ABR Dynamic Funds' Portfolio Construction Series: Part 3

Fooled by the Referee

Morningstar and others have developed an industry around categorizing and ranking funds. However, the endeavor is not as useful as most people think. The data indicate that the statement "past performance does not guarantee future results" should be amended to "past performance has very little to do with future results." Funds that have been highly rated have been scattered throughout the rankings in subsequent time periods.

Morningstar uses a 5-star ranking system, with 10% of funds earning the top rating of five stars and 10% of funds earning the bottom rating of one star. Of course, that means that at any given time, a randomly selected fund has a 10% chance of earning five stars and a 10% chance of earning one star. Let's see if a highly ranked (five star) fund subsequently performed much better than a random one.

According to the Wall Street Journal, of the funds that earned a five star rating at one point in time, only 12% received that same rating over the next 5-year period. Furthermore, 10% of those initial five star funds received the lowest rating of one star over the next five years. A five star-fund's 12% chance of a subsequent five star rating is just a tiny bit over a random fund's 10% chance of that same rating. Meanwhile, a five star-fund's 10% chance of a subsequent one star rating is exactly a random fund's 10% chance of that same rating. Therefore, those figures of 12% and 10% indicate that the five star rating did not carry very much performance-related predictive power.

Despite the industry that has sprung up around this idea, picking funds based on how well they've done recently hasn't helped investors very much. This should come as no surprise. Even though no investor wants to hear it, 3-5 years is an extremely short period of time from which to develop performance expectations.

Morningstar itself has expressed concern with many investors' overreliance on performance rankings:

> 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."
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> He added, "That needs to change."

To read the full article, please follow this link to the Wall Street Journal (subscription required):

https://www.wsj.com/articles/the-morningstar-mirage-1508946687

Next Week's Preview: In the very near future, we will follow-up on an important question raised by this installment: what is the length of time that defines "long-term" (where "long-term" means long enough to develop performance expectations based on realized results)? However, our next installment, which will come after the holidays, addresses the use of volatility as a measurement of risk.