# The Morningstar Mirage

## Investors everywhere think a 5-star rating from Morningstar means a mutual fund will be a top performer—it doesn't

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Millions of people trust Morningstar Inc. 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. In addition, the Journal found Morningstar only rarely gave funds the lowest analyst rating, “negative.”

Mr. Mansueto, growing up in suburban Chicago, sold lemonade by the roadside before moving up to Christmas trees. At the University of Chicago, he and a roommate sold chips and soda and advertised by hanging posters for the “Room 607 Soda Service.” He also made his first mutual-fund investment, with $250 from a restaurant job.

After college, he and the ex-roommate, Kurt Hanson, started a business that provided market research for radio stations. It surveyed listeners and created a sheet of charts detailing their behavior. Mr. Mansueto then got a job as a financial analyst at Harris Associates LP, a Chicago money manager.

Mutual funds were proliferating, and a few fund managers were becoming stars, such as John Templeton and Peter Lynch. Funds didn’t give much information about themselves, and what they provided was opaque to nonprofessionals. Mr. Mansueto told a colleague he wanted to start a fund newsletter in the mold of the radio-station fact sheets.

The colleague, Ralph Wanger, cautioned that financial newsletters didn’t have a record of success. “That turned out to be the dumbest...thing I ever said,” he recalls. “What I meant to say was, ‘Joe, that’s the best idea I’ve ever heard—how about I quit and we go 50-50?’ ”

Mr. Mansueto launched Morningstar from his one-bedroom apartment in 1984 with $80,000, taking the name from the ending of Thoreau’s “Walden”: “The sun is but a morning star.”

He later spent $50,000 to hire Paul Rand, the noted designer of IBM’s logo, who created a signature red font consisting of tall letters with an “O” looking like a rising sun. With reports obtained from fund companies, Mr. Mansueto laid out data points so they were easy to read, and advertised his reports in Barron’s.

When BusinessWeek later asked him to devise rankings for an issue devoted to mutual funds, Mr. Mansueto began work on what would become his five-star rating system. He toyed with using symbols suggesting little bags of gold before deciding on stars.

Since then, assets invested in U.S.-based mutual funds have multiplied more than forty-fold. Morningstar rode the wave and went public in 2005.

Today, investors descend on Chicago for Morningstar’s annual conferences, a pilgrimage for money managers and financial advisers hoping to gather assets. At this year’s event in April, shirtless male acrobats cartwheeled and stood on each other’s shoulders while financiers sipped cocktails and mingled.

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 stars.

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.

The Journal also reviewed retirement-plan data, fund ads and regulatory filings, and interviewed dozens of current and former Morningstar employees, fund officials, financial advisers and investors.

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.

Morningstar’s ratings of taxable-bond funds, which include corporate bonds and Treasurys, proved a little more indicative of future performance. Of five-star bond funds, about 16% turned in a five-star performance over the next five years.

Still, 8% of the five-star taxable-bond funds performed poorly enough to merit only one star.

Hickory Hills, Ill., not far from Morningstar’s Chicago headquarters, has a small pension fund for about 50 active and retired police officers. In 2011, it moved about $2.1 million into the Nuveen Santa Barbara Dividend Growth Fund, which had a five-star Morningstar rating.

The pension board paid close heed to star ratings. “Our brokers thought it was one of the best measurements we had available to decide whether the fund is worth investing in,” said board secretary Mary McDonald, referring to brokers from Morgan Stanley.

The fund had beaten 95% of others in Morningstar’s “large blend” category—funds that buy large-company stocks using a blend of what investors call a “value” strategy and a “growth” strategy.

The following year, the fund beat only 26% of similar funds, and in 2013 just 11%.

The president of the Santa Barbara fund family, John Gomez, attributed the Dividend Growth fund’s performance to its focus on stocks with growing dividends, not just the highest-yielding ones.

The Hickory Hills board pulled $1.2 million from the fund in 2014, and in early 2016 it took out $750,000 more. It has since switched to a local broker, in part because of Morgan Stanley’s reliance on Morningstar ratings, said David Wetherald, a police officer who is also the pension board’s president.

The experience was frustrating because “we rely a lot on the financial people. We’re not completely blind and naive, but we’re smart enough to know that this is what they do,” Mr. Wetherald said.

Morgan Stanley declined to comment.

Morningstar said its five-star rating of Nuveen Santa Barbara Dividend Growth in 2011 “was an accurate historical grade on the fund. It was not intended as or presented as a conclusion as to what they should do.”

Morningstar also said this type of fund generally did poorly after 2011. The example "presents an underperforming fund in a badly underperforming category as if it's representative of the full rating set, which it's not," the firm said.

