its ratings can influence demand, though Mr. Mansueto says he believes investors typically move money mainly based on a fund's performance, not its star rating.

The Journal found more than a dozen cases where well-performing funds attracted few investors until they won a fifth Morningstar star. ...

Inflows sparked by high star ratings are especially important for managers of actively managed funds now that more investors have migrated to passive ones that just try to match an index. On calls with securities analysts,

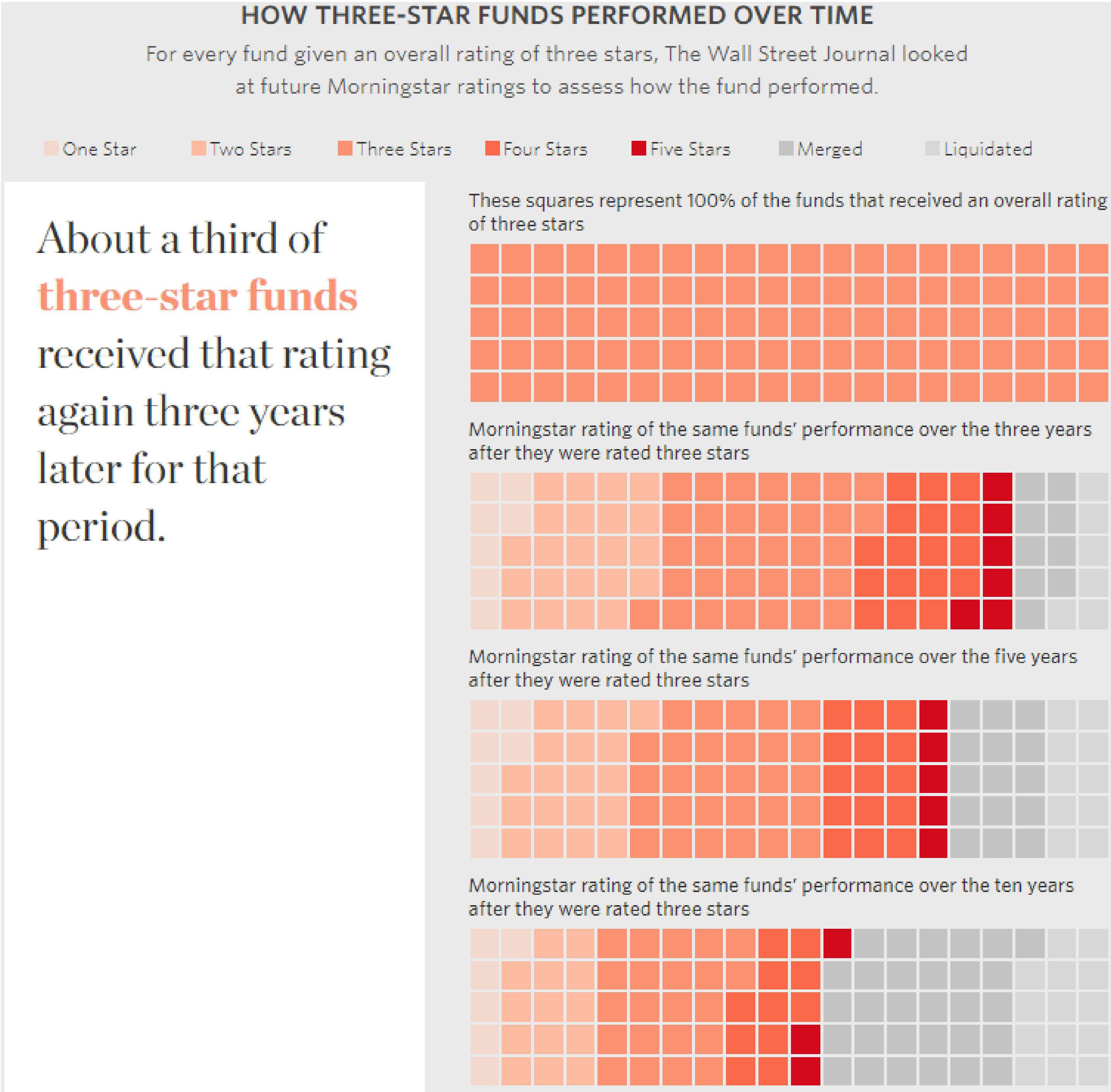


Notes: In select charts, the threshold for rounding has been adjusted to ensure the sum of whole integers will equal an even 100. Please see the methodology for precise figures. Funds rated by Morningstar can have up to four ratings: a three-year rating, a five-year rating, a 10-year rating, and an overall rating that is based on a combination of the others. Read the methodology.

fund-company chiefs often trumpet how much of their asset total is in four- and five-star funds, as a sign of the companies' ability to attract cash. ...

Current and former Morningstar employees said some advisers use the ratings as a crutch.

