

Power your Success with our Enhanced Manager Research and Analyst Ratings



Jeffrey Ptak, CFA
Global Director, Manager Research
Morningstar Research Services

March 11, 2020

Morningstar Research Services

Manager Research Services: Who We Are



Key Stats

121	Global Manager Research Analysts
13.2 yrs	Avg. Industry Experience
7.4 yrs	Avg. Morningstar Experience
41 Analysts	CFA Charterholders
116	Advanced Degrees

Source: Morningstar Research Services LLC as of 11/7/2019. Analyst statistics exclude the Manager Selection team.

Manager Research Services: What We Do

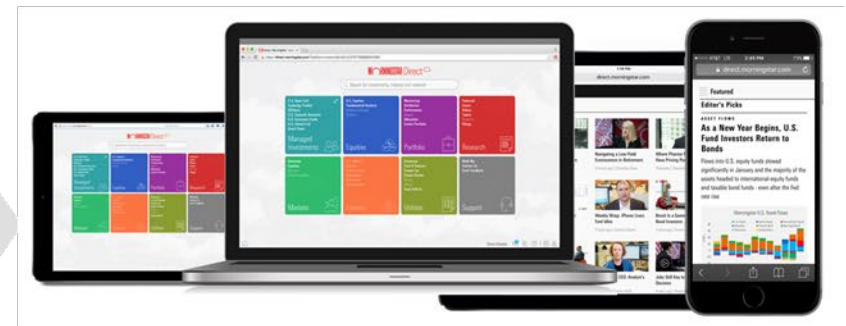
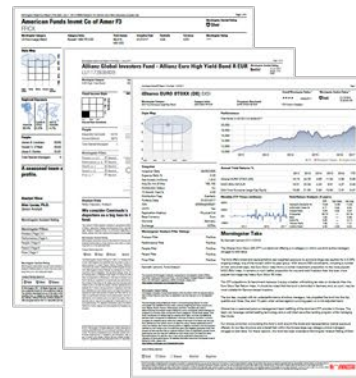
Our analysts' research takes various forms across our platforms

Strategy Research

- Open-end Funds and ETFs
- Separate Accounts, CITs, Model Portfolios
- 529 and HSA Plans, Tgt.-date Fund Series

Thematic Research

- Landscape Reports
- Global Fee Studies
- White Papers



Manager Research Services: What We Cover

Coverage Universe	Unique Investments	All Share Classes	AUM (\$T)
Mutual Fund	1,715	8,104	\$ 13.5
ETF	220	220	\$ 3.1
SMA/CIT/Model	301	1,006	NA
529 College Savings	62	62	\$ 0.3
HSA Plans	11	11	NA

The Enhanced Analyst Rating

Executive Summary

- ▶ What are we doing?
 - ▷ Enhancing the Morningstar Analyst Rating
- ▶ Why are we doing it?
 - ▷ To make the Analyst Rating more effective and useful
- ▶ When are we doing it?
 - ▷ We began gradually rolling out the updated ratings on Oct. 31, 2019
 - ▷ To be completed by 4Q 2020

FUND SPY

Looking Forward to Changes to Our Forward-Looking Ratings

We're enhancing the Morningstar Analyst Rating and Morningstar Quantitative Rating to make them even more useful to investors.



Jeffrey Ptak, CFA
Jul 8, 2019

Later this year, we'll be enhancing our forward-looking fund rating systems, the Morningstar Analyst Rating for funds and the Morningstar Quantitative Rating for funds. We'll be changing the way we assign these ratings to managed investments like mutual funds. In this piece, I'll walk through what's changing and the benefits we think these changes will confer. (Morningstar Direct and Office clients can find a more detailed explanation of the new process [here](#).)

