



## Letter to the Editor re Hedge Fund Ratings

March 11, 2008

*The following letter was received in response to our [article](#) last week on Morningstar's hedge fund ratings.*

Dear Editor,

Morningstar Associates, as a Registered Investment Advisor, is marketing passive backward-looking asset allocation services in competition with those who rely on their rating services. As such, they seem to have a conflict of interest with many mutual fund investors investing proactively, globally and in ETFs and/or Separately Managed Accounts (especially portfolios of mutual funds).

The evidence of Morningstar's bias toward passive strategies is their failure to rate hedge funds of funds, and their apparent unwillingness to promote their ratings of Separate Accounts. These investment vehicles allow investors to go short or utilize cash, which is essential to succeeding in today's bear market. Although Morningstar rates virtually all actively managed mutual funds, these funds are highly diversified in long-only positions with very little cash.

Morningstar's strong editorial focus is often on costs and previous performance and ignores the value an RIA might add in exchange for seeking economically comparable services, adding alpha by managing money more successfully, or being willing to take defensive asset management action in a prolonged down market. As an advisor whose goals seek these benefits, we report enough information to Morningstar for their clients to decide on our value for themselves. In fact, they rate our portfolios in their Separate Accounts data base.

The Morningstar bias toward long-term passive buy-and-hold strategies stands in the face of a bear market, while the past five-year performance ignores the previous three-years bear market, the past ten-year performance masks the impact of those three years, and their new hedge fund ratings ignore that period; yet they continue to force-feed investors with their opinion that passive long-term investing is the only choice.

The success of ETFs alone demonstrates the need for another choice being demanded by many knowledgeable advisors. ETFs offer investors low-cost investments that welcome proactive investors who choose to trade. Morningstar has the data base to know that.

Morningstar has ignored two important classes of investment pools: 4,400 fund-of-funds hedge funds and 6,439 Separately Managed Accounts in Morningstar



Principia's Separate Accounts data base. They also show traditional funds and hedge funds net of fees (SEC standard) while Separately Managed Accounts are gross of fees (AIMR standards) making comparison difficult.

In addition, Morningstar rates hedge funds on the past five years, conveniently ignoring the 2000-2002 bear market, the most critical information for investors in today's turbulent markets. What will hedge funds do in the current bear market? I strongly recommend that the full 21<sup>st</sup> Century record for the past eight years be offered at least as an alternative period for ratings.

It seems to me that Morningstar has several strong biases:

- (1) A broadly-based passive asset allocation bias (excluding the 2000-2002 bear market) as opposed to a proactively managed fund-of-funds-style separate account made feasible by ETFs. If you look at the return of the benchmark S&P 500 since the turn of the century, you would discover an annualized 0.09%, barely breaking even on a dividend-adjusted return. Passive investing has not served investors well and the current downturn certainly does not encourage soon-to-retire investors.
- (2) The discouragement of innovative risk reduction portfolios (including a refusal to rate inverse and leveraged ETFs, for example) in the face of the under-performance of many traditional mutual funds in all markets except the 1982-2000 bull market, which was explained more by interest rates falling from historic highs than any other measurable causality or theory such as modern portfolio theory or practice such as asset allocation. During that period nearly any investment strategy worked.
- (3) Morningstar refuses to rate inverse and leveraged funds and ETFs offered by Rydex, ProFunds, and Direxion. Morningstar arbitrarily and inconsistently rates foreign stock ETFs, perhaps due to the unwillingness of the traditional funds to offer a wider variety of predominantly foreign stock funds (such as the many sector ETFs offered by Barclays, iShares and others).
- (4) Morningstar clings to the fantasy that only the manager has any input to the success of a fund: hence, managers are honored and ETFs do not qualify for manager honors. Significantly, 66 ETFs outperformed Morningstar's Fund Manager of the Year.



- (5) A strong willingness to ignore and downplay their data base of 6,439 Separately Managed Accounts, for which many spend hundreds of thousands of dollars or more to supply them data.