"It's a cover-your-ass type of service," says Samuel Lee, a former strategist at Morningstar. "An adviser can say, 'I'm going to put you in this fund, it's a 5-star fund,' …and if something goes wrong the adviser can shunt blame to Morningstar."



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Scott Jennings, a former Morgan Stanley financial adviser, recalled struggling last year to explain to a company's employees which funds they should choose in their retirement plans. He decided to keep it simple and told them, "You only have two funds rated by Morningstar—one's a two-star and one's a four-star. Go with the four-star." He could see a look of understanding flash across their faces.

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

HOW TWO-STAR FUNDS PERFORMED OVER TIME

For every fund given an overall rating of two stars, The Wall Street Journal looked at future Morningstar ratings to assess how the fund performed.

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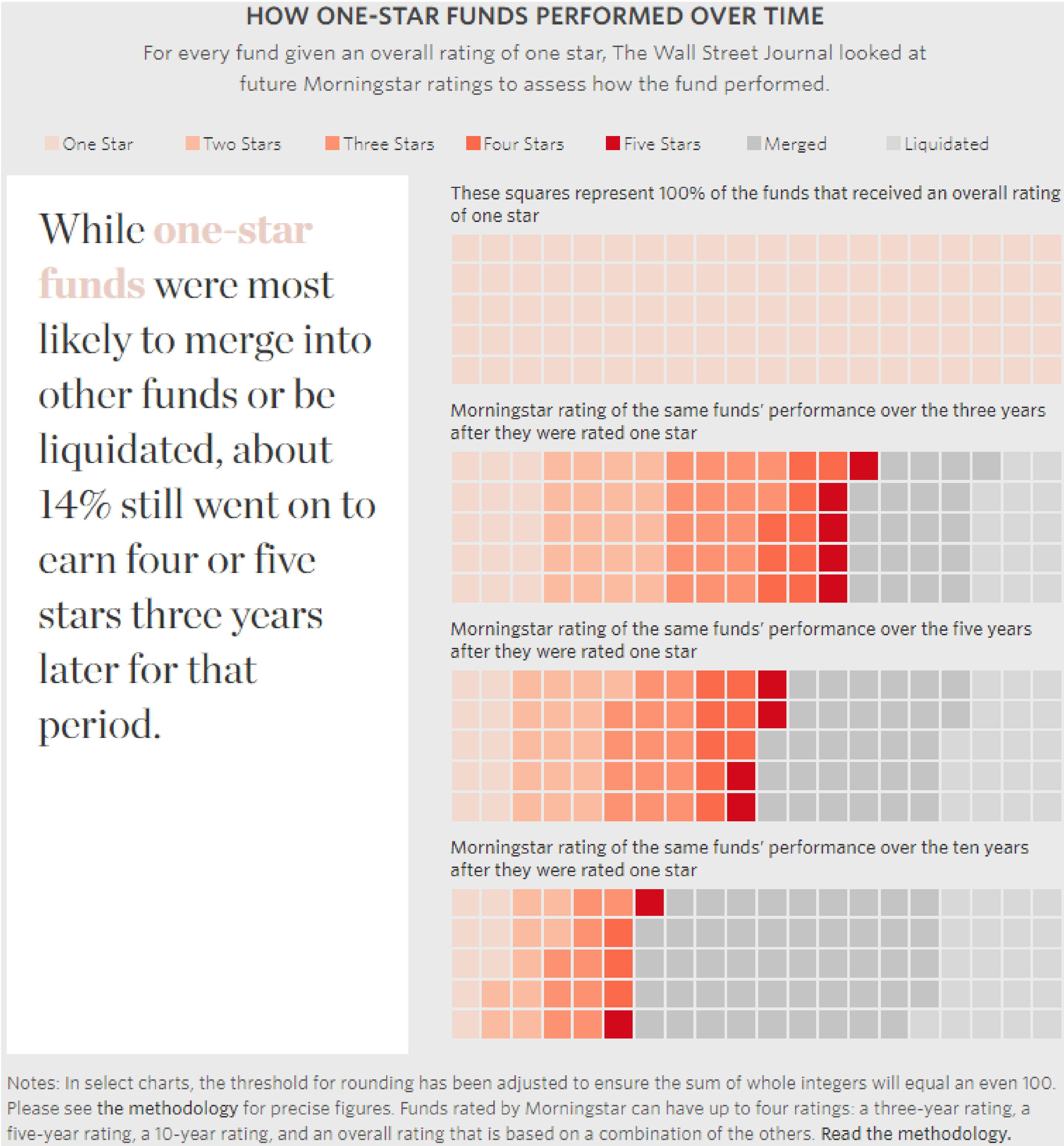
Morningstar said if advisers use the ratings this way, "this is a fault with the users of the ratings, not the ratings.... If an advisor wants to do proper due diligence, we provide a robust set of information." The firm's marketing cautions that "a high rating alone is not a sufficient basis for investment decisions."

