



June 24, 2011

In This Issue

The Star-Spangled Fund Universe

Anyone who has invested in mutual funds should be familiar with the phrase "past performance is no guarantee of future results." Yet for years, many individual investors have largely ignored this advice by basing their mutual fund selections in part or entirely upon Morningstar's "star" ratings--a system that focuses heavily on past performance.

In fact, Morningstar's star system is so in tune with the average investor's tendency to chase performance that, according to *The Wall Street Journal*, 90% of assets flowing into mutual funds end up in funds with a four- or five-star rating. This occurs despite the fact that past performance--and Morningstar's star ratings--have historically had little correlation to future performance.

Earlier this month, Morningstar tacitly acknowledged the limitations of its star system and announced that they'd developed a new, forward-looking methodology called "Analyst Rating" to evaluate funds. The new system is intended to supplement the star system, which the firm will continue to use. It focuses less on past performance (or underperformance) and relies upon the analysis and opinions of Morningstar analysts. The firm is characterizing the new system as an "aptitude test" for funds, while they refer to the existing star system as an "achievement test."

According to Morningstar, the new ratings, which will start rolling out in the fall, will be based on five P's: People (quality of the management of the fund), Process (a fund's objective and how closely it's followed), Parent (quality of the fund family behind the fund), Performance (long-term results and consistency throughout market cycles) and Price (expenses and fees).

Based on how Morningstar's analysts feel about a fund's five P's, they'll each be rated on a five-part scale, ranging from AAA (best of breed), AA (notable advantages), A

- The Star-Spangled Fund Universe
- True Independent Research and Advice

(the lowest favorable rating), neutral and negative. In short, the rating will be based on the analyst's conviction in the fund's ability to outperform its peer group and/or a relevant benchmark on a risk-adjusted basis over the long term.

Morningstar estimates that only 10% to 20% of the funds it rates will earn positive ratings, while 20% will likely receive negative ratings. The majority of funds will be rated as "neutral." The new rating system will replace the current "Analysts' Picks and Pans" system.

We expect the Vanguard funds we own to score well on low costs (price), "stewardship" (parent) and "process," as Vanguard's portfolio oversight group holds managers' feet to the fire and tells them what they can and can't do. Additionally, since Vanguard outsources portfolio management to other large sub-advisors, we expect they will earn high "people" and "performance" marks. The Fidelity funds we've included in client portfolios will likely also earn high ratings in most of the five P's.

True Independent Research and Advice

While we commend Morningstar for broadening the scope of its research, we caution investors against putting too much stock in the new analyst ratings. For one thing, it's hard to view Morningstar as a truly independent arbiter of mutual fund performance. Visitors to Morningstar's website are greeted by a splashy ad from a large mutual fund firm touting the fact that 45 of its no-load funds received four or five stars. Advertisements from several other fund firms are scattered across the site. The firm publishes a magazine for financial advisors that features full-page ads from these same mutual fund firms. We are not implying that Morningstar is engaged in any malfeasance, but the fact remains that their "independent" business model relies on ad revenues from the very companies they review.

At Adviser Investments, we don't earn commissions or any other form of compensation from the fund companies in which we invest. We focus on protecting our clients' hard-earned savings and helping them achieve their financial goals. As a truly independent, fee-only adviser, we have aligned our interests with our clients' interests. Our success depends upon their success.

Furthermore, while Morningstar's new ratings do consider the people and teams who manage mutual funds, we believe the fund manager's expertise should outweigh other criteria. When you buy an actively managed mutual fund, what you are really buying is the manager's expertise. Because managers change frequently, it can be difficult to determine who was really at the helm and who

was responsible for the fund's performance numbers.

We solve this problem with our in-house, deep research into the managers behind the fund universe, which identifies those who have added the most value over time, while adjusting for differences in fund objectives and benchmarks. We deploy one of the largest private databases of mutual fund and exchange-traded fund information, which helps supplement our fundamental research with trend analysis. We make it our business to know the fund managers, their styles and their history better than anyone else in the industry.

While Morningstar's new analyst ratings offer investors an additional tool for researching funds (the value of which will obviously be dependent on the quality of the analysis behind the ratings), it won't provide the independent, personalized analysis and attention that we provide our clients. With Independence Day approaching, we believe it's important to remind investors of the benefits of truly independent financial research, advice and money management.

About Adviser Investments

Adviser Investments and its subsidiaries operate as an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 2,400 clients and over \$2 billion dollars under management, Adviser Investments is one of the nation's largest mutual fund research and money management firms. Our staff of 50 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is \$350,000.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.
