Special Report

Introducing Morningstar's New Star Rating

by Christine Benz | 07-03-02 | 11:00 AM

We don't make changes to an industry icon lightly. But the time has come to revamp the Morningstar Rating for funds--the ubiquitous star rating.

Why We Made the Change

When we rolled out our star ratings in 1985, most investors weren't sure if they wanted a value fund or a growth fund, a small-cap fund or one that bought General Electric GE. Instead, they wanted a fund that would perform well in a variety of market conditions. That's why our original star rating compared funds within extremely broad peer groups. Domestic-stock funds of every stripe got compared with other domestic-stock funds, for example, while all taxable-bond funds were lumped together.

That had an unfortunate side effect: When a particular style of investing was hot--like growth was in the late 1990s or deep-value investing is right now--a disproportionate share of funds within that style received 4 or 5 stars. It didn't matter if the manager was good or bad. By being in the right place at the right time, they were able to pick up stars.

We wanted to make our new star rating less sensitive to market movements, and we also wanted it to reflect the fact that investors are far more sophisticated than they were 15 years ago, thanks in no small part to Morningstar innovations like the Morningstar Style Box and use of funds' actual investment styles, rather than prospectus objectives, to categorize funds. Most fund investors understand that it's a tall order to expect a single fund or two to look good in every kind of market environment. (Unless you happen to luck out and your manager is Bill Nygren, that is!) Instead, they realize that exposing their portfolios to a broad range of asset classes and investment styles is their best plan of attack. The key challenge for investors has evolved from picking a great fund or two to picking a number of funds that fill their roles exceptionally well.

How It Works

Happily, we didn't have to look very far to hit on an approach that helps investors make the very kind of apples-to-apples comparisons they should be making. Our category rating, launched in 1996, assesses funds' risk/reward profiles alongside other offerings that practice a similar style. Because it helped investors separate managers who were truly skilled within their peer groups, the category rating quickly became a favorite of Morningstar analysts and other cognoscenti.

The new star rating takes the best of the old star rating (its emphasis on long-term performance) and the best of the category rating (its emphasis on apples-to-apples comparisons) and merges them into a single rating. (We'll no longer show the category rating in our products.)

Rather than using just four broad peer groups to rate funds (domestic stock, international stock, taxable bond, and municipal bond), as we have in the past, the new rating compares funds with others in one of the 48 different Morningstar categories. For example, in the past, for star-rating purposes we compared a large-growth fund like Janus Fund JANSX alongside a small-value fund such as Fidelity Low-Priced Stock FLPSX, because both are domestic-stock funds. Under the new system, we'll check out Janus Fund's risk/reward profile versus other large-cap growth funds', and we'll rate Fidelity Low-Priced Stock relative to other small-value funds. (For complete details on how it works, click here. You will need Adobe® Acrobat® Reader to view and print the report.)

What It Means for Your Funds

Overall, 5,534 out of the 10,296 funds in Morningstar's database changed ratings. A look at some of the biggest funds' ratings before and after our methodology shift will give you a sense for how the landscape has changed. (Click here for a table of the 50 largest funds.) In general, you'll notice that funds' ratings are much less beholden to recent market movements than they were in the past. Under the old system, for example, more than half of all small-value funds with star ratings earned 5 stars, thanks to the strong recent performance of small, inexpensive stocks. Large-growth funds were brutalized under the old system, however, owing to the ongoing slump in that part of the market. At the end of May, just five (out of 683!) large-growth funds qualified for a full 5 stars.

Because the new system gives funds in every category an equal shot at top ratings, it does a much better job of identifying winning funds whose styles are simply out of favor, while penalizing weak funds that are merely riding the coattails of a hot asset class. For example, the biggest fund whose rating changed was American Funds Growth Fund of America AGTHX, which rose from 4 stars to 5. The change here is pretty obvious. It’s no longer being punished for being a large-growth fund, and it also benefited from our increased emphasis on risk. The fund generally avoided the sort of speculative stocks that have burned many of its large growth competitors.

Fidelity Growth & Income FGRIX also picked up a star. Manager Steve Kaye has produced outstanding risk-adjusted performance relative to other large-blend managers, but the poor overall returns of large cap stocks had been holding the fund back under our old system. Now the fund has a well-deserved fifth star.