Morgan Stanley declined to comment.

Fund firms often cite Morningstar ratings in their advertising—at times even out-of-date ones. AllianceBernstein ran an ad for nine of its funds in a spring edition of Private Wealth magazine, citing star

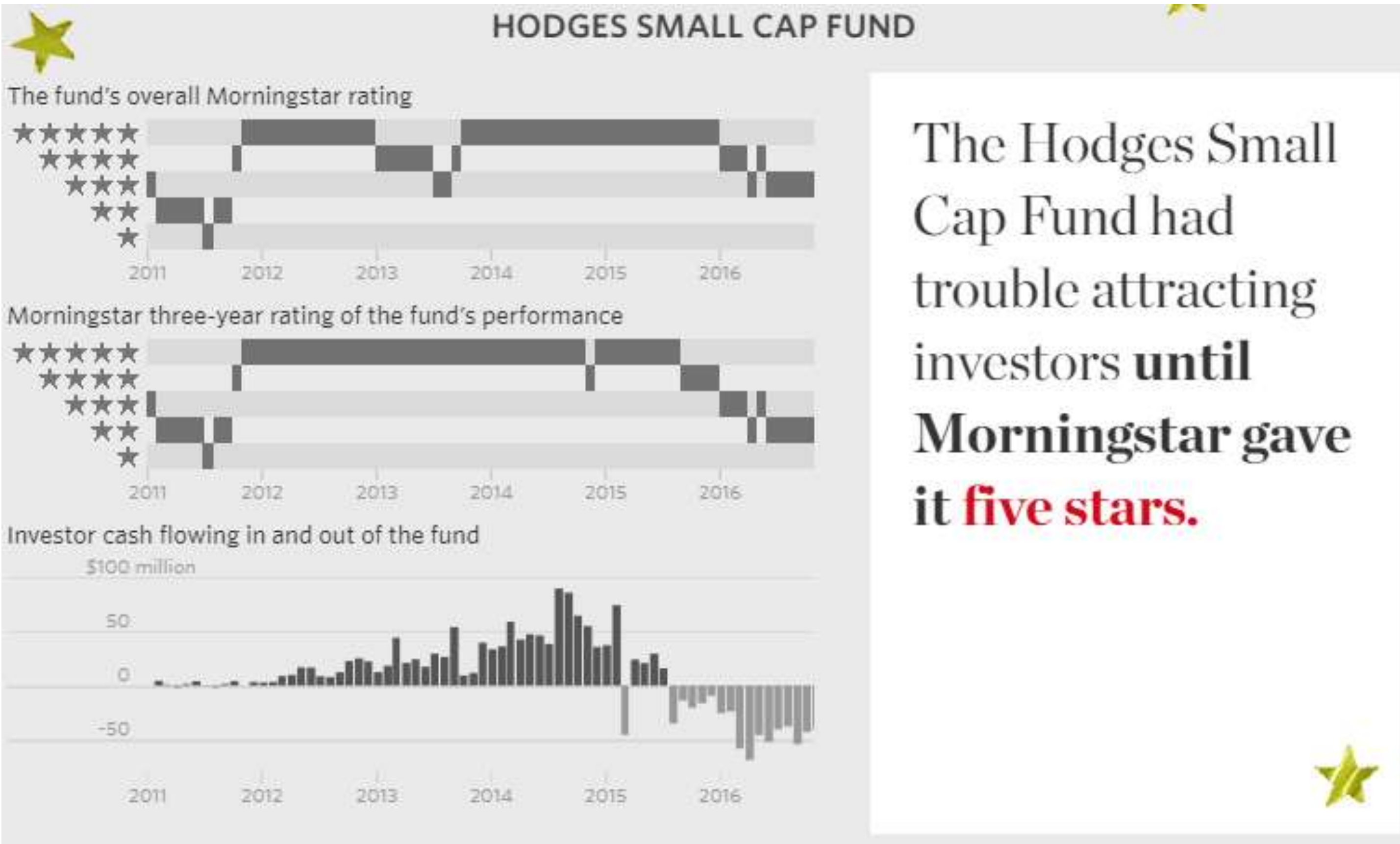


ratings from September 2016. Two of the funds' ratings had fallen by the time the ad ran. AllianceBernstein ran a similar ad with the September ratings in a Morningstar handout at the research firm's April conference.

A spokesman for AllianceBernstein said it made a "human error" in two instances out of "hundreds of digital and print ads running that quarter."

Dallas-based Hodges Small Cap Fund's retail share class beat 95% of similar funds in 2010 but had less than $100 million in assets. Late in 2011 Morningstar gave it a fifth star, and everything changed, said Craig Hodges, who manages Hodges Capital Management. Charles Schwab put the fund on its "Schwab Select List." Mr. Hodges and his brother Clark decided to advertise the star rating on a billboard in Dallas/Fort Worth airport.

Hodges Capital paid more than $10,000 to Morningstar for the right to advertise the stars, Craig Hodges said. By the end of 2014, assets in that fund reached about $1.6 billion, according to Morningstar data. ...



Notes: Retail share class. Funds rated by Morningstar can have up to four ratings: a three-year rating, a five-year rating, a 10-year rating, and an overall rating that is based on a combination of the others. Read the methodology.

Morningstar said it publishes the ratings because it believes they have investment merit, not for financial gain. It said its intellectual-property licensing packages, which include the stars, contributed just 4% of revenue in 2016. ...

As for the Hodges Small Cap Fund, its performance has since turned down. Its rating has fallen to two stars from five, and assets that had soared after the top rating have dropped by more than half.

Morningstar in 2011 launched a second rating system, currently covering 26% of fund share classes, in which the firm's analysts do a more qualitative assessment. Unlike the star system, analysts' ratings often refer to likely future performance. The firm said analysts' ratings reflect its level of conviction that a fund will "outperform its peer group and/or relevant benchmark."

The analysts give funds one of three medals—gold, silver or bronze—or a "neutral" or "negative" rating.

The Journal examined how these funds performed in future years, as measured in their star ratings. It found that five years after having a gold-medal rating from Morningstar's analysts, funds had an average rating of 3.4 stars for that five-year period.

