

INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**



BARNETT
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Uneasy lies the head that wears a crown



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Modern society loves a ‘star rating’. Most know what to expect if they book a 5-star hotel stay for a business trip when compared to a 3-star bed-and-breakfast for a weekend away. The investment field is no different, with many institutions offering their own spin on star ratings and how to calculate them. Unlike the hotel industry, many of the rating systems that assess the funds used by investors are best ignored. In this short note, we investigate why.

A quick Google of a fund name will most likely return links to some of the major data providers out there such as Trustnet, Morningstar, and The Financial Times. On these pages one might find star ratings, or similar, implying the relative quality of a product. The screenshot below shows an example of a UK equity fund that is currently rated as ‘5 Crowns’ on Trustnet through a system calculated by Financial Express¹. Note that this is not a recommendation of any kind!



Figure 1: ‘5 Crowns’ UK equity fund example rated by FE fundinfo

Source: Trustnet (2021), <https://www.trustnet.com/factsheets/o/k9k8/blackrock-uk-d-acc>

The challenge with these types of ratings is that the focus is solely on recent, short-term performance as opposed to long-term, sensible structure. Without getting too granular, the Crown Ratings are derived using 3-year performance and volatility - how much the performance moves up and down - compared to a benchmark, such as the FTSE 100 Index. 3-years is not nearly enough time, nor the sole use of performance figures insightful enough, to properly test the efficacy of one’s strategy, or the ability of a manager to pick stocks or time markets – not that this is a game played by sensible, systematic investors! Reviewing a track record of 20-years would be statistically more prudent, however, to have benefited as an investor one would have had to identify the investment in advance.

A crown is merely a hat that lets the rain in.

Frederick the Great, Prussian King (1712-1786)

Structuring portfolios based on ratings that are derived with hindsight goggles is a dangerous game. Sadly, there are many investors out there that do pay attention to these ratings and are engaged in a repetitive cycle of buying-high and selling-low. As a demonstrative exercise, we looked at the '1 Crown' and '5 Crown' UK equity funds, whose ratings were last updated in January 2021. The 1 Crown funds that faired poorly during the years where the ratings were calculated, have materially outperformed the 5 Crown funds on average so far this year.

Group	No. funds	2018-2020 average <u>annualised return</u>	2021 average <u>annualised return*</u>
1 Crown	31	-4%	44%
5 Crowns	26	8%	27%

Figure 2: UK equity fund performance of 1 Crown and 5 Crowns funds
 Source: Financial Express. Morningstar Direct © All rights reserved. *Annualised performed to 05/05/2021.
 Returns in GBP.

This goes to show that just because something has done well recently does not mean that it will continue to do so. As the famous investor Warren Buffet once said:

In the business world, the rearview mirror is always clearer than the windshield.

Our approach to investing accepts that markets work well and that beating them is extremely difficult without the benefit of hindsight. Therefore, your portfolio is structured to capture sensible market risks over time, through broad diversification across countries, sectors and companies whilst keeping costs as low as possible. The evidence suggests this is a 5-star solution.

End notes

1. Trustnet (2021) FE fundinfo Crown Ratings.
<https://www2.trustnet.com/learn/learnaboutinvesting/FE-Crown-Fund-Ratings.html>

Other notes and risk warnings

Use of Morningstar Direct® data

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