



Letters to the Editor – Morningstar Responds

December 15, 2009

The first three letters are in response to our article last week, [Morningstar Ratings Fail over a Full Market Cycle](#). The letter from Morningstar was received yesterday and our response, if any, will be published next week.

Dear Editor,

Robert Huebscher's article will be required reading in our office today.

Thanks,

Barbara Warner
Warner Financial, Inc.
Bethesda, MD

Dear Editor,

This article was one of the more useful items I've received in any newsletter, even though I own more ETFs than mutual funds.

Excellent information and very valuable.

Thanks for sending it,

Robert Pavlik
Cleveland, OH

Dear Editor,

Advisor Perspectives' recent piece about the Morningstar Ratings misses the mark on three accounts.

First, no study over a fairly short time period of several years can be said to show that the stars either "fail" or "succeed." The study will illustrate how the stars performed during that particular time period, but the next time period may well have a different result, and the next one different again. We would need a much longer data series to form a definitive conclusion about the stars' efficacy.



Second, the study does not demonstrate that the Morningstar ratings fail over a full market cycle. Rather, the study illustrates that the star ratings had a positive predictive value for the time period 2004-06 and a negative predictive value for the time period 10/2006 – 9/2009. In other words, the stars worked during the early/mid section of previous market cycle, and they did not work during the late section.

For this late section, the S&P 500 began the period with an index value of 1355 and concluded the period with an index value of 1055. Thus, the article’s contention that the star ratings “fail” over a full market cycle is based solely on the results from a three-year period in which the S&P 500 was thoroughly clocked.

Third, at least for the buy-and-hold investor, the stars *did* have positive predictive value over the full market cycle. Morningstar examined the time period 7/02 through 6/09. Encompassing the first several years after we switched to our current approach of calculating the star rating, this time period begins shortly before the September 2002 market trough, and ends shortly after the subsequent trough of early March 2009. It’s a full market cycle.

Here are the results for funds that survived that time period. As with the Advisor Perspectives study, we ignored front- and back-end load charges, and we presented returns on an annualized basis.

Raw returns and probabilities of success, 7/02 – 6/09, surviving funds only

	Broad Asset Group	Funds Rated ...	Return	% Beating Category Average
Equity	U.S.	1 star	0.73	49.0
		2 stars	1.60	42.8
		3 stars	1.64	45.1
		4 stars	1.96	52.2
		5 stars	2.41	57.1
International Equity		1 star	5.75	27.7
		2 stars	5.36	40.6
		3 stars	6.20	48.8
		4 stars	6.38	50.2
		5 stars	6.90	64.1
Balanced		1 star	1.79	29.2



	2 stars	2.06	37.1
	3 stars	2.49	50.2
	4 stars	3.10	58.5
	5 stars	5.35	79.5
Taxable Bond	1 star	4.10	53.5
	2 stars	3.90	44.7
	3 stars	4.56	63.0
	4 stars	4.57	63.0
	5 stars	5.08	65.6
Municipal Bond	1 star	2.12	12.5
	2 stars	2.72	38.7
	3 stars	3.09	63.7
	4 stars	3.40	80.9
	5 stars	3.48	86.4

As the Advisor Perspectives' article highlights, the Morningstar rating performed better earlier in the market cycle than later. Thus, investors who did not hold the funds they purchased at the start of this period, and who sold them out to buy funds that gained their 5-star rating later in the market cycle, would not have fared as well. However, Morningstar does not counsel such a policy of "star chasing," and it's not clear at any rate if such trades would have led to a below-average outcome for the owner of 5-star funds.

In summary, the Advisor Perspectives article would have been accurate if titled, "Morningstar's Ratings Succeed Early in the Past Market Cycle, Fail Late." As is, however, the article gives a false impression of the ratings' behavior.

Sincerely yours,

John Rekenhaller, CFA
 V.P. Research
 Morningstar Inc.



The following letter is in response to our article, [The Investment Value of Art](#), which appeared last week:

Dear Editor,

Being a collector myself (of antiquarian books, ephemera, and maps), and having spent some time considering the investment aspects of collecting, I find very persuasive Professor Goetzmann's research results on the lack of diversification benefits of fine art. I should add only that those who argue for the investment benefits of fine art probably are neglecting the carrying costs and the very large bid-ask spreads and other transaction costs, which considerably diminish the economic returns to art in even the best of times. Still, those who collect for other than mercenary reasons may find that the application of ideas from investment management can lead to a deeper understanding of their avocation, and may even affect their decisions about what to buy. But this is a subject for another day.

Sincerely,

Adam Apt
Peabody River Asset Management
Cambridge, MA

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