On the flip side, domestic-hybrid, world-stock, and small-value funds generally shed stars. Janus Worldwide JAWWX and Fidelity Asset Manager FASMX both slipped from 4 stars to 3 stars.

You can see a similar phenomenon in the bond-fund world. Top offerings that operate in slumping groups, such as Northeast Investors NTHEX, a terrific high-yield bond fund, now receive a greater share of five-star ratings. Meanwhile, we've deducted stars from lackluster funds that just happen to operate in hot fixed-income groups, such as intermediate- and long-term government-bond funds.

Aside from the switch to category-based peer groups, the basic framework for our original star-rating methodology remains intact. As in the past, the new rating provides a snapshot of a fund's historical risk/reward profile. It rates funds on a scale of 1 to 5 stars, and takes sales charges into account. And we still refuse to rate a fund that doesn't have at least three years worth of history. For funds with longer track records, we'll rate the funds' three-, five, and 10-year records, then weight each of these ratings to come up with an overall star rating.

Other Refinements

We've also improved our methodology in other ways. The most notable of these improvements relates to how we gauge risk. In the past, we scored a fund's riskiness by looking at the degree to which its monthly returns had underperformed those of the 90-day Treasury bill, which offers a risk-free rate of return. The problem with that methodology, however, was that it failed to flag funds whose huge returns indicated they were engaging in risky behavior. For example, the old star rating failed to adequately penalize many growth- and tech-stock-laden funds in the late 1990s. Although many such funds had posted few losses over that stretch, their huge returns suggested they were taking on a fair amount of risk--a huge amount, in some cases.

Enter our new risk measure. Although it retains the spirit of our original risk measure, in that it dings funds hardest when they lose money, it penalizes a fund for all variations in its returns--both on the upside and the downside.

We've also adjusted how we treat funds with multiple share classes. In the past, each share class of an individual fund took up one "slot" on the scale where we plotted funds' ratings. That scheme made less sense as we switched to smaller, category-based peer groups, however, because it enabled five share classes of a single top- or bottom-performing fund to monopolize the 1- or 5-star ratings within a given category. Thus, our new system counts a fund with multiple share classes only once within the rating-distribution scale. That means that for a fund that has A, B, C, D, and I share classes to choose from, each share class takes up just one fifth of a slot on the distribution scale. (It's still possible that various share classes of the same fund will have different star ratings, however.)

Finally, you may be wondering about funds that have switched categories. How does the new star rating handle those situations? If a fund built its early record as a large-growth fund but a new manager switched over to a small-value style, for example, we wanted our star rating to give more weight to how the fund has fared as a small-value fund and relatively little weight to the earlier record. With this in mind, we've developed a scheme that considers the magnitude of a fund's category shift in determining how much weight to give a previous record. For example, for a fund that had shifted from our mid-cap value category to the large-value group, as Oakmark Fund OAKMX recently has, we'd still put a fair amount of weight on its record as a mid-value fund, because the two style boxes are contiguous. A fund that shifted from large-growth to small-value, however, would see its history as a large-growth fund seriously discounted for the purpose of our star rating.

(Last month, we also introduced changes to the methodology behind another Morningstar tool: the Morningstar style box. The changes were initially applied to funds' current investment style boxes, and we've now adjusted our category classifications--which are based on the past three years' worth of style boxes--to reflect the new methodology. Click here for more on the changes we've made to the style box classifications. To find out more about which funds changed categories, click here.)

Conclusion

The star rating will continue to work best as a screen that will help you narrow a crowded mutual fund field down to a more manageable size. In addition, you can use it as quick check on funds already in your portfolio. Thus, we believe they will prove to be valuable time savers that will help you navigate your way through an enormous universe of choices.

In both cases, though, it can't make the final decision for you. You'll still need to do fundamental analysis of the strategy and management in order to figure out if the star rating is a true reflection of a fund's prospects. Our Analyst Reports will help with that. You'll also want to examine how well a fund fits into your portfolio so that you can be sure you don't have any unwanted sector bets and you're close to your asset allocation target.

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