

Star Gazing, Your Future and the Rear-View Mirror

A visitor from Mars might be forgiven for assuming that mutual fund investing is a branch of astrology. Fund company ads blast out the "star" ratings for their mutual funds as published by Morningstar, Inc. Of course, Darwinian law dictates that funds with favorable star rankings are those most likely to advertise. A huge percentage of new mutual fund investments go into funds with four and five stars (the highest Morningstar rankings). How smart is this for investors?

Every emerging market bond manager's record, according to Morningstar star rankings, is right up there with Bluto Blutarsky's grade point in "Animal House."

Morningstar's objective is to rank fund returns on a risk adjusted basis for funds with at least three years of returns. In theory, the top 10 percent of funds have a five star rating, while the bottom 10 percent of funds have a one star rating.

The ranking universes are in broad categories, however, with all domestic equity funds compared against one another. U.S. large growth funds are compared to small value funds. How can we evaluate what this means? When you choose a five star fund, what are you getting? We used Morningstar data from April 1999 to research this issue.

More than a third of U.S. large growth equity funds had a top Morningstar ranking of five stars. In the foreign arena, your choices were two in three of getting a five star fund if you limited your choice to European funds, but less than one in eight if choosing among diversified foreign funds. Apparently, not having the ability to invest in Japan has equaled genius in the past few years. If you were choosing among emerging markets bond funds, you had a 100 percent chance of getting a one star ranking, a record rivaled only by Bluto Blutarsky's grade point average in the movie *Animal House*. Do the fund companies only assign their poor managers to this area? Only about one half of one percent of large company, blended style stock funds or intermediate bond funds had a one star ranking. Are we to conclude that there are almost no poor managers of such funds?

We believe these statistics demonstrate that Morningstar rankings do an excellent job of telling you what you already know. Whether it's from "following the stars" or a cruder method of just directly chasing performance, investors send their money to where the performance has been, not necessarily where it's going. The performance and cash flows of the Janus 20 fund, perhaps the hottest fund of the past year or so, provide an excellent example. Janus 20 had a big year in 1991, with a total return of 69 percent, more than 38 percent better than the S&P 500 index. Sigma estimates that in 1991 and 1992, the fund enjoyed new cash flows of almost \$2.7 billion. From 1992 through 1997, the fund performed worse than the S&P 500 in five out of six years. Sigma estimates cumulative cash flows

from 1993-97 amounted to only \$27 million -- about one-tenth the amount in five years as in the two years during and just after the stellar 1991 performance.

***Fund rankings in December 1997
would have given no clue how
well Janus 20 would do in 1998***

In 1998, lightning struck again and the fund had a 73.4 percent total return. Sigma estimates a \$5.4 billion cash flow into the fund in 1998 and \$7.2 billion more through April 1999. This cash flow was more than double the amount the fund had accumulated from its inception in 1985 through 1997. Clearly, money follows performance, but could you have seen it coming relying on Morningstar ranks? An investor analyzing Morningstar data in December 1997 would have seen that while Janus 20 had a four star rating (putting it roughly in the top third of domestic stock funds), its category ranking within its peer group of large growth funds was only in the middle of the pack. Its one year and three year star ratings were average and its five year star rating was below average. In other words, the rankings would not have motivated you to throw money at the fund that was about to have a blowout year.

We do not intend any of this as a criticism of Morningstar, Inc., which is Sigma's principal source of mutual fund data. Morningstar is a superb research organization that has put huge amounts of previously unavailable information in the hands of investors. To their credit, they have expressed dismay at the use of their star rankings by fund companies and the media and have repeatedly warned against misinterpreting the "stars." We are sometimes asked if all that data available from Morningstar or over the Internet poses a threat to Sigma's business. On the contrary, we believe it is pretty clear that investors have either been bored or overwhelmed by the data available to them and wind up relying just on performance or "star" rankings.

While we don't use the fund in client portfolios, we also do not intend this as a criticism of the Janus 20 fund, which holds a concentrated portfolio of large growth stocks. Large growth stocks did very well in 1997 and 1998. Janus 20's star ranking now reflects this, but it tells you nothing about the future. If large growth companies run into a rough patch, the fund's portfolio would likely be severely hurt. If small company and foreign stocks are dominant in the next several years, the fund will have a hard time keeping up, even independent of the challenges of managing a concentrated fund that is suddenly ten times bigger than it was in 1994.

The message is that having a rational investment process is more important than looking back at recent performance. While you might be able to drive a car for at least a while looking only through the rearview mirror, it's not advisable. Sigma's investment process includes looking inside mutual funds and analyzing what makes them work. If you want analysis more akin to medicine or engineering than astrology, call us.