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Five-year performance numbers may be misleading

Morningstar considers adding a seven-year reporting period to give investors a better perspective

By **Dan Jamieson**
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As 2008 rolls around, it will bring an important historical marker: The five-year anniversary of the bull market.

In mid-March of 2003, the U.S. stock markets began a broad-based rally. That anniversary means that the upcoming five-year reporting period, from 2003 to 2008, will look unusually good — too good, according to some industry observers.

The period had such strong returns, along with low volatility, that Morningstar Inc. of Chicago is worried that investors might be misled by five-year numbers.

As a result, the research firm is "seriously considering" adding a seven-year performance number to its reports, said Morningstar analyst Paul Herbert.

Some researchers at the firm feel that including the bear market years of 2001 and 2002 in a seven-year figure, along with the standard 10-year data, will give investors a better perspective, he said.

Five and 10-year periods are required for advertising purposes and so have become industry standards, said Mike Breen, senior analyst at Morningstar. "But we're looking at finding better ways to tell the story. More reporting periods is one of the things investors want," he said.

The firm is not considering using seven-year periods in calculating its star ratings, Mr. Breen said. Morningstar's products for professional users have customizable periods, so static time frames are not such an issue for them, he added.

Offering more time periods for evaluation might help less sophisticated investors and advisers, industry observers said.

"I'm not sure it's particularly helpful to have seven-year numbers, [but] it might be more representative of a full [market] cycle," said Burton Greenwald, president of BJ Greenwald Associates, a Philadelphia-based financial services and mutual fund consulting firm.

"Having an interim period of seven years might be a device [for Morningstar] to differentiate themselves from Lipper [Inc. of New York] and some other [fund researchers]," he added.

Lipper has no plans to change its reporting periods, company spokeswoman Yuni Park said.

Money managers can look good or bad, regardless of their skill, depending on the time period and benchmark used, said Barry Mendelson, managing partner at Capital Market Consultants LLC in Milwaukee. Nevertheless, "people always buy on performance," he said. "They always believe past performance is a guarantee of future results."

Rolling five-year numbers already look enticing.

In Morningstar's large-blend category, for example, the average five-year return through last Monday was 11.8%. Over three years, the category returned 9.46%, and for one year, 7.84%.

World stock funds averaged 17.63% over five years, 15.08% for three years and 14.59% for one year.

Most fund categories tout similarly high five-year returns. But "it's always important to look over as many [market] cycles as you can" in evaluating managers, Mr. Mendelson said. "There's nothing magical per se about a three- or a five-year time period."

Bob Kargenian, founder of TABR Capital Management LLC in Orange, Calif., said the last full market cycle actually encompasses eight years — back to the end of 1999 — assuming that the October 2007 peak was the high point for the rally.

"Over the last five years, from the end of 2002 to the present, the [Standard & Poor's 500 stock index] compounded at 15% per year," he said. "But if you go back to Dec. 31, 1999, that annualized return drops to 2% per year."

For eight years, the market went "nowhere," Mr. Kargenian added. Assuming a dividend yield under 2% over that time period, "the market has underperformed cash" for eight years, he said. Ratings services such as Morningstar should incorporate such full market cycles in their analysis, Mr. Kargenian added.

Mr. Mendelson suggested evaluating a number of rolling time periods. "How did [a manager] do in recession? How did they perform when interest rates were going up or down?" Mr. Mendelson asked.

"The periods mean nothing," said Bryce James, president of Smart Portfolios LLC in Seattle, which manages money primarily for independent advisers. "I want to know whether the manager is a closet indexer, if he's making factor bets, whether he's diversified or concentrated."

Mr. James said asset allocation is far more important than the returns of a particular fund.

Mr. Mendelson said managers should always be judged on the basis of their style. "That's where you get an accurate picture if a manager knows what he's doing," he added.

Inaccurate style analysis and the wrong benchmark can create unfair comparisons, Mr. Mendelson said.

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