Key Takeaways

What We're Doing

- ▶ We're not changing the Analyst Rating scale (Gold, Silver, Bronze, Neutral, Negative) but we are making three key methodology changes:
 - ▶ Heavier emphasis on fees
 - ▶ Higher bar for active funds
 - ▶ Two fewer pillars
 - ▶ More structured approach

Exhibit 1 Active Funds' Success Rates by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	10-Year (Lowest Cost)	10-Year (Highest Cost)
U.S. Large Blend	32.3	29.0	13.6	8.0	14.5	18.0	18.7	1.1
U.S. Large Value	34.4	33.3	15.9	7.0	20.4	12.1	18.8	1.4
U.S. Large Growth	54.3	38.8	30.5	8.0	12.0	—	14.6	3.1
U.S. Mid Blend	46.3	26.5	14.3	7.7	8.1	11.6	13.8	0.0
U.S. Mid Value	32.0	33.3	23.8	11.6	26.9	—	16.0	4.2
U.S. Mid Growth	79.1	59.5	54.0	29.8	26.9	—	40.4	24.0
U.S. Small Blend	45.3	29.3	26.0	22.1	19.3	34.0	39.5	18.9
U.S. Small Value	45.1	44.8	39.3	39.5	25.7	—	47.8	21.7
U.S. Small Growth	75.8	61.3	52.8	35.2	26.3	—	38.3	23.4
Foreign Large Blend	29.8	29.7	32.6	32.3	31.2	37.1	34.2	16.7
Foreign Large Value	8.5	23.4	44.1	32.6	—	—	36.8	15.8
Foreign Small-Mid Blend	34.5	21.4	24.0	82.4	—	—	100.0	100.0
World Large Stock	55.2	46.6	33.7	31.8	28.7	—	41.2	17.6
Diversified Emerging Markets	33.9	43.4	55.8	49.0	—	—	66.7	28.6
Europe Stock	20.8	13.6	23.8	48.1	34.2	—	83.3	33.3
U.S. Real Estate	56.9	31.9	38.8	35.1	32.8	27.1	53.3	26.7
Global Real Estate	76.4	19.7	51.9	38.6	—	—	33.3	11.1
Intermediate Core Bond	26.8	52.6	34.9	31.3	16.6	9.5	44.4	17.1
Corporate Bond	13.2	68.8	57.8	61.5	—	—	83.3	60.0
High Yield Bond	37.7	57.7	43.1	57.4	—	—	67.9	51.9

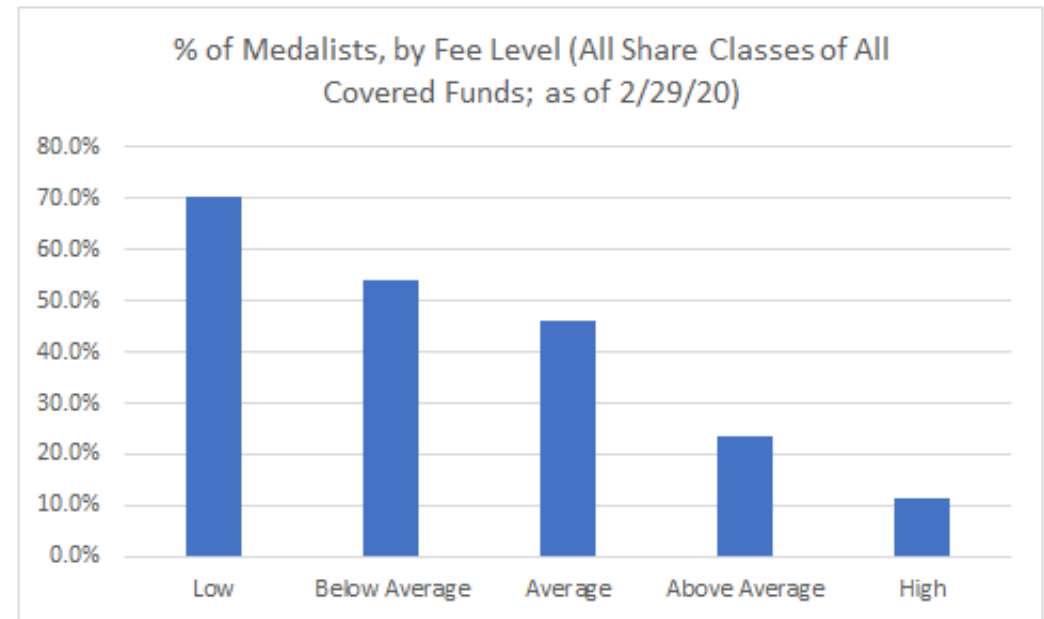
Source: Morningstar. Data and Calculations as of 6/28/19.

* Green/red shading indicates that active funds in this fee quintile had above/below average success rates.

