

BCA Market Perspective ©

Portfolio Manager Challenge... Staying on Top

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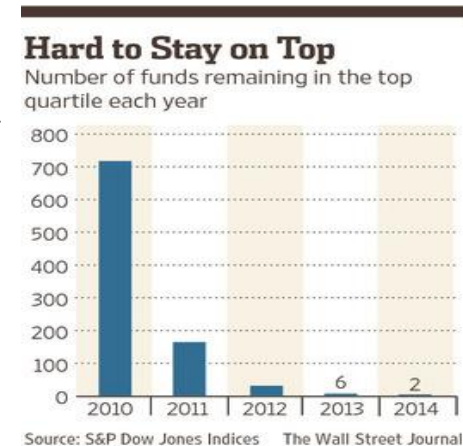
Since March 9, 2009, the Standard & Poor's 500 Index has expanded 192 percent through September 30, 2014. In an environment where the Federal Reserve has promoted ownership of stocks, irrespective to quality, the majority of portfolio managers have trailed their respective index targets. For the five-year period ending September 30, 2014, the S&P 500 index returned 15.7% per year and ranked in the top 12th percentile of the Morningstar large-cap blend universe – that is, beating 88% of the universe of products. Naturally, this has encouraged investors to embrace index funds. Of course, that also means accepting the volatility and risk of a defined market.

According to the Wall Street Journalⁱ, top-rated mutual funds from 10 years ago (2004), having five-star ratings from Morningstar Inc., many have dropped to four stars, three stars or worse. Among the fund products with five-star ratings 37% had lost one star 10 years later, 31% lost two stars, 14% dropped three stars, and 3% lost four. That works out to 85% of the peer group got worse. Only 58 funds out of the original 403 funds carried the same five-star rating through July 2014.

Separately, Professors Christopher Blake of Fordham University and Professor Matthew Morey of Pace University analyzed the predictive powers of Morningstar ratings and found several conclusions.

1. Morningstar ratings, at best, do only slightly better than alternative predictors in foretelling product performance.
2. There is weak statistical evidence that five-star rated products outperform the four and three-star funds.
3. Morningstar was able to predict low-performing funds below three stars, which generally have much worse future performance than other groups.

BCA has found a similar paradox when reviewing investment managers having top quartile five-year performance. It has been shown that sequential five-year performance samples reveal a new set of top performers. And managers that were narrowly below the median for a five-year period were more likely to end up in the next five-year period.



ⁱ WSJ Sept 7, 2014

