

# The Five Star Myth

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When investing, buying into a “Five Star Rated” mutual fund creates an opportunity for investors and advisors to boast about how spectacular their investments perform. It is not uncommon to hear a client ask, “Well how many stars do your mutual funds have?” Examining the star rating system put together by Morningstar reveals that it’s designed to compare mutual funds side by side to a similar mutual fund, and it is not an indicator of future performance. In fact, Morningstar disclosures will tell you in detail how their star ratings do not translate into positive performance in the future. Star ratings only describe what a fund **has done** compared to its peers or mutual funds in a similar asset class. Yet clients and advisors continue to pour money into highly rated funds despite the fact the star rating system doesn’t attempt to forecast the future. In fact:

- In 1995, 70% of new money went into 5 star rated funds
- In 1998, 90% of new money went into 5 star rated funds
- More recently, research showed that 95% of all new mutual fund money going into mutual funds that are five star rated funds.<sup>1</sup>

Investors end up pouring money into investments that have performed well with the expectation that it will continue to do so. Advisors recommend these investments that have done well to woo new clients and impress existing ones. The truth is that the highly rated funds do not perform better and typically perform worse once becoming a five star rated fund.

Now more than ever in this information age with countless data available and updated every minute it is critical that investors do the following:

1. Understand and discuss your financial goals and set up a plan that focuses on achieving important objectives.
2. Assess the risk tolerance of your current investments and compare that risk to the risk outlined in your financial plan to be sure the two are aligned. Don’t take on more risk than you need to and be certain the returns in your portfolio match the risk you are taking!
3. Measure the performance of your managers/mutual funds on a regular and reoccurring basis. Compare their performance to the market averages and be certain that a strategy is in place that focuses on what is next.

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<sup>1</sup> Source of data: Federal Reserve Bank of Atlanta, *Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows*, August ,2001

4. Diversify wisely across a gamut of investment styles to take advantage of areas in the market that should perform well over the next 12 to 18 months, ignore star ratings and what has performed well.
5. Stop looking at the past to decide where to invest! The key is to hire a financial advisor whose philosophy and investment process includes tactical movements to find and invest in areas of the market poised for growth given a variety of market indicators.

So look to your CPA at Henry and Horne, LLP to help you put together a team of professionals dedicated to objectively construct an unbiased portfolio of progressive investments and integrate that investment plan with a detailed financial plan and risk assessment that considers all factors prior to making an investment decision. If investing was simply a matter of choosing what investments did well in the past than certainly we would all invest in five star rated mutual funds and every year have superior performance. Understanding the truth behind the five star myth sheds light on the importance of investing with a professional dedicated towards creating a forward looking portfolio poised for long term results.

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