An updated methodology document will be available on Morningstar's website in the near future

What We're Doing: Biggest Changes

- ▶ Analyst Ratings will change (downgrades > upgrades)
- ▶ There will be two fewer pillar ratings
- ▶ There will be a refined pillar-ratings scale



Source: Morningstar Direct

What We're Doing: Before vs After

Before

- Five pillars
- Positive, Neutral, Negative pillar ratings scale
- Analysts assign same Analyst Rating to all share classes irrespective of fee differences

Open End Funds		United States Mutual Funds							
Action View Untitled		Save	Search	Edit Data	Sort	Locate	Export	PDF	Refresh
		Morningstar Analyst Rating	Morningstar Analyst Rating - Parent Pillar	Morningstar Analyst Rating - People Pillar	Morningstar Analyst Rating - Performance Pillar	Morningstar Analyst Rating - Price Pillar	Morningstar Analyst Rating - Process Pillar	Annual Report Net Expense Ratio	
<input type="checkbox"/>	1 Total Return Admin	Gold	Positive	Positive	Positive	Neutral	Positive	0.96	
<input type="checkbox"/>	2 Total Return Instl	Gold	Positive	Positive	Positive	Neutral	Positive	0.71	
<input type="checkbox"/>	3 Total Return A	Gold	Positive	Positive	Positive	Neutral	Positive	1.05	
<input type="checkbox"/>	4 Total Return C	Gold	Positive	Positive	Positive	Neutral	Positive	1.82	
<input type="checkbox"/>	5 Total Return R	Gold	Positive	Positive	Positive	Neutral	Positive	1.32	
<input type="checkbox"/>	6 Total Return I2	Gold	Positive	Positive	Positive	Neutral	Positive	0.81	

After

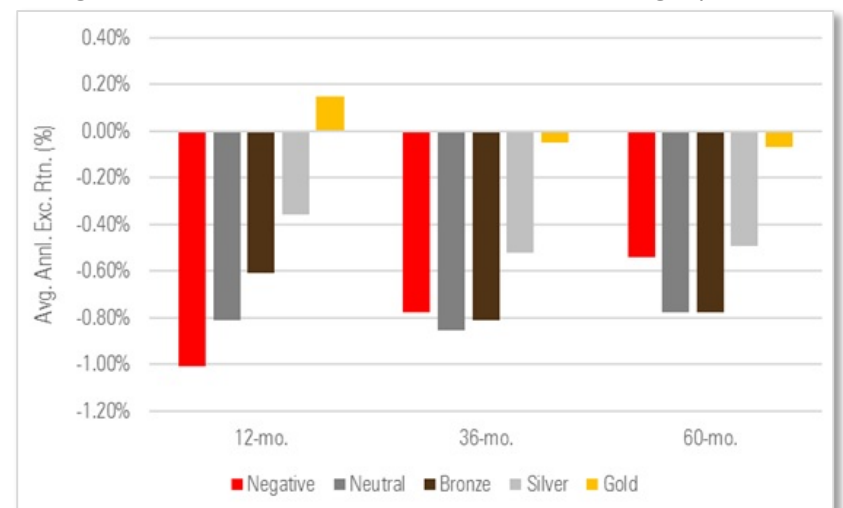
- Three pillars
- High, Above-average, Average, Below-average, Low pillar scale
- Analysts tailor Analyst Rating to each shareclass, accounting for fee differences

Open End Funds		United States Mutual Funds							
Action View Untitled		Save	Search	Edit Data	Sort	Locate	Export	PDF	Refresh
		Morningstar Analyst Rating	Morningstar Analyst Rating - Parent Pillar	Morningstar Analyst Rating - People Pillar	Morningstar Analyst Rating - Performance Pillar	Morningstar Analyst Rating - Price Pillar	Morningstar Analyst Rating - Process Pillar	Annual Report Net Expense Ratio	
<input type="checkbox"/>	1 Total Return Admin	Bronze	Above Average	High			High	0.96	
<input type="checkbox"/>	2 Total Return Instl	Gold	Above Average	High			High	0.71	
<input type="checkbox"/>	3 Total Return A	Bronze	Above Average	High			High	1.05	
<input type="checkbox"/>	4 Total Return C	Neutral	Above Average	High			High	1.82	
<input type="checkbox"/>	5 Total Return R	Neutral	Above Average	High			High	1.32	
<input type="checkbox"/>	6 Total Return I2	Gold	Above Average	High			High	0.81	