Silver-medal funds were rated 3.3 stars for their performance over the following five years. Bronze-medal funds had an average rating of 3 stars. In other words, while funds rated highly by the Morningstar analysts did better, the differences among the funds weren't large.

A Morningstar spokeswoman said there was a mismatch in how the Journal evaluated the performance of analyst-rated funds because it relied on star ratings. She said unlike analysts, the star ratings take into account a "load"—a sales fee—that some funds have.

The Journal analysis also found Morningstar analysts' ratings of funds were overwhelmingly positive. From November 2011 through August 2017, the firm gave analyst ratings to about 9,200 fund share classes. Just 421, or 5%, received negative reviews. At the end of August, only 1% did.

Mr. Mansueto said analysts tend to choose better funds to examine, since they can't review them all. "Investors want to know what funds they should be investing in," Mr. Mansueto said. "They don't care so much about what the terrible funds are." ...

J.P. Morgan Chase & Co. is among asset managers that regularly send portfolio managers to talk to Morningstar analysts about the merits of their funds. BlackRock Inc. has a team that works to persuade Morningstar analysts of the merits of various funds, according to people familiar with the matter.

They added that BlackRock CEO Laurence Fink met with Morningstar analysts early this year to discuss the firm's ratings. In May, Morningstar upgraded to positive BlackRock's "parent pillar" rating, an evaluation in which analysts are looking for factors including an alignment of interests between fund shareholders and those who manage the funds.

A BlackRock spokesman said its team that works with research providers "is focused on providing transparency, education and information about our products to facilitate informed decisions."

Morningstar said BlackRock had changed how portfolio managers were paid in a way that led to their having more of their own money invested in BlackRock funds. "We followed the same process in evaluating Blackrock's standing as a parent that we do with any other firm," said a Morningstar spokeswoman.

Mr. Kapoor, the Morningstar CEO, said analysts operate independently from fund companies and without influence from management despite frequent angry calls executives must field. "We prize our independence," he said. ...

"The nature of what we do is going to end up alienating some portion of the industry," said Jeffrey Ptak, Morningstar's global director of manager research. "That's not something we relish but it's part of our job." ...

Setting the Record Straight on Our Fund Ratings

We find the star rating has been a useful starting point, and the Analyst Rating, while newer, has also exhibited predictive power.

By Jeffrey Ptak, CFA | 10-25-17

Today, *The Wall Street Journal* ran a story profiling Morningstar. We wanted to make you aware of the story, which makes a number of concerning assertions about the Morningstar fund ratings that we publish, among other claims. In this piece, I'll aim to constructively set the record straight.

Executive Summary

The Wall Street Journal claims that our ratings, including the Morningstar Rating for Funds (the "star rating") and the Morningstar Analyst Rating have not succeeded. The *Journal*'s analysis, which we disagree with, suggests that highly rated funds do not outperform low-rated funds in the future. However even using the *Journal*'s own findings, which were selectively disclosed in the feature article that ran today, we find that highly rated funds were far more likely to outperform low-rated funds in the future.

Introduction

We've long believed in the merit of the straightforward, transparent approach the star rating takes to ranking funds: It's an objective "report card" on funds' past performance. By the same token, we've frequently acknowledged the star rating's limitations, which are common to any measure that relies on past performance. Since launching the star rating in 1985, we've augmented it with a host of other tools and measures and made enhancements to our methodology several times along the way, the forward-looking Morningstar Analyst Rating being a signal example.

We've encouraged users to consider combining the star rating with other data and measures to aid in fund selection. In this way, users could benefit from some of the star rating's more distinctly valuable features--that is, the way it emphasizes longer time frames, accounts for risk, and measures performance after fees and charges, considerations that don't normally figure into "leaders and laggards" tallies--while leveraging other forward-looking measures like the Morningstar Analyst Rating. In that context, we've often described the star rating as a potential starting point for research.

Star Rating Performance

We've run several recent studies on the performance of the star rating. You can find them here: "Does the Star Rating for Funds Predict Future Performance?" and "The Morningstar Rating for Funds: A Good Starting Point for Research."

