Improving on Morningstar's Ratings: Moving Beyond Past Performance

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In a December 8, 2009 *Advisor Perspectives* article, Robert Huebscher published evidence that, between 2004 and 2009, Morningstar's "star" ratings were poor predictors of future fund returns:

> "Our analysis found that Morningstar's ratings lost virtually all of their predictive ability when measured over a full market cycle. … Advisors might as well flip a coin to decide whether to move to a fund with a rating that is one star higher."

Huebscher's results are consistent with other studies that show stars are poor predictors of future fund performance. As Huebscher observes, if advisors were looking for ways to make better investment decisions during this particularly volatile period, stars would have been of little help.

The reason stars fail is that they are based on a 20/30/50% weighted average of three-, five-, and 10-year historical fund performance. I have estimated the predictive power of these weighted historical returns using a survivor-bias-free sample of all active US equity mutual funds spanning the period from January 1980 through June 2008, which constitutes half a million fund-month observations. The fraction of the equity funds' subsequent one-year return volatility explained by these weighted historical returns is .002 (i.e. r-squared). An essentially zero r-squared over the last 30 years is right in line with Huebscher's finding that stars are not predictive of future fund performance.

Past returns provide little or no help in choosing the best fund going forward, and Morningstar's stars are the best known example of this failure.

In spite of this evidence, the vast majority of advisors still use past performance when making investment decisions. Furthermore, many believe that longer performance track records produce better predictions. After all, it is argued, superior skill will reveal itself over a longer time period and therefore highlight which funds are best. Unfortunately, the evidence shows just the opposite: predictive power declines precipitously when going from one-, to three-, to five-, to 10- year performance numbers. In fact 10-year returns provide the lowest predictive power.

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Strategy consistency and focus

Rather than look in the rearview mirror at historical fund returns, it is critical to look at current behavior. The leading research in this area identifies several key drivers of forward-looking performance, all related to current behavior. Specifically, managers with a disciplined and consistent strategy and managers with high-conviction stock selections outperform. (See, for example, Randy Cohen et. al (2009), *Best Ideas* and Russ Wermers et al. (2007), *The Investment Value of Mutual Fund Portfolio Disclosure.*)

Strategy is the way the manager analyzes, buys, and sells stocks in an attempt to generate excess returns. Once the strategy has been identified, it should be pursued consistently by the manager over time and applied to investments that fit that strategy. And since an active manager is being hired for her or his investment skill, the portfolio should be concentrated in the manager’s best stocks, and a high-conviction portfolio is desirable.

Financial advisors employ legions of research analysts and a variety of methods to identify funds for their clients. In conducting their due diligence, they frequently focus on, among a variety of other things, the same key attributes – investment strategy, consistency and focus. The funds that rate highly on these attributes are then included in recommended lists and model portfolios.

Clearly, past performance should not be the primary factor when identifying top funds, for the reasons discussed above. At most, past performance should be a secondary consideration in the identification process. The focus should be on how the manager is currently making investment decisions and their confidence in those decisions.

Measuring current manager behavior

AthenaInvest has identified the equity strategy being pursued by each of the 3,000 active domestic and International equity mutual funds domiciled in the US. Using this comprehensive set of data, we objectively measured the strategy consistency and strategy focus of each fund. Consistency is measured as the percent of stocks held by the fund that are consistent with the fund’s stated strategy, where stocks are categorized by strategy each month based on the collective holdings of all strategy-identified managers. Focus is measured by the extent to which the fund is holding high-conviction positions in the portfolio. These two measures provide an up-to-date snapshot of how the manager is executing his/her stated strategy. It is important to note that no past performance is included in either of these measures. (See here for a full explanation of the methodology.)

Using each month’s consistency and focus measures, each fund is rated and assigned a diamond rating (DR), with DR5 ratings going to those funds with the highest levels of consistency and focus and DR1 ratings going to the lowest. The assigned DR is an

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objective measure of fund/manager quality, based on consistency and focus. The higher the rating, the better the fund.

