

Reprint of 9/5/2017 article: <https://www.morningstar.com/articles/831785/frequently-asked-questions-morningstar-rating-for-funds>

## WHAT ARE MORNINGSTAR RATINGS ALL ABOUT?



### What is the Star rating?

The Morningstar Rating for funds, often called the Star rating, is a data-driven measure that compares a fund's performance to similar funds, adjusted for the risk the fund takes.

### How is it calculated?

Morningstar groups funds into categories based on their investments to calculate the Star rating, allowing an apples-to-apples comparison.

Each fund in the category is then ranked based on its trailing three-, five-, and 10-year returns, adjusted for the risk the fund has taken.

The funds are then assigned a Star rating based on a bell-shaped distribution: The 10% of funds with the best rankings receive a 5-star rating; the next 22.5% get 4 stars; the 35% after that earn 3 stars; the next 22.5% receive 2 stars; and the bottom 10% of funds earn 1 star. With few exceptions, any fund with a three-year track record is eligible for a Star rating.

### What's the best way to use the Star rating?

The Star rating is a helpful starting point for fund research, but it should be combined with other measures and data.

While the Star rating has inherent limitations, given its reliance on past performance, it points investors toward cheaper funds that are easier to own and likelier to outperform in the future, qualities that correspond with investor success.

### Does the Star rating point investors toward less expensive funds?

Our analysis shows that it does. Using funds' historical annual report net expense ratio data, we find that higher-rated funds have consistently been cheaper than lower-rated funds. Indeed, the average cost difference between 5-star and 1-star funds was nearly 0.60% during this span; that gap has not closed meaningfully even in recent periods (as of May 2017, the average 5-star fund cost 0.92%, while the average 1-star fund levied a 1.51% annual fee).

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This is important because expenses reduce investment returns basis point for basis point. Our research has also shown fees to be one of the best predictors of future performance. As such, investors are well-advised to judiciously manage costs, paying no more than they need to.

### **What's the difference between the Star rating and the Morningstar Medalist rating?**

The Star rating (Morningstar Rating for funds), is a purely data-driven measure of risk-adjusted past returns. It serves as a helpful jumping-off point for research.

The medalist rating (Morningstar Analyst Ratings for funds) is driven by a human analyst's assessment of a fund's likelihood to outperform its category over time.

Analysts reach their conclusions by focusing on five pillars (Process, People, Performance, Price, and Parent). Funds with Gold, Silver, and Bronze ratings are expected to outperform; neutral funds should perform in line with the category, while Negative funds are expected to underperform.

### **Are funds with high Star ratings less risky?**

Morningstar's head of global manager research, Jeff Ptak, recently examined trends in the riskiness of Star-rated funds and found that, on average, higher-rated funds tended to experience less dramatic downward performance spikes in the three years following the assignment of a Star rating. (Morningstar Risk, a measure of a fund's downside return volatility, was used as a proxy for risk here.)

### **Are funds with high Star ratings likely to outperform those with low ratings?**

Though we do not expect the Star rating to predict performance, it's still an important question.

One way to answer is to examine the relationship between funds' Star ratings and the Star ratings they received subsequently. This is a meaningful test in that it measures funds based on their subsequent load- and risk-adjusted returns versus peers, not just their raw returns. In that way, it is an apples-to-apples comparison of rated funds' performance before and after they receive a Star rating.

Although the results are not clear-cut, it's evident that higher-rated funds are far more likely to finish a subsequent period highly rated than lower-rated funds. Such funds were also much less likely to become laggards--that is, lower-rated--in subsequent periods or to die. By contrast, low-rated funds seldom reversed their fortunes; most continued to languish as 1- or 2-star funds, if they survived at all.

This pattern held by asset class, though the absolute level and magnitude varied: It was strongest among allocation and bond funds and weakest among U.S. equity funds, as shown below. More on the performance of the Star rating can be [found here](#).