To summarize, what we found is that the star rating possesses moderate predictive power, which is what we'd expect of a starting point for research. It points investors toward cheaper funds that are easier to own and more likely to outperform in the future, qualities that correspond with investor success.

	Morningstar rating of next 10 years of performance						
Starting overall rating	1	2	3	4	5	Merged	Liquidated
1	8%	9%	9%	3%	2%	48%	21%
2	7%	14%	14%	7%	2%	41%	16%
3	6%	14%	22%	11%	3%	30%	14%
4	6%	14%	25%	17%	6%	21%	11%
5	8%	13%	22%	21%	14%	13%	9%

You wouldn't know that from reading *The Wall Street Journal* piece, which portrays the star rating as ineffective in tilting the odds in investors' favor. But the *Journal*'s own analysis largely corroborates what we found in our own tests of the rating's performance: The odds of success were much higher in high-rated funds than low-rated funds, as shown in a panel of the *Journal*'s analysis (which wasn't included in the feature piece):

The left column of the above table shows a fund's starting star rating, while the second row from the top shows the subsequent rating that those funds achieved in the 10-year period that followed. What the *Journal* itself found is that while high-rated funds didn't unerringly outperform over the decade that followed the rating, they were *far more* likely to succeed (defined as a subsequent 4- or 5-star rating) than low-rated funds. For instance, 5-star funds succeeded about seven times more often than 1-star funds. Conversely, low-rated funds failed (defined as a subsequent 1- or 2-star rating, or that died through merger or liquidation) at a much higher rate than highly rated funds. By this definition, 1-star funds were twice as likely to fail as 5-star funds.

Again, don't take our word for it: *The Wall Street Journal* is saying so. [1]

Analyst Rating Performance

	Three-year rating three years later						
Starting analyst rating	1	2	3	4	5	Merged	Liquidated
Gold	6%	20%	29%	28%	14%	3%	1%
Silver	8%	20%	28%	23%	16%	3%	2%
Bronze	10%	23%	34%	19%	7%	3%	3%
Neutral	8%	24%	37%	17%	6%	4%	3%
Under Review	12%	19%	25%	22%	14%	8%	0%
Negative	7%	23%	21%	15%	5%	2%	28%
	Five-year rating five years later						
analystRating	1	2	3	4	5	Merged	Liquidated
Gold	5%	17%	28%	28%	17%	3%	1%
Silver	8%	16%	27%	27%	18%	2%	2%
Bronze	8%	22%	33%	19%	11%	4%	3%
Neutral	4%	22%	37%	18%	9%	8%	3%
Under Review	16%	16%	22%	23%	14%	8%	2%
Negative	4%	10%	17%	18%	11%	5%	35%

The *Journal* also raises questions about the efficacy of the Morningstar Analyst Rating. For those unfamiliar, the Analyst Rating is a forward-looking, qualitative assessment of a fund's prospects. Morningstar's manager-research analysts assign these ratings based on their evaluation of factors like people, process, performance, parent and price. The rating takes the following form (from highest to lowest): Gold, Silver, Bronze, Neutral, Negative. We expect "medalist funds" (Gold, Silver, Bronze) to outperform relevant peers or benchmark indexes over a full market cycle. "Neutral" and "Negative" funds are those our analysts have less conviction in.

... Here again, we'll delve into the *Journal*'s own findings--those that it included in an accompanying exhibit to the piece, not the piece itself--to illustrate that the Analyst Rating has performed well.

The left column shows the Analyst Rating at the start of each period and the columns to its right show the star rating that those funds achieved, on average, over the subsequent three- or five-year periods. For instance, from the above we learn that 30% of Negative-rated funds achieved a 1- or 2-star rating over the subsequent three-year period, on average, and another 30% died (after being merged or liquidated away), and so forth for the other Analyst Ratings and time periods.