Why We're Doing It

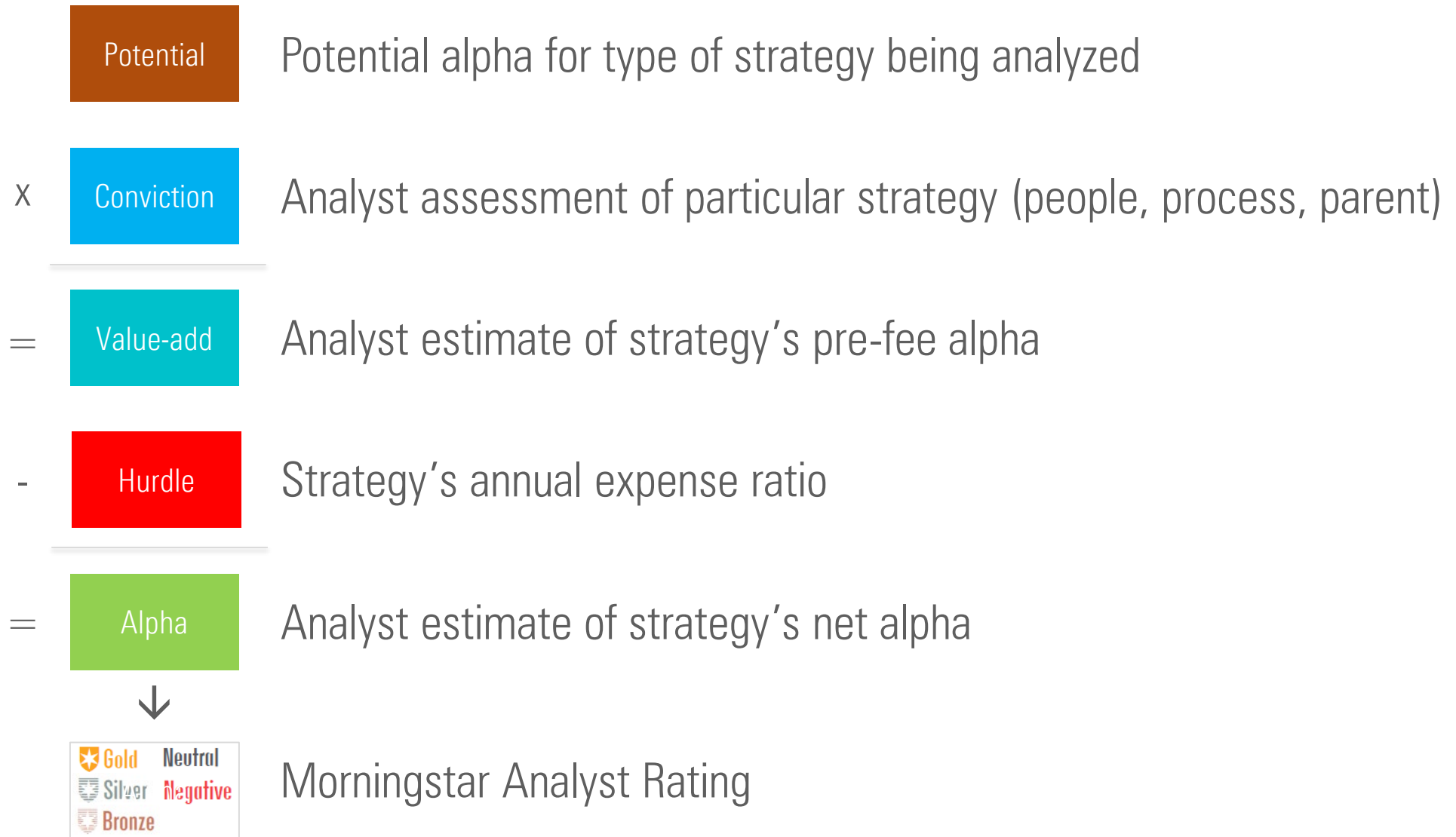
- ▶ To make the Analyst Ratings more useful to investors in these ways:
 - ▷ Based on what matters
 - ▷ More weight on people, process, parent, and fees
 - ▷ More effective
 - ▷ Promotes ratings efficacy; facilitates portfolio construction
 - ▷ Relevant to key decisions
 - ▷ To stick with active vs. index; to choose an appropriate share class
 - ▷ Easier to understand
 - ▷ Streamlined framework; refined ratings; clearly delineated expectations

