

# Shedding light on star ratings

Jingyi Sui, CFA, CFP® • Mutual Fund Research Analyst



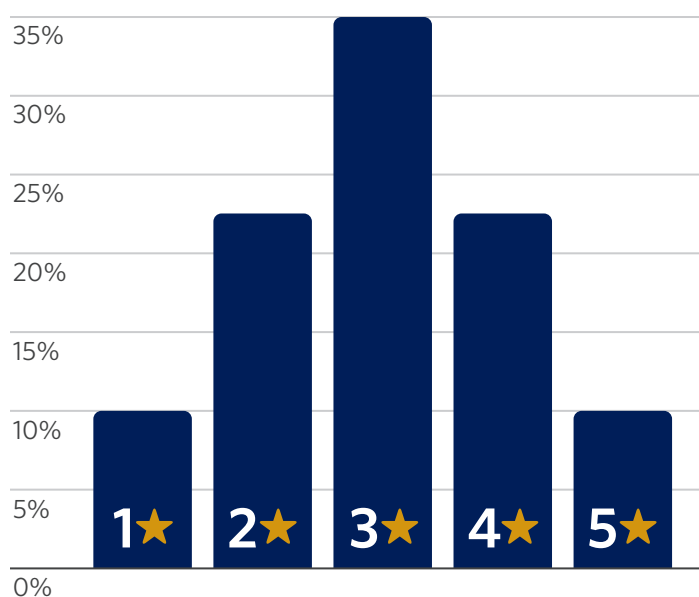
Many people use Morningstar “star ratings” to evaluate mutual funds. However, when you’re trying to understand the quality of a mutual fund, the star ratings may not give you the full story. Understanding how star ratings are assigned can help you make better-informed decisions about which mutual funds may be appropriate for you.

## What are star ratings?

Morningstar describes its star ratings as “... strictly a quantitative measure ... based solely on the investment’s historical performance.” Morningstar measures each fund’s risk-adjusted return, which is calculated based on the level of market volatility impacting that return.

The star ratings range from one star as the lowest to five star as the highest. Among similar funds, the ratings reflect a bell-curve distribution, meaning 35% of the funds in a category will receive the median three-star rating. In addition, only 10% of funds in that category will receive the lowest (one-star) rating, while 10% will receive the highest (five-star) rating, as the chart illustrates.

## Distribution of star ratings



Source: Morningstar

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## Five limitations of star ratings

Star ratings can be useful when researching mutual funds; however, past ratings alone shouldn't be used to estimate future performance. Like last week's weather report, they may be interesting but have limited use when planning for the future.

### 1. The fund is rated, not the portfolio manager

An important nuance of star ratings is they measure performance of the fund and not the people responsible for the fund's performance, as shown in the table below. Portfolio managers change frequently, and if a successful portfolio manager leaves, the fund's star rating remains, potentially overstating the quality of a fund.

	Morningstar rating	Morningstar category	Manager tenure (longest)
Fund A	Five star	Large-cap blend	23 years
Fund B	Five star	Large-cap blend	3 years

Source: Morningstar Direct, 3/31/2023.

On the other hand, there are circumstances in which a star rating may understate the quality of a fund. For example, a portfolio manager with a quality investment philosophy and process can assume responsibility for a struggling fund with a low star rating.

### 2. Short-term performance can create biases

Morningstar ranks funds over three periods (three, five and 10 years). Since each period takes into account the most recent three years, star ratings are more sensitive to shorter-term returns. This rating may overstate or understate the fund manager's abilities because events outside the manager's control can highly impact short-term performance.

### 3. One fund may carry multiple star ratings

A mutual fund usually has multiple share classes. Each share class has a separate star rating because of different fee and inception dates (when the class was created). Therefore, despite the fund being managed by the same team and its owning the same investments, different share classes of the same fund may carry different star ratings.

#### 4. Ratings are not comparable across asset classes

Morningstar categorizes funds based on asset class. When looking at funds across categories, it's not an apples-to-apples comparison. Two five-star funds in different asset classes may have considerably different risk profiles. Standard deviation, one measure of risk, may be higher for a five-star small-cap blend fund than a five-star large-cap blend fund. The chart below illustrates the importance of evaluating whether a fund is consistent with your risk tolerance and how it may fit within your portfolio.

	Morningstar rating	Morningstar category	Standard deviation*
Fund A	Five star	Small blend	28.2%
Fund B	Five star	Large blend	15.6%

\*Source: Morningstar Direct. Five years ending 3/31/2023.

#### 5. Ratings do not account for complexity

A star rating helps communicate a fund's past performance but doesn't account for how the returns were achieved. For example, star ratings don't identify funds that use complex instruments such as derivatives, which may expose investors to additional risks.

##### Morningstar analyst ratings

In November 2011, Morningstar began supplementing star ratings on select funds with qualitative analysis performed by its analysts. These analysts evaluate a fund's five pillars: People, Process, Parent, Performance and Price.\*

While Morningstar Analyst Ratings provide additional context that can be helpful, this framework targets a wide audience and shouldn't be the determining factor on whether a fund is appropriate for you.

\*Source: Morningstar

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## What you can do

If the limitations are considered, star ratings can be among many items to think about when you're searching for quality mutual fund investments. Fortunately, Edward Jones has resources to help with the fund evaluation process and ultimately with the final investing decision. Your financial advisor is supported by two groups dedicated to mutual fund selection and portfolio construction:

- **Mutual Fund Research** — The Mutual Fund Research department searches the mutual funds market for quality, long-term investments. Our team of 19 investment professionals has more than 200 years of collective investment experience, and all our analysts are required to earn the Chartered Financial Analyst® (CFA) designation.
- Mutual Fund Research analysts conduct quantitative and qualitative analysis to identify mutual fund investment teams who have been successful in the past and who they anticipate can be successful in the future.
- **Investment Policy Committee** — The Investment Policy Committee (IPC) is responsible for providing investment guidance and developing policies, such as asset allocation guidelines, that financial advisors can use in helping clients reach their financial goals. This committee, which includes investment professionals from numerous areas throughout Edward Jones, also seeks input from our financial advisors and industry professionals outside the firm.

Together with your financial advisor, these teams can help you understand your mutual fund investment options. Talk with your financial advisor to determine which mutual funds are designed to help you work toward your unique, long-term financial goals.

