

Mutual Fund Rating Systems: 401(k) Advisors vs. Morningstar

February 2006

Introduction

As investors demand more usable information (along with stronger returns), companies strive to find better ways to analyze investments. The purpose of this article is to illustrate the difference between 401(k) Advisors' *Scorecard*SM System and Morningstar's® Star Rating System.

A widely used investment tool, the Morningstar Star Rating System uses a risk/return measure to score mutual funds from 1 to 5 stars. While the star rating offers good analysis on the historical risk/return characteristics of mutual funds, it ignores several important factors that should be considered before selecting an appropriate investment.

401(k) Advisors' *Scorecard* System employs a complete approach that takes into account risk adjusted return characteristics, style analysis, peer group rankings and various qualitative factors. This process is very similar to what the largest and most advanced investment institutions in the world utilize, yet has been simplified so it can be used for 401(k) plans by someone without a PhD in Finance.

The Morningstar Approach

Morningstar's rating system has been popular among retail investors for over a decade. The star rating is purely based on risk adjusted performance across various time periods, from 3 to 10 years (with significant weighting on the most recent 3 years of returns). In 2002 Morningstar revised its rating system to include an enhanced risk adjusted returns formula that penalizes funds for both upside and downside deviations in returns, and compares each fund only to other funds in the same asset class.

Morningstar gives the top 10% of funds a 5 star rating, the next 22.5% 4 stars, the next 35% 3 stars, the next 22.5% 2 stars and the bottom 10% 1 star. The star system offers investors some good insight into the historical risk adjusted

performance of a mutual fund, but falls short of the due diligence that should be completed before making an investment decision. Morningstar acknowledges this by stating "We (Morningstar) hope that the star rating will help you reach your goals when you make it part – not the heart – of your process."

Beyond 5-Star Ratings: 401(k) Advisors *Scorecard*SM System

401(k) Advisors' *Scorecard* System embodies a comprehensive approach to investment due diligence. The *Scorecard* System measures three different risk/return criteria (versus Morningstar's single measure) as well as style characteristics, peer group rankings and multiple qualitative factors, including portfolio manager tenure, expenses and strength of statistics. The scoring system is built around pass/fail criteria (0-10, with 10 being the best).

While the Morningstar rating measures risk/return characteristics, it fails to take into account several other important metrics. For example, portfolio manager tenure: A fund may have an attractive 5 year return, but also have an entirely new portfolio management team not responsible for that past performance. The star rating also fails to look explicitly at fund expenses (which many studies have been shown to be a strong indicator of future out-performance) and neglects to consider certain style aspects of a fund, such as style drift. Managers that chase returns in other asset classes may actually be rewarded, rather than penalized, in the star rating system.

Conclusion

Not all rating systems are created equal. 401(k) Advisors' proprietary *Scorecard* System incorporates multiple criteria into the fund rating (or score). This comprehensive and balanced approach affords fiduciaries an extremely powerful investment tool they can use to select and monitor funds; it can be applied to any 401(k) plan, regardless of size or sophistication.