Rampant misclassifications make bond mutual funds appear far less risky, significantly impacting investors, study shows

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Some mutual fund managers appear to be overestimating the safety of their holdings, resulting in misclassifications by Morningstar that have a significant impact on investors, according to new research from the University of Notre Dame.

"Don't Take Their Word For It: The Misclassification of Bond Mutual Funds," a new study co-written by Huaizhi Chen, assistant professor of finance in Notre Dame's Mendoza College of Business, provides the first systematic examination of bond funds' reported asset profiles to Morningstar—a large third-party research service that strives to help investors navigate funds and their performance—against their actual portfolios. It finds some 30 percent of fixed-income mutual funds contain "misclassified" holdings, or riskier holdings than what is being reflected by Morningstar.

Chen, along with co-authors Lauren Cohen of Harvard Business School and Umit Gurun from the University of Texas at Dallas, state in the report: "We find significant misclassification across the universe of all bond funds. This misreporting has been persistent, widespread, and appears strategic—casting misreported funds in a significantly more positive position than in actuality."

Many funds report more investment-grade assets than are actually held in their portfolios, making these funds appear significantly less risky. This results in pervasive misclassifications of funds across the universe of U.S. fixed-income mutual funds by Morningstar, which relies on these reported holdings.

Analyzing data from 2003 through 2019, the team compared Morningstar's fund summaries with the actual holdings of 1,294 U.S.-based fixed-income mutual funds based on reports the funds made to Morningstar and the U.S. Securities and Exchange Commission in quarterly filings.

Chen explains that mutual fund managers might misclassify their holdings for a number of reasons, including higher yields.

"Typically, we think of yields as compensation for risk," he says. "Riskier bonds have to pay investors more yields in order to compensate for the risk. We find that, despite being classified in the same risk categories, misclassified funds have higher reported and actual yields than correctly classified funds."

Misclassified funds also have higher returns than the correctly classified funds within their Morningstar risk categories.

"Controlling for expense ratio (which decreases returns), and duration (a measure of maturity), misclassified funds have returns that are 10.3 basis points higher than their peers," Chen explains. "This is 14 percent of the average quarterly return of investment-grade bond funds in the Morningstar universe and results in them being higher-ranked relative to peers—a real benefit from misreporting.

"If we compare misclassified funds to other mutual funds within their actual risk categories or use their actual holdings to classify them into the correct risk category, they seem to be mediocre performers."

Additionally, misclassified funds have more fund ratings known as "Morningstar stars" than the correctly classified funds within their risk categories. Controlling for expenses and durations, misclassified funds have, on average, 0.34 more stars compared with the other funds in their risk categories. An average fund has about three stars, so this adds up to around 10 percent more.

Because they noted investors seem to like misclassified funds, the team examined why.

They used misclassified stars—Morningstar stars given to a misclassified fund above their peers in their Morningstar risk category—as an experiment to see how investors depend on Morningstar's classification system. One misclassified star implies a 13.8 percent increase in the likelihood that an investor would put money into a bond mutual fund.

"Overall," Chen says, "this association of flows to misclassification shows that investors use Morningstar's classification system and that this misclassification of assets has an impact on how investors invest."

The funds being misclassified also seem to be those that have recently been performing poorly. The study finds those that have done poorly in the past three years are more likely to begin being misclassified.

The study suggests investors are over-reliant on the aggregated summary statistics from data vendors like Morningstar. Risk classification metrics such as average credit quality will most likely understate the risk they take on by purchasing a bond mutual fund, which is most prevalent with self-reported data.

"In a lot of our cases, funds designated as AAA portfolio by Morningstar are actually full of junk bonds," Chen says. "Initially, we hope our findings prompt investment advising vendors to change how they report data. In the long term, we hope to see better relations between data vendors, investment products such as mutual funds and consumers."

Chen recently was awarded the Dr. Richard A. Crowell Prize for his research that revealed when mutual fund managers tap into their networks for information on insider trades, portfolios benefit.

More information: Huaizhi Chen et al. Don't Take Their Word For It: The Misclassification of Bond Mutual Funds, (2019). DOI: 10.3386/w26423

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