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.

Tiny Buffalo Emerging Opportunities Fund saw little interest despite beating many similarly focused funds over three years, including gaining 24% in 2012. After it got a fifth star from Morningstar in spring 2013, hundreds of millions came in, quadrupling assets to above $400 million in five months.

The small management team in Mission, Kan., closed the fund to new investors six months later, a step managers sometimes take when given more cash than they feel they can invest. The Journal found many instances of funds closing after an influx that followed a high star rating.

At Buffalo Emerging Opportunities Fund, fortunes soon reversed. In 2014 it lost more than 7% and trailed about 95% of other funds focused on growing small companies. Over the next two years its Morningstar rating fell to two stars and its assets plunged to less than $100 million.

Buffalo Funds declined to comment.

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, 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.

From his office park in Mechanicsburg, Pa., financial adviser Donald DeMuth starts each workday by logging onto Morningstar Office, which helps him organize client portfolios. He also uses Morningstar data to check on fund performance and details such as how rapidly a fund's portfolio turns over.

Mr. DeMuth, 66, has used Morningstar so long he can't remember when he started. "With rare exception, we would want a fund to have five stars," he said.

In early 2012 he put some of his clients' money in a fund called Permanent Portfolio when it had a five-star Morningstar rating. The fund invests across an array of assets, including gold and silver.

Its performance had already started to slip. By the end of 2012, it was 5 percentage points behind its Morningstar category benchmark, the "Morningstar Moderate Target Risk," which is a mix of global bonds and global stocks.

Mr. DeMuth moved his clients out in the fall of 2013, a year when the fund trailed that benchmark by 16 percentage points. At the end of 2013, Morningstar gave the fund a one-star rating for its performance over the prior three years.

Client David Peterseim, a 55-year-old retired surgeon in Charleston, S.C., said he was relieved the financial adviser got out. He was disappointed "Morningstar didn't have some semblance to reality," Dr. Peterseim said.

Michael Cuggino, president of the San Francisco-based family of Permanent funds, said Permanent Portfolio's performance suffered as the price of gold and silver dropped.

Morningstar said Permanent Portfolio was an "outlier" that "was designed as an inflation hedge; when precious metals are in favor, it will score well, and when they're not, this fund won't do well." Major rallies in gold and silver ended in 2011, shortly before Mr. DeMuth invested.

Other industry practices show how much Wall Street's system for buying and selling mutual funds revolves around Morningstar ratings. Brokerage firms recommend high-stars funds to their networks of tens of thousands of financial advisers, and those brokers in turn put clients' money in the funds. Large fund firms such as Fidelity Investments and T. Rowe Price Group Inc. allow investors to filter out funds with low star ratings on their websites.

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."

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."

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.

Investment giants Vanguard Group and Fidelity Investments pay upward of $1 million a year for licensing, data and other tools from Morningstar, said people familiar with the arrangements. It's unclear how much is just for advertising.

Michael Rawson, who was a Morningstar fund analyst for six years until spring 2016, said asset managers who pay to advertise their stars are misrepresenting their funds because the ratings are solely backward-looking.

"We know people misuse it. If we know people misuse it, why don't we do something about it?" Mr. Rawson said.

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.

Mr. Mansueto said employees are encouraged to debate issues related to its products, but the efficacy of its star ratings no longer comes up internally. "This is not a hot topic or even a cold topic at Morningstar today," he said.

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.

Aware of criticism of its star ratings, 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."

Morningstar recently started a third "quantitative ratings" system that it says applies analyst screening to a broader universe of funds. This one is likely to include more negative ratings, executives said.

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.

Morningstar’s application to the Securities and Exchange Commission for permission to launch nine mutual funds of its own has led some critics to cry conflict of interest. The Morningstar spokeswoman said the firm is in a quiet period related to the filing, restricting what it can say, but she said the firm’s analysts sit “in a separate entity” from Morningstar Investment Management, which would oversee the company’s funds.

The Journal spoke with more than three dozen executives at asset-management firms large and small about Morningstar. Few would go on the record.

Several years ago, some were unhappy when Morningstar changed the way it calculates its “stewardship grade,” which is supposed to measure the corporate culture of each fund company. Executives from fund companies viewed the change as the latest example of Morningstar acting unilaterally and without explaining itself.

The money managers drafted a two-page letter to Morningstar that accused the company of “bullying” fund companies and running a monopoly, according to people familiar with the letter.

“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.”

When the time came for the money-management firms to put their names to the letter, they balked. The letter was never sent.