What the *Journal*'s own analysis tells us is that Gold-rated funds were almost twice as likely to succeed (defined as a subsequent 4- or 5-star rating) than Neutral- and Negative-rated funds, on average. Conversely, Neutral- and Negative-rated funds were much more prone to failure (defined as a subsequent 1- or 2-star rating, or death through merger or liquidation) than Gold-rated funds.

These results are consistent with our findings, when we've evaluated the Analyst Rating using a risk-adjusted measure like CAPM alpha. In summary, while the *Journal* paints a downcast picture of the Analyst Rating, it has performed pretty well in the six years we've been assigning it, with the Journal's own findings seeming to corroborate ours.

Conclusion

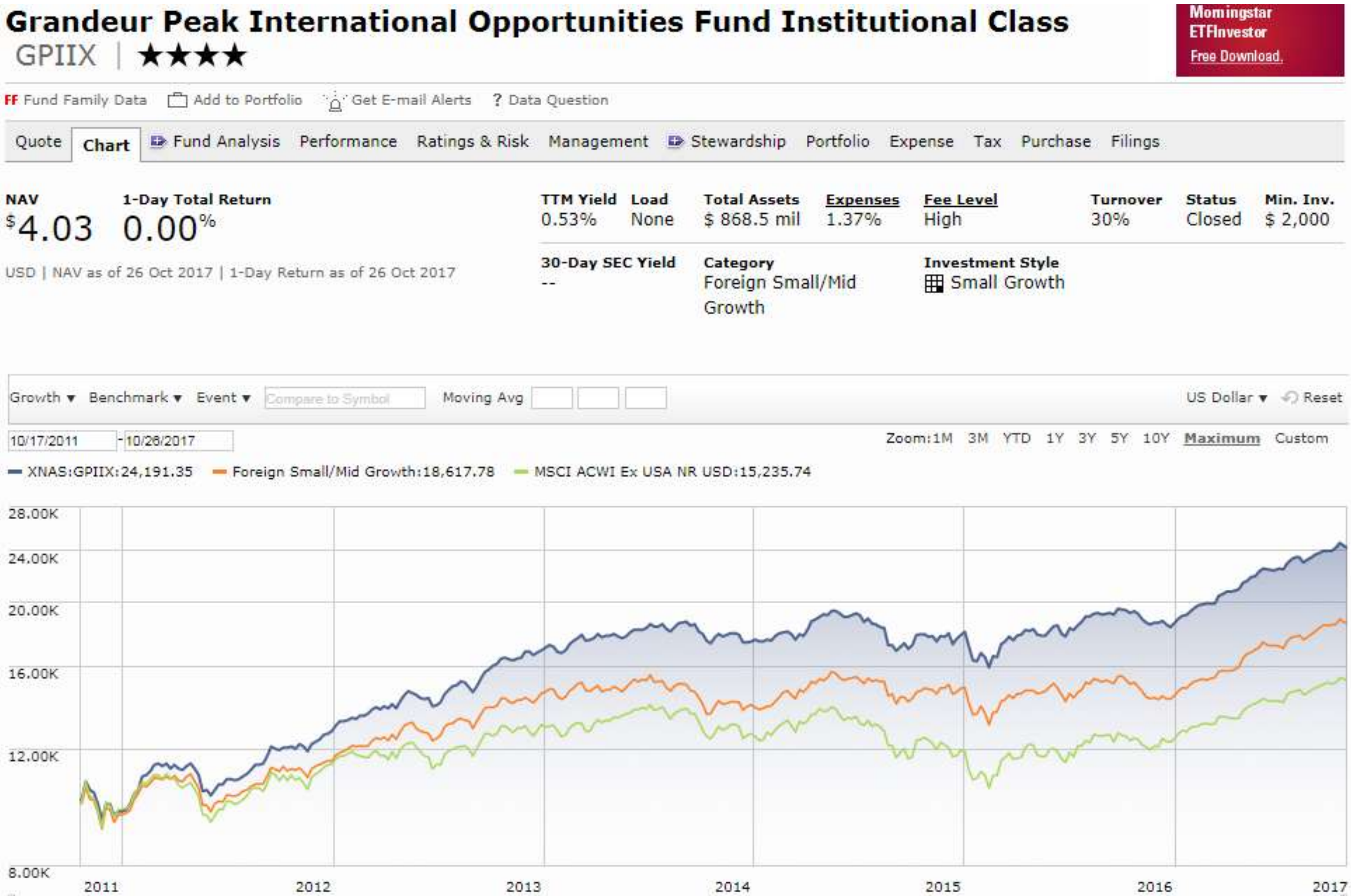
The *Journal*'s story notwithstanding, the star rating has been a useful starting point for research that tilts the odds of success in investors' favor. The forward-looking Analyst Rating, while newer, has also exhibited predictive power. Used together, or separately, we think these ratings can improve outcomes and help investors achieve their goals, which is entirely in keeping with our mission as a firm.