We have had prospective clients call Morningstar about our separately-managed accounts only to be told by Morningstar, "We've never heard of W. E. Donoghue & Co., Inc." Considering we have been reporting monthly to Morningstar Separate Accounts for over a decade and have even paid for a license to advertise our high ratings at the time, this is more than disappointing. Morningstar has written articles in which it would be appropriate to acknowledge our lowered-risk and higher long-term return Power Income Portfolio and which they chose not to include us. The author of the article, when pressed on their motives, said she had never even researched their Separate Account data base, which she felt showed accounts which were too expensive.

Morningstar's own data bases show that, using ETFs in our portfolios instead of no-load mutual funds, on average, would have saved 53 basis points and added 95 basis points of alpha to the returns of our separate accounts. The total average of 148 basis points of improvement more than made up the for our average management fee of 110 basis points.

As Morningstar publishes their Separate Accounts data base on a pre-fee basis (rendering it of less value to us as I cannot show gross returns to a client) while showing SEC-required after-fee returns on Mutual funds, Morningstar makes it difficult to do comparisons between the two investments to show to prospects. Again, Morningstar discourages competition for clients and innovative portfolios in general.

Morningstar's job is to collect all data on all categories of portfolios (traditional mutual funds, insurance sub-accounts, separate accounts, hedge funds, fund of funds, etc) appropriate for objective comparison and not to tell us which type of portfolios to use or force a choice of strategies on their clients.

When they acquired S&P, Altvest, and Ibbotson, Morningstar cornered the market on rear view mirrors and became the advocate for outdated passive asset allocation investment strategies. Such strategies are no longer relevant in a volatile market with opportunity determined more by currency movements, the growth of Asia, and the chronic problems of the credit markets. At the least, providing alternative strategies is the domain of investment advisors, not Morningstar, which is at risk of being out of date, irrelevant and perpetuating misleading conclusions by restricting the data to only that which can do great harm to investor portfolios. Sticking solely to passive buy-and-hold portfolios may have cost investors as much as \$6 trillion from 2000 to 2002.



The future, in my opinion, is in proactively managed fund-of-funds-like portfolios of ETFs, not solely in deer-in-the-headlights traditional mutual funds that take no effective defensive action in down markets. The baby boomer generation, the most highly-educated and ironically mislead generation in human history cannot afford to take no action to protect their assets from depletion in the prolonged bear market ahead of us. They have already suffered through three years of such a market. Morningstar could at least entertain the possibility of an alternative vision of retirees' future and objectively present relevant data for advisors to make their own decisions about that prospect.

In 1980, one standard for mutual fund data bases was Donoghue's Mutual Fund Almanac, of which we sold millions of copies. Morningstar started three years later. At the time Morningstar started, due in part to the beginning bull market and in part due to my NY Times best-sellers Complete Money Market Guide and No-Load Mutual Fund Guide which introduced a new generation to mutual funds after a chaotic 1966-1982 stock market, Morningstar added the style-box classification approach, which had not previously been in vogue. In the ensuing years, as interest rates fell from record highs, nearly any investment strategy worked and asset allocation was very saleable as were mutual fund ratings.

Morningstar succeeded beyond my wildest expectations and I congratulate them. However, today I question the value they have added since 2000 by sticking to passive investing strategies and conveniently ignoring the terrible 2000-2002 bear market, most recently in their new hedge fund ratings which ignore that period. Frankly, I think investors want to know what hedge funds will do in a bear market; but, if they buy based on Morningstar's hedge fund ratings, that knowledge may come too late.

Morningstar thrives on looking back, but proactive investment managers empowered by the freedom of a wide range of ETFs are attempting to build the future.

If Morningstar intends to promote their ratings of high cost hedge funds, they should also promote their objective and comparable coverage of the alternative, separate accounts in Principia's separate account data base as well; it is only fair. Let the public and investment advisors decide objectively and don't let Morningstar provide objective data on the problem (inflexible, illiquid passive buy-and-hold investments) and not the lower-cost solution (liquid, proactive investments in separate accounts.)

It is revealing to note that Morningstar does not even include ratings on funds-of-funds hedge funds or include a tactical reallocation strategy as a potential hedge fund strategy class. Morningstar needs to refocus on serving their clients, not competing with them.



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