MAINSTAY CAPITAL MANAGEMENT LLC

The Risk in Morningstar Ratings

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About this time last year my research team at Mainstay Capital Management was busy searching for opportunities for 2009. We believed technology, among some other sectors, would perform well in 2009. Our research led us to a fund named **White Oak Select Growth**. We added this fund to our IRA and non-retirement account portfolios in December. Then we received phone calls from a few clients asking the question, “Why are you adding a fund to my portfolio that is rated only 1-star by Morningstar (their lowest rating)?”

It was a valid question and a reminder of just how seriously investors take Morningstar ratings. In fact, mutual fund companies spend a great deal of money advertising the Morningstar rating of their funds, especially when they can boast a coveted 5-star rating, Morningstar’s highest. It’s very effective marketing. Many investors don’t want to spend the time researching a fund on their own and want a quick way to look at how “good” a fund is, ideally from an unbiased source. Morningstar’s fund rating system gives them just that. Or does it?

By early 2009, White Oak Select Growth was not only outperforming the S&P 500 Index, it had climbed well into positive territory in the first few months of the year, while the S&P 500 was still in negative territory. As of September 30, 2009, White Oak Select Growth was up 46% year-to-date versus a 19% year-to-date return for the S&P 500. It also significantly outperformed a Morningstar 5-star rated fund in its peer group, **Amana Growth**, which was up only 22% year-to-date as of September 30th.

As it turned out in this case, the 1-star that Morningstar rated White Oak Select Growth at the end of 2008 was a very poor predictor of how the fund was about to perform in 2009. This performance demonstrates an even more important point about Morningstar ratings.

Morningstar ratings can be especially misleading at market inflection points. Everyone has read the disclaimer, “Past performance is no guarantee of future results.” At no time is this more true than at market inflection points.

Whether you believe the rally of the past seven months is the start of a long-term bull market or just a cyclical bull market within an ongoing secular bear market, stocks definitely passed through a market inflection point last winter. And therein lies the risk in Morningstar ratings. A rating based on the performance of an aggressive growth equity fund, which includes the worst bear market since the Great Depression, was not a good indicator of how that fund was about to perform in 2009.

To be fair, Morningstar is very clear about what the stars rate: Past performance, relative to peers, with an adjustment for risk. In our research we were looking for investment vehicles that would perform well in the coming market environment, not the environment behind us. (Investors, like generals, need to be careful not to “fight the last war”.)

We have another example from earlier this year within the GM and Delphi 401(k) portfolios we manage. Our research led us to **Ariel Fund**, an investment option available within these 401(k) plans that we were confident would thrive in an ongoing stock market recovery. Ariel Fund has not historically been a consistently exceptional performer, but its exposure to financial stocks, among other sectors, looked attractive in this market environment. We added this fund to our GM and Delphi portfolios, and subsequently received a few calls from MCM clients asking, “Why did you buy a 1-star rated fund in my account?”

Again, this was a valid question. Nevertheless, Ariel Fund has been an exceptional performer this year. It is also the best performing diversified equity fund within the GM and Delphi 401(k) plans through the first nine months of 2009.

This risk in Morningstar ratings at market inflection points works in the opposite direction as well. Going back to the bull market of the late 1990's, **Fidelity Aggressive Growth** (subsequently renamed Fidelity Growth Strategies) had performed admirably and was sporting a 5-star Morningstar rating at the beginning of 2000. However, this 5-star rating was a very poor predictor of how the fund was about to perform heading into the coming bear market. To be fair, 2000 through 2002 was not a good market environment for aggressive growth stock funds, but Fidelity Aggressive Growth significantly underperformed its benchmark as well. In fact, investors who bought this 5-star rated fund and held it from February of 2000 to October of 2002, saw the value of their position in the fund decline by more than 80%.

Investors should also consider newer funds that do not yet have a Morningstar rating. We hold **Lazard Developing Markets Equity** in our more aggressive IRA and non-retirement accounts. The fund is less than two years old and is not yet rated by Morningstar. We like this fund's veteran portfolio management team, coupled with the small asset size of a newer fund. This combination has enabled outstanding performance this year. Lazard Developing Markets Equity was up 88% year-to-date through September 30, 2009, far outperforming its benchmark and many emerging market funds that have high Morningstar ratings. Investors waiting for a Morningstar rating, that will not come until the fund has a three year performance track record, have missed out on an outstanding opportunity this year.

The performance of White Oak Select Growth, Ariel, and Lazard Developing Markets Equity may wane in the next year or two, but as tactical asset allocators we are investing for months, not years. Therefore, we have very little use for a fund rating system that only looks at past performance. We must be looking ahead.

Investors need to look at Morningstar ratings for what they really represent. Morningstar's star ratings are essentially an "achievement award" for past performance, not an aptitude test for how the fund will necessarily perform in the coming months. Investors who rely only on Morningstar ratings to pick funds may be gaining a false sense of confidence that could lead to disastrous results for their portfolio.

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