‘Performance-enhanced’ bond funds? Evidently.

By Editorial Staff *Thu, Nov 7, 2019*

Many actively managed bond funds are riskier than advertised, and often provide higher returns than their stated portfolio holdings would suggest, according to research by business school professors at Harvard, Notre Dame and the University of Texas.

Do active bond fund managers doctor their funds with performance-enhancing fixed income instruments in order to get a better Morningstar rating and increase fund inflows? Professors in three major graduate schools of business say many of them do.

“Many funds report more investment grade assets than are actually held in their portfolios, making these funds appear significantly less risky,” write Huaizhi Chen of Notre Dame, Lauren Cohen of Harvard, and Umit Gurun of the University of Texas-Dallas.

“This results in pervasive misclassifications across the universe of US fixed income mutual funds by Morningstar, who relies on these reported holdings,” they found, charging that “the problem is widespread—resulting in about 30% of funds being misclassified with safer profiles, when compared against their actual, publicly reported holdings.”

[Morningstar’s response to the paper’s findings can be found here: **https://www.morningstar.com/learn/bond-ratings-integrity**.]

Not all fund firms practice this enhancement to the same degree, according to the paper, entitled, “**Don’t Take Their Word for It: The Misclassification of Bond Mutual Funds**.” The paper was published this month by the National Bureau of Economic Research (Working paper 26423).

“We find that some fund families essentially never misstate holdings, while some families engage in misstatement regularly – and for nearly all of the funds in the their family. The list of the most frequent misstating and misclassified funds is in [table at right]. As can be seen, 100% of certain families’ fixed income funds are misclassified into safer categories as compared to what their actual holdings imply.”

The upshot is that these funds are riskier than advertised. and often provide higher returns than their portfolio holdings—as self-reported to Morningstar by the asset management firms but not as reported to the Securities & Exchange Commission—would suggest. Misclassified funds outperform their peers by an average of 10.3 basis points per quarter, the paper said, but underperform their peers by 11 basis points per quarter when properly categorized.

“We show that misclassification is widespread, and continues through present-day, rising to 33% of high and medium credit quality funds in 2018,” the authors write. “Moreover, as mentioned above misclassifications are overwhelmingly one-sided: 1% of all misstatements push funds down a category—99% of misstatements push up to a safer category.”

“A large portion of bond funds are not truthfully passing on a realistic view of the fund’s actual holdings to Morningstar and Morningstar creates its important risk classifications, fund categorizations, and even fund ratings, based on this self-reported data. Roughly 30% of all funds (and rising) in recent years, are reported as overly safe by Morningstar. This misreporting has been not only persistent and widespread, but also appears to be strategic.”

The paper concluded, “The misreporting has real impacts on investor behavior and mutual fund success. Misclassified funds reap significant real benefits from this incorrectly ascribed outperformance in terms of being able to charge higher fees, receiving ‘extra’ undeserved Morningstar Stars, and ultimately receiving higher flows from investors.”