Our thoughts

Morningstar produces a valuable product. The fact that the WSJ's analysis discovered that Morningstar's ratings are subject to reversion to the mean, a law of investing discovered long ago, isn't quite up there with the earth not being the center of the universe. However, is "The Morningstar Rating for Funds: A Good Starting Point for Investors?" as Jeffrey Ptak, CFA (who wrote Morningstar's WSJ response above) asked in a 9/5/17 article. Our answer would be a resounding "NO!", as all too often by the time 3 years have passed in order for Morningstar to calculate a rating, some of the best OEFs have already closed. Two examples:

On March 12, 2014 we wrote to a prospective client: "We had been using Grandeur Peak's International Opportunities Fund (GPIIX) for international exposure within Quest Opportunity Fund (QOF) and for clients. They use a similar Quantitative approach to our own, and outperform their peers, which, in turn, outperform their benchmark. However, on March 5th it hard closed to all investors." However, HCM was subsequently granted a waiver, enabling us to continue to use this outstanding OEF for clients since shortly after it opened on

10/17/11. Its initial rating from Morningstar, after it had already closed to new investors, was 5 stars, and it has continued to be rated 4 or 5 stars ever since. As can be seen below, it continues to outperform its peers (orange line), which continue to outperform the MSCI ACWI Ex USA (green line) index, Morningstar's benchmark for the fund.



For clients needing to reduce risk, our favorite fund continues to be AQR's QMNIX. Morningstar first wrote about this OEF on 9/1/17, before its inevitable 5 stars appear, but after it had already soft (meaning we can still get clients in) closed:

"AQR conducts rigorous research into the sources of long-term investment performance. AQR Equity Market Neutral seeks to generate returns via a systematic stock-selection process that harnesses the output of this research. This well-designed process has manifested itself in a strong, albeit short, track record. The fund earns an initial Morningstar Rating of Bronze.

The stock-selection process employs a quantitative model to rank stocks from the MSCI World Index using well-established factors such as value and momentum and less quantifiable factors such as investor sentiment, which may use a metric (among others) such as change in percentage of shares shorted. High-ranking stocks are held in a long portfolio, low-ranking stocks are sold short, and the portfolio is structured to be market-neutral with no sector or country bets.

Since the fund's October 2014 inception through July 2017, its annualized gain of 10.8% trounced the market-neutral Morningstar Category average's 1.1% return. ... much of the fund's outperformance since its launch occurred in 2015, when it had a much smaller asset base and held more concentrated portfolios relative to current positioning. Outperformance has moderated, but the fund continues to outshine its category peers. As an indication of the fund's capacity constraints, AQR closed this fund to new investors in June 2017 when assets under management for this fund and AQR Long-Short Equity QLEIX, which employs the same stock-selection process, was $5.9 billion.

... overall, this fund is a solid liquid alternative option for those who have access to it."

QMNIX has not only "trounced" its peers (orange line), and Morningstar's assigned benchmark (green line), but it has outperformed the S&P 500 since inception, with **0 Risk** when measured by historical Maximum Drawdown relative to S&P 500 declines of at least 10%.