The results of this approach are impressive. The test underlying the table below was conducted as follows: A DR from 1 to 5 was assigned to each strategy-identified active US equity fund at the beginning of each month, from March 1997 through June 2009 (for a total of 335,731 month-fund observations). I then calculated the average return differential and the probability of a DR5 fund outperforming a DR4 fund over the subsequent month, up to a comparison of DR5 funds to DR1 funds. Return differentials and probabilities were calculated over all funds and all months for each year in the sample. Subsequent-month fund returns are net of automatically deducted fees (i.e., net of fees other than sales loads and redemption fees) and the fund's average strategy return for that month. Funds were strategy-identified beginning in 2007, so funds that did not exist in 2007 or later are not included in the sample. (More calculation details are provided in the footnotes to the table).

Annual Probability DR5 Funds Outperform lower rated Funds
Annualized Excess Returns (Strat Peer Group Benchmark) March 1997 - June 2009

	DR5 vs DR4		DR5 vs DR3		DR5 vs DR2		DR5 vs DR1	
Year	**Ret Diff**	**Prob**	**Ret Diff**	**Prob**	**Ret Diff**	**Prob**	**Ret Diff**	**Prob**
1997	-2.90	42%	-5.27	35%	-7.13	29%	-7.11	30%
1998	-5.23	39%	-10.23	28%	-14.80	18%	-16.50	15%
1999	-8.22	37%	4.70	58%	12.87	73%	16.22	78%
2000	1.23	51%	-2.04	48%	3.34	54%	8.01	60%
2001	-0.74	49%	2.31	54%	5.37	60%	6.75	63%
2002	4.50	60%	6.63	64%	6.62	66%	7.89	70%
2003	-1.01	47%	-0.25	49%	5.10	65%	7.86	73%
2004	0.53	52%	2.41	58%	3.52	62%	3.53	63%
2005	1.73	55%	3.21	61%	6.88	73%	9.22	79%
2006	2.26	57%	-0.13	50%	-2.24	41%	-4.21	34%
2007	0.28	51%	2.21	58%	1.70	56%	2.30	59%
2008	2.34	54%	1.16	53%	0.41	51%	1.44	53%
2009	2.18	54%	4.21	59%	7.33	66%	10.31	72%
97-09	**0.50**	**54%**	**1.44**	**62%**	**2.87**	**73%**	**4.27**	**82%**

= Less than 50% probability (shaded cells)

Ret Diff = Average monthly excess return times 12 for DR5 funds minus the lower DR average

Prob = Probability that Ret Diff exceeds zero assumes a normal distribution with a standard deviation of

SQRT(DR5SD^2+Other DRSD^2)*SQRT(12) for the annual calculations and *SQRT(12)/SQRT(13) for the 97-09 calculations.

The Ret Diff standard deviation calculation assumes across DR and through time independence.

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The results reveal that higher-DR funds have a greater-than-50% chance of outperforming lower-DR funds. Over the entire 1997 through 2009 time period, DR5 funds outperformed DR4 54% of the time and DR1 funds 82% of the time. This latter result is of interest, since over this time period average DR1 fund performance was roughly in line with market (S&P 500) performance. Thus DR5 funds during this time period generated an average annual excess return of greater than 4% and had an 82% chance of beating the market.

Year-by-year results reveal DR5 dominance in most years. The worst two years were 1997 and 1998 when DR5 funds underperformed the other four DRs. However, over the most recent decade, 2000-2009, DR5 funds dominated, outperforming in all but six of the 40 comparisons.

Most recently, DR5 funds have outperformed all other ratings in each year from 2007 to 2009. This is particularly impressive since 2008 was a terrible bear market while 2009 was a strong bull market, which indicates that highly consistent, focused managers successfully navigated these exceedingly difficult markets.

It was during this full market cycle, by the way, that Morningstar's methodology had the least predictive power.

In another test of validity, client portfolios managed by AthenaInvest using the diamond rating system have outperformed the market with excess returns in line with these results.

Focus on what managers do, not what they did

All this leads to one unmistakable conclusion. Current behavior is more predictive than past performance and portfolios managed with this approach deliver higher excess returns.

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