# Morningstar emphasizes fees, performance in upgrade of fund ratings

Changes to forward-looking analysts' ratings could lead to more downgrades than upgrades

Jul 8, 2019 @ 2:25 pm
By **Jeff Benjamin**

In the latest iteration of its **forward-looking analysts' ratings, Morningstar Inc.** is placing more emphasis on fees and raising the bar for actively managed funds, which will be required to beat both their benchmark and their peer group to earn higher scores.

Unlike Morningstar's better-known star rating system, which is based on historical performance, the **analysts' ratings** are designed to give investors and financial advisers a perspective on how a fund is likely to **stack up in the future.**

funds will be evaluated beginning in November involve a greater emphasis on fund fees and a higher bar for performance, said Jeffrey Ptak, Morningstar's global director of manager research.

As a part of the increased focus on fees, the rating system, which was first introduced in 2011 and covers more than 4,000 individual funds, will factor in fees at different share-class levels. Until now, the gold, silver, bronze, neutral and negative ratings were applied singularly across a fund's various share classes.

"What that [original method] missed was conveying the differences in share classes, so we're now tailoring ratings to individual share classes," Mr. Ptak said. "For example, share classes that embed fee increments to pay for distribution will now be penalized, and we'll probably see downgrades outnumber upgrades."

Globally, the analysts' ratings cover 4,004 unique funds, which expands to 21,415 when taking into account multiple share classes.

There are analyst ratings for 1,914 U.S. funds, which expands to 8,330 when factoring in multiple share classes.

and 33 funds have negative ratings. (Another nine funds are under review and not currently rated.)

Mr. Ptak said that unlike the **performance-based star ratings,** which are designed for a bell-curve-shaped distribution across the fund universe, the analysts' ratings tend to skew more positive because the funds are being subjectively selected for review.

The new evaluation process includes an analysis of the "people, process and parent company," Mr. Ptak said, explaining that performance and price are not being removed, just calculated in a different part of the process.

> Price, for example, will be evaluated after all other analysis has been completed.

Todd Rosenbluth, director of mutual fund and ETF research at CFRA, a competitor to Morningstar, said fees are front and center for more advisers and any increased emphasis will be welcomed.

"Advisers are increasingly gravitating to the cheapest mutual funds and incorporating fund expense ratios into their due diligence rather than relying on performance success that can be fleeting," Mr. Rosenbluth said. "In the past, strong performing funds would see strong inflows, but given the competition from ETFs, some of these funds have been bleeding assets."

right context. If a value strategy does well in a growth market, for example, we want to make sure it's truly a value strategy."

The new performance bar also requires a fund to beat both its benchmark and peer group net of fees in order to achieve a higher rating. Until now, a fund only had to beat one of the two, not both.

Time will tell whether financial advisers will pick up on and appreciate the nuanced changes, but it is clear advisers are paying attention.

"Screening active fund managers with a significant emphasis on fees could potentially include more of the larger big-name funds with low fees and at the same time exclude smaller, more nimble funds with seasoned managers that may warrant their higher expenses," said Jon Ulin, managing principal at Ulin & Co. Wealth Management.

"In most cases, the outcome of an active mutual fund's performance does not always live up to its grandiose name, star ratings or competing to be the lowest-cost player in their sector," Mr. Ulin said. "We remind investors and clients that outside of screening for fees and share classes, to not pick an active fund by its star ratings or past performance, which is a case of hindsight bias and chasing returns."

Kashif Ahmed, president of American Private Wealth, confessed to having a "low opinion" of star ratings and

"Some funds have way too many share classes and most investors can't figure out why, and more importantly the fees can be different on the same fund," he said. "If Morningstar can achieve this without confusing investors even more, I think it is a positive thing."

Rose Swanger, president of Advise Finance, reminds investors that any kind of ratings for funds should only be a starting point.

"Looking for funds with gold- and five-star ratings is only the beginning,"Ms. Swanger said. "Next, you have to check out the fees, inception date, manager tenure, yield, etc., before adding to one's portfolio."