SCHNEIDER DOWNS
Wealth Management

Scorecard System vs. Morningstar

As investors demand more usable information (along with stronger returns), companies strive to find better ways to analyze investments. The purpose of this article is to illustrate the difference between RPAG's Scorecard System™ and Morningstar's Rating System.

A widely used investment tool, the Morningstar Rating System uses a risk/return measure to score mutual funds from 1 to 5 stars. While the star rating offers good analysis on the historical risk/return characteristics of mutual funds, it ignores several important factors that should be considered before selecting an appropriate investment.

The Morningstar Approach

Morningstar's rating system has been popular among retail investors for over a decade. The star rating is purely based on risk-adjusted performance across various time periods, from three to 10 years (with significant weighting on the most recent three years of returns). In 2002 Morningstar revised its rating system to include an enhanced risk-adjusted returns formula that penalizes funds for both upside and downside deviations in returns, and compares each fund only to other funds in the same asset class.

Morningstar gives the top 10 percent of funds a 5-star rating; the next 22.5 percent, 4 stars; the next 35 percent, 3 stars; the next 22.5 percent, 2 stars and the bottom 10 percent, 1 star. The star system offers investors some good insight into the historical risk-adjusted performance of a mutual fund, but falls short of the due diligence that should be completed before making an investment decision. Morningstar acknowledges this by stating "We (Morningstar) hope that the star rating will help you reach your goals when you make it part – not the heart – of your process."

Beyond 5-Star Ratings: RPAG's Scorecard System

RPAG's Scorecard System embodies a comprehensive approach to investment due diligence. The Scorecard System measures three different risk/return criteria (versus Morningstar's single measure) as well as style characteristics, peer group rankings and multiple qualitative factors, including portfolio manager tenure, expenses and strength of statistics. The scoring system is built around pass/fail criteria (0-10, with 10 being the best) and measures active, passive and asset allocation investment strategies.

While the Morningstar rating measures risk/return characteristics, it fails to take into account several other important metrics. For example, portfolio manager tenure: a fund may have an attractive five-year return, but also have an entirely new portfolio management team not responsible for that past performance. The star rating also fails to look explicitly at fund expenses (which many studies have shown to be a strong indicator of future out-performance) and neglects to consider certain style aspects of a fund, such as style drift. Managers that chase returns in other asset classes may actually be rewarded, rather than penalized, in the star rating system.

Conclusion

Not all rating systems are created equal. RPAG's proprietary Scorecard System incorporates multiple criteria into the fund rating (or score). This comprehensive approach affords fiduciaries an extremely powerful investment tool they can use to select and monitor funds; it can be applied to any retirement plan, regardless of size or sophistication.