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Morningstar Ratings and Mutual Fund Performance

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Abstract

This study examines the Morningstar rating system as a predictor of mutual fund performance for U.S. domestic equity funds. We also compare the predictive abilities of the Morningstar rating system with those of alternative predictors. The results indicate findings that are robust across different samples, ages and styles of funds, and performance measures. First, low ratings from Morningstar generally indicate relatively poor future performance. Second, there is little statistical evidence that Morningstar's highest-rated funds outperform the next-to-highest and median-rated funds. Third, Morningstar ratings, at best, do only slightly better than the alternative predictors in forecasting future fund performance.

I. Introduction

In recent years, increasing attention has been paid to the persistence of mutual fund performance in the finance literature.[1] Yet, to date, there has been considerably less attention devoted to the predictive abilities of the Morningstar five-star mutual fund rating service that many investors use as a guide in their mutual fund selections. This study attempts to fill that void by examining the ability of the Morningstar ratings to predict both unadjusted and risk-adjusted returns in comparison with performance metrics common in the performance literature.

The question of whether Morningstar ratings predict out-of-sample performance is an important one, given that several studies in the performance literature have documented that new cash flows from investors are related to past performance ratings (see, e.g., Sirri and Tufano (1998) and Gruber (1996)). In fact, there is evidence that high-rated funds experience cash inflows that are far greater

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[1]For example, see Hendricks, Patel, and Zeckhauser (1993), Goetzmann and Ibbotson (1994), Malkiel (1995), Brown and Goetzmann (1995), Elton, Gruber, and Blake (1996a), and Carhart (1997).