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Morningstar to offer predictive power

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Morningstar plans to begin publishing estimated trading costs for individual mutual funds this year, a new measure the firm says may help investors make smarter choices when picking funds.

But the forthcoming metric is not without controversy, as industry representatives cite past efforts to accurately ascertain those costs that have proven to be more art than science.

Chicago-based Morningstar, which has been working with liquidity provider ReFlow and a team of academics on the project, has not yet finalised the methodology it will apply, says Russel Kinnel, director of mutual fund research.

Still, these costs, which are not factored into funds' published expense ratios, and can trump those figures in size, offer "predictive power", making them valuable to investors and their advisers as they sort through what seems like a myriad of similar products, Mr Kinnel says.

"There are mountains of data on mutual funds and very little has a predictive power to help people pick funds," he says. "If this is one of them, by all means, let's get it out there."

Estimated trading costs give investors a rough view of the hurdles a fund faces in delivering the types of returns an investor may seek, some in the industry argue.

Roger Edelen, an assistant professor of management at the University of California at Davis and previously director of research at ReFlow, called trading costs "invisible" and said they "can be very damaging," during a presentation at the Morningstar conference in Chicago.

Trading costs include not only the commission and bid-ask spread, but the price impact of a trade, which he says can account for 65 per cent of the total trade cost. Commissions, the factor that has probably received the most attention from investor watchdogs, by comparison, account for less than 20 per cent of the cost.

In a study of trade data for one group of funds of various sizes and strategies published in 2008, Mr Edelen and two other academics found the aggregated trading costs of those funds, on average, was 1.44 per cent. The average expense ratio, on the other hand, was 1.19 per cent.

The Morningstar initiative is expected to focus only on US-domiciled funds, for now, Mr Kinnel says. In the US market, the launch of the product is likely, at least at first, to really only generate interest among a cadre of financial advisers and fund providers "looking over each other's shoulders" to gauge how they fare among competitors, says Phillip Silitschanu, a senior analyst at Aite Group, who has written extensively about trading strategies and systems.

But if Morningstar manages to introduce the metric to the European market, the furore over these fees is likely to be even more intense, he says.

In part, that is due to the high cost of cross-border trading in Europe, says Mr Silitschanu, who recently published a report on European multilateral trading facilities.

Industry leaders, however, warn against putting too much credence in estimated costs, because the calculation of things like market impact can be hard to pin down.

Most fund companies do have their own strategies for measuring and tracking trading costs, but those figures are "taken with a large grain of salt", says Paul Haaga, director with Capital Research and Management and former chairman of the Investment Company Institute, the US fund industry trade organisation.

"It is worth having these numbers, and it is worth knowing them, but it is not worth relying on them too heavily," Mr Haaga says.

Several years ago the US Securities and Exchange Commission proposed requiring funds to delineate fund trading costs, but backed off after the ICI and others argued the task of reaching one agreed-upon industry standard for measuring the costs was too daunting and the methods too imprecise to yield data that would be useful to investors.

Morningstar's effort is not to suggest that all trading is bad, Mr Edelen stressed in his presentation. Rather, if trading fund securities is done to accommodate fund outflows, for example, rather than to take advantage of information or a

new investment idea, the result can be a significant drag on performance.

Conversely, funds that see large inflows of cash might have trouble effectively putting that money to work while remaining true to a fund's overall strategy or mandate.

Those concerns are what prompted ReFlow to begin trying to measure the impact of trades.

ReFlow has helped fund some of the more recent research of Mr Edelen and his colleagues. Their methodology, the ReFlow Trading Cost Average Methodology (RTCAM), is what ReFlow relies on and has licensed to Morningstar, which continues to hone the methodology to suit its new product.

Paul Schaeffer, president of ReFlow, dismisses criticism about the firm's role in funding some of the academic research, saying there is a rich canon of academic studies dating to the late 1980s. "We have done everything we can to keep arm's-length independence from the actual research."

The relationship between ReFlow and Morningstar is a licensing agreement only, both parties say. Mr Kinnel adds that Morningstar has faced harsh criticism in the past and prevailed. "I think bringing this information to light and increasing the focus on it could lead to better results for investors, and that seems like a good thing," he says.

Hannah Glover is a senior reporter with Ignites.com, a Financial Times publication.

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