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1st Quarter 2018

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How independent research can improve investment decisions

By ***Egemen Genc and Marno Verbeek***

Independent research that expands the information set to include qualitative elements can help investors make better investment allocation decisions. This is one of the central findings explained in a recent paper, which attempts to pin down the influence of qualitative ratings awarded by the independent fund analysis firm Chicago-based Morningstar on the perception of any given individual fund.

Morningstar, Inc is one of the most highly regarded investment analytic houses in the world. Its brief corporate history on its own website shows that it was launched in Chicago on 16 May 1984. It describes itself today as a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisors, asset managers, retirement plan providers and sponsors, and institutional investors. It provides data and research insights on a wide range of investment offerings.

Morningstar launched a new set of analyst ratings in 2011, partly to answer the demands for improved research with respect to future mutual fund performance. Morningstar's analysts combine qualitative, research-based information with quantitative, numerically based analysis to generate a composite rating of a fund's prospect to provide superior risk-adjusted return over the long term. The analyst conducts a thorough analysis of the fund across five pillars (People, Process, Parent, Price and Performance), which Morningstar believes to be crucial for predicting future performance.

These ratings summarise the outlook of its analysts for each rated fund using a five-tier scale with three positive (recommended) ratings of Gold, Silver, Bronze, a Neutral rating and a Negative rating. The analyst rating is freely available on Morningstar's website while the corresponding analyst report can only be accessed by paying a subscriber fee. Subsequent to the initial rating, Morningstar analysts monitor rated funds on an ongoing basis and periodically provide additional analyst reports, which may (or may not) lead to a change in the analyst rating. Additionally, any time there are material changes to a fund (eg, a change in the management team), the analyst initiates a new review of the fund's rating.

Fund performance

Returning to our research, we found evidence that the new rating system identifies funds that outperform peer funds by a clear margin. Moreover, we found that an investor who follows a naive (equal-weighted) strategy of investing in a portfolio of Gold-rated funds would earn significantly higher returns than would be obtained by investing in Not Recommended funds.

While there is a substantial literature that examines analyst recommendations of individual stocks, there is little research available that assesses the impact of forward-looking ratings of mutual funds. In our paper, we investigate Morningstar's qualitative, forward-looking analyst ratings, which reflect independent analysts' expectations of a fund's future performance. We find relatively higher flows to funds receiving higher ratings, suggesting that the average investor values the analyst's subjective views when allocating their wealth.

Earlier academic research largely suggests that mutual fund investors either rely heavily on measures of historical fund performance, which lead investors to chase returns or follow recommendations from brokers representing the funds.

Unfortunately, quantitative measures of historical performance are backward looking and contain little information regarding future performance. Broker recommendations also offer little value to investors, especially after taking fees and expenses into account.

Our aim in the paper is twofold. First, we explore how analyst ratings affect the capital allocation decisions of fund investors and how this relation changes with fund characteristics previously shown to affect flows, including

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the widely followed star ratings. The qualitative nature of these ratings has the potential to expand the information set of uninformed investors as the ratings summarize both tangible and intangible information pertaining to the rated funds into a relatively easy-to-understand metric.

Further, Morningstar's reputation as a well-known, independent source of mutual fund information should facilitate broader investor adoption of these ratings. Unlike broker advisers, Morningstar operates a business model in which analysts do not prospect for potential customers through advising, nor do funds commission their research. This means that there is no obvious incentive mechanism that would compromise the ability of its fund analysts to be impartial.

Second, we assess the value of these ratings as a criterion for identifying which mutual funds are expected to have relatively higher future performance. Backward-looking measures such as star ratings are documented to have limited value in terms of selecting better-managed funds. Morningstar's stated objective is to identify funds with the potential to outperform their peers on a risk-adjusted basis over the long term (ie, a full business cycle). Given that many retail investors follow Morningstar's research, it is important to understand whether the forward-looking analyst rating contains information with respect to a fund's future performance.

We next examine how variation in Morningstar's star ratings, also a strong predictor of fund flows, affects the relation between analyst ratings and fund flows. We find that additional flows accruing to Gold-rated funds are higher when funds have star ratings of three stars or less; flows to Not Recommended funds are lower when funds have star ratings of four or five stars.

These results are consistent with investors responding to the analyst rat-

The numbers involved are large. Household investments in mutual funds represent approximately 89 per cent of the US$16 trillion in assets under management at the end of 2016. With approximately 8,000 mutual funds in existence, the question of how investors choose to allocate wealth across this set of mutual funds is a topic of ongoing debate.

ings, and even more so when the ratings offer a contrary view to the star ratings. If investors disproportionately allocate more capital to funds with star ratings of four or five stars as shown in the literature, the Gold rating may result in increased investor interest in funds that have relatively low star ratings.

In contrast, investors who remain in poorly performing funds are less information-sensitive. If more vigilant investors have already withdrawn capital from funds with relatively low star ratings, a negative signal such as receiving a Not Recommended rating is likely to have less further impact on the flows of these funds relative to funds with higher star ratings.

Establishing a robust flow response to funds with high analyst conviction, we next assess if the analyst ratings contain information about the rated funds' future performance. We found that Gold-rated funds outperform Not Recommended funds by 1.2 per cent per year on a risk-adjusted basis. This finding is robust to controlling for performance predictors and various managerial characteristics documented in the literature. In comparison, Silver or Bronze ratings have no predictive power for fund performance. These results suggest that funds with the highest analyst conviction fulfil Morningstar's objective of identifying superior funds, but not all analyst ratings are equally informative.

Our results are important for investors seeking to maximise return on their investments and for fund managers trying to maximise assets under management. Given the proliferation of investment advice from various sources, investors should be interested in knowing the reliability and value of analyst recommendations.

Understanding the value of the recommendations is especially important since traditional backward-looking measures have little power to predict superior future performance. Further, the impact of analyst ratings on future fund flows may incentivise fund managers to improve in the key areas that affect their fund's analyst ratings. This is important in an industry in which more than 90 per cent of fund managers are compensated with a fixed percentage of assets under management. ■

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This article draws its inspiration from the paper *Going for Gold: An Analysis of Morningstar Analyst Ratings*, written by Will J. Armstrong, Egemen Genc, and Marno Verbeek, and published online in *Management Science*, 22 December 2017. DOI: http://dx.doi.org/10.2139/ssrn.2419669

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