

November 2nd, 2017

Mark Spina,
Head of Advisor &
Intermediary Solutions

Mutual fund ratings, The Wall Street Journal and the value of manager research



The Wall Street Journal recently published a report on the issues with Morningstar ratings. As they said in the article, "...investors, and the people paid to guide them, take for granted that the number of stars awarded to a mutual fund is a good guide to its future performance. By and large, it isn't."

As any advisor or investor who has ever read a disclosure statement knows, *past performance is no guarantee of future results*.

That disclosure language appears to be true. In the Journal's report, they find that only 14% of funds that received a five-star overall Morningstar rating performed at that level over the next three years.

In my opinion, the key to the WSJ article, and to the truth, is that star ratings like Morningstar, by definition, focus on past performance. To be clear, we believe Morningstar's data on past performance sets an industry standard. And, as long as investors and advisors understand the limitations of the historical track records, Morningstar data and star ratings provide valuable inputs.

So, what's an investor or advisor to do? There are never guarantees. Investing is always inherently risky. But is there a meaningful way to be more predictive than by focusing on past performance?

We think so. That way is called manager research.

At Russell Investments, we look beyond performance. With nearly fifty years of manager research experience, we believe that superior manager research can identify skilled active managers. We work to identify these potential outperformers with a *hire* rank.

As part of that effort, we follow a process similar to Morningstar's star-rating system, carefully crunching performance numbers. But as the Journal report and our own years of data show, performance only looks backwards. In other words, where many investors stop their due diligence, Russell Investments' manager research is just getting started. Past quantitative performance analysis is necessary, but by no means sufficient.

Let's look at the results of our manager research. Of the lists of managers that earn a *hire* ranking from our process, approximately 73% beat the peer universe median over five-year rolling time periods, measured over the past 10 years, gross of fees.

Not a bad track record. Then again, past performance is no guarantee of future results.

How do we identify potential outperformers?

As of June 30, 2017, we are actively monitoring more than 13,000 active manager investment products. We continually research more than 7,800 investment products. Only 755 of these earn a *hire* rating by our dedicated team of manager researchers. If you followed those numbers, you recognized that we research more than just mutual funds (of which the Morningstar database covered approximately 10,800 according to the article), and only 10% of the products we monitor actually wind up with a *hire* rank.

Experience counts in this effort. Our senior research analysts average more than 18 years of investment industry experience. We follow a process that we've developed over that time, which we believe identifies which money managers will outperform over a full market cycle. That's what we're after—excess performance. A money manager has to be able to beat the index to be worth their fees. In our manager research process, manager performance is validation of how well we've understood a manager's process. We strive to understand not only when we expect a manager to outperform their peers and/or benchmark, but also when we expect them to underperform. We balance our understanding of the manager within the context of overall market performance to evaluate how well a manager has executed their strategy relative to our expectations.

That's why a huge part of our effort goes beyond quantitative performance data and brings qualitative tools into play. As of December 31, 2016, we hold more than 2,000 face-to-face meetings with managers each year, looking into their people, their processes and other hard-to-quantify factors. From those meetings, we've created a proprietary database that contains more than 20 years of our qualitative assessments and interview notes.

The longevity of this database means our collective memory as an organization can be mined by our analysts across numerous market cycles. It means we rarely go into a money manager meeting blind. We can see how they performed in the past in different market environments, how we have previously described their process, how they describe their process to us, who has worked for them, and who they've worked for. We also look at their holdings—at the contents of their portfolio. Do their holdings match the investment process they claim? Have they made good buy decisions? How about sell decisions? We want to know. Our research analysts are trained at relentlessly getting to the bottom of these—and many more—questions.

Why do the money managers give us this access? After all, it's a lot of time and a lot of proprietary information we're after. We believe it's because they recognize that we can also give *them* access: to assets. We advise on more than \$2.3 trillion (as of June 30, 2017) and have more than \$280 billion in assets under management (as of Sept. 30, 2017), so managers are motivated to work hard and to keep us informed.

Here's another validation: Morningstar itself takes a somewhat similar process with its *analyst ratings*. As they say in a rebuttal to the Wall Street Journal report, "...the Analyst Rating is a forward-looking, qualitative assessment of a fund's prospects. Morningstar's manager-research analysts assign these ratings based on their evaluation of factors like people, process, performance, parent and price."

Apparently, great minds think alike.

Disclosures:

These views are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. The information, analysis, and opinions expressed herein are for general information only and are not intended to provide specific advice or recommendations for any individual or entity.

This material is not an offer, solicitation or recommendation to purchase any security.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Nothing contained in this material is intended to constitute legal, tax, securities or investment advice, nor an opinion regarding the appropriateness of any investment. The general information contained in this publication should not be acted upon without obtaining specific legal, tax and investment advice from a licensed professional.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Investments that are allocated across multiple types of securities may be exposed to a variety of risks based on the asset classes, investment styles, market sectors, and size of companies preferred by the investment managers. Investors should consider how the combined risks impact their total investment portfolio and understand that different risks can lead to varying financial consequences, including loss of principal. Please see a prospectus for further details.

Indexes are unmanaged and cannot be invested in directly.

The information, analysis and opinions expressed herein are for general information only and are not intended to provide specific advice or recommendations for any individual entity.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments Group, LLC 2017. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Russell Investments Financial Services, LLC, member FINRA (www.finra.org), part of Russell Investments.

RIFIS: 19441

Disclosures

Russell Investments does not control, endorse or accept responsibility for content, services, security or privacy on third-party sites.

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments Group, LLC 2017. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Russell Investments Financial Services, LLC, member FINRA (www.finra.org), part of Russell Investments.

Not FDIC Insured • May Lose Value • No Bank Guarantee

Read this post on our blog: <https://blog.helpingadvisors.com/2017/11/02/value-of-manager-research/>