Avg. Annl. Event-Horizon Excess Rtn. (vs. Category Idx)

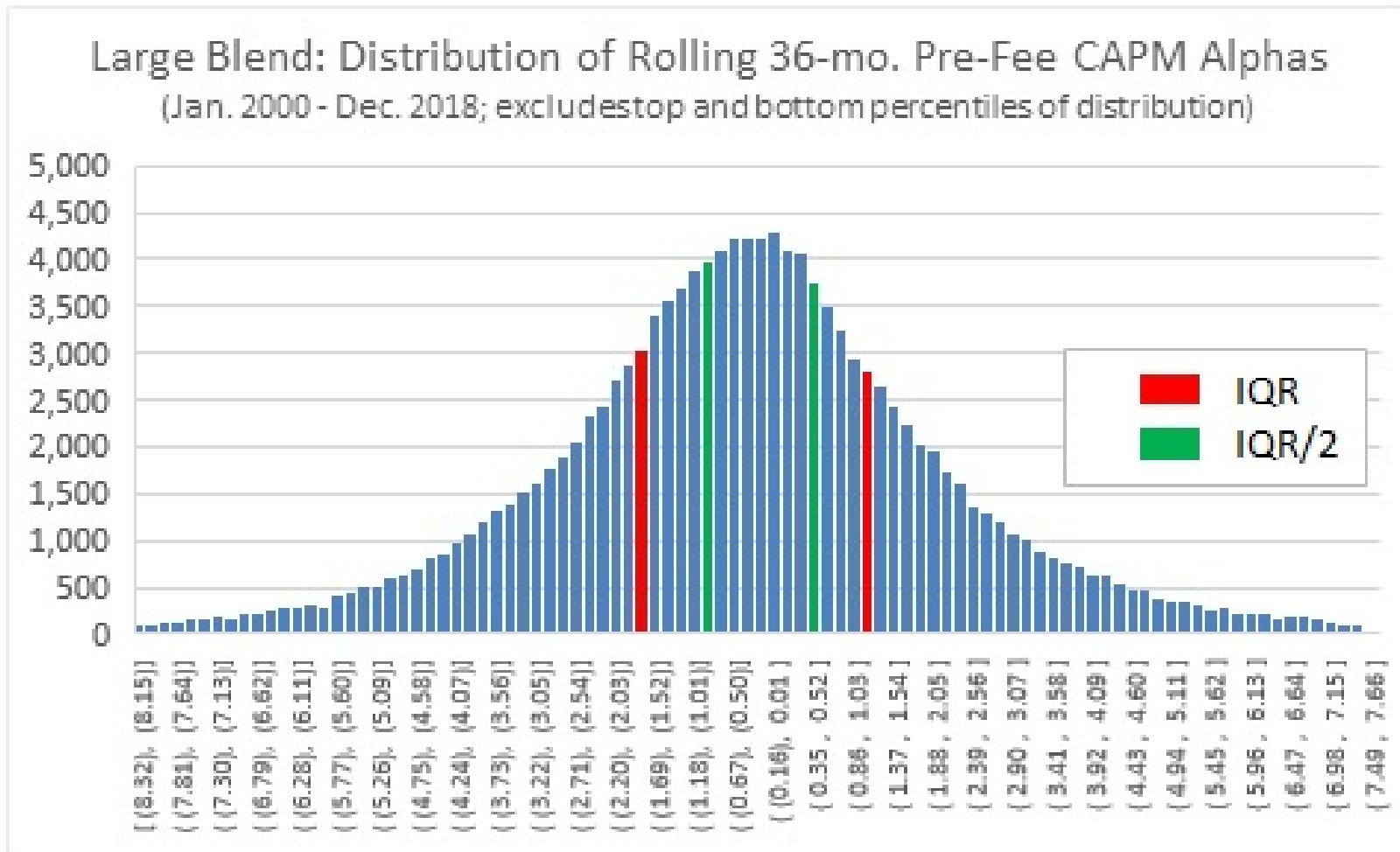


For illustrative purposes only; data as of 6/30/19

How We're Doing It: Active Strategies

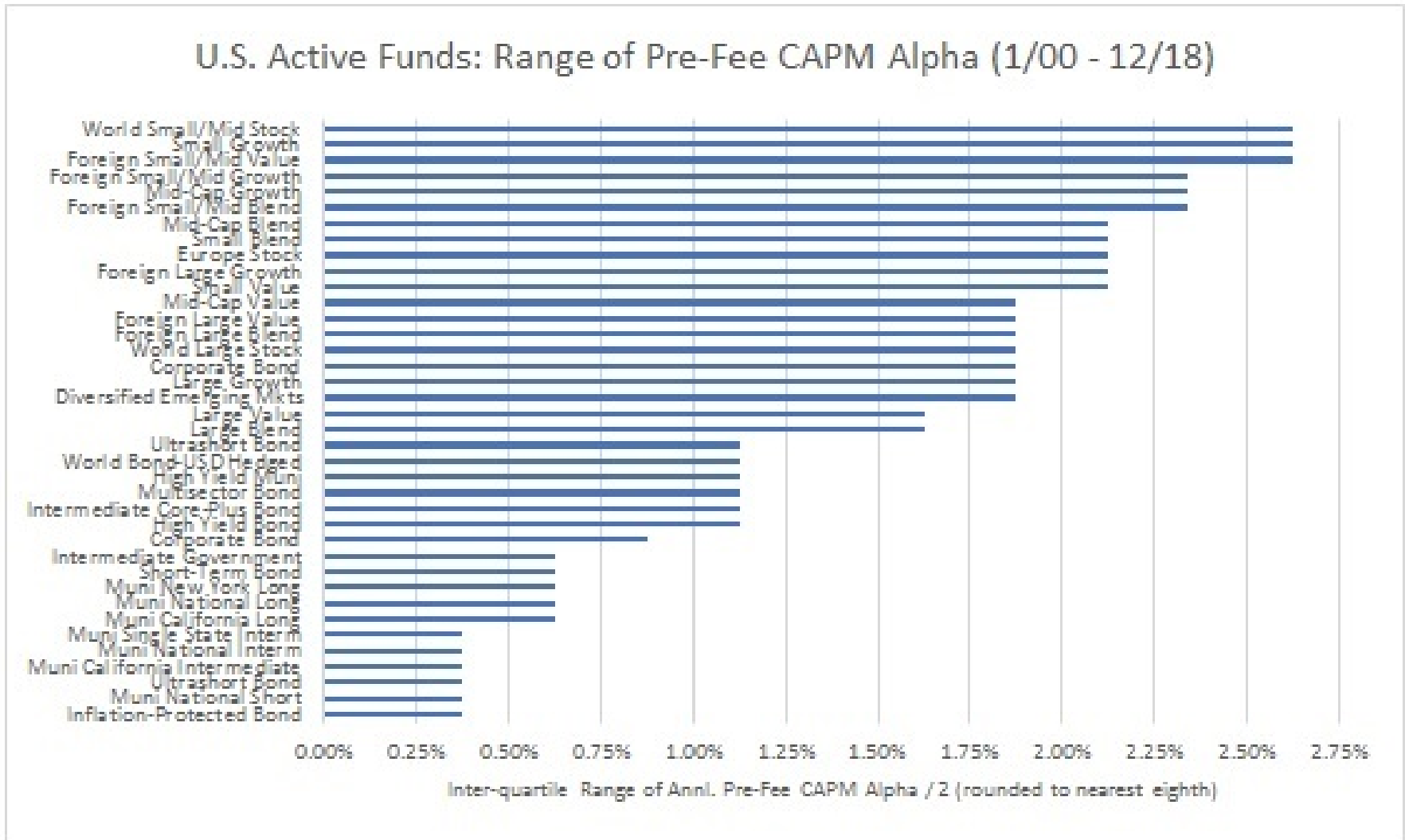


How We're Doing It: Assessing a Strategy's Potential



Source: Morningstar,

How We're Doing It: Assessing a Strategy's Potential



Source: Morningstar,

How We're Doing It: Assessing an Active Fund's Potential

Potential

Conviction

<u>Pillar</u>	<u>Est. Potential Pre-Fee Alpha</u>		<u>Pillar Weighting</u>		<u>Pillar Rating</u>
People	1.13%	x	45%	x	High
+ Process	1.13%	x	45%	x	Average
+ Parent	1.13%	x	10%	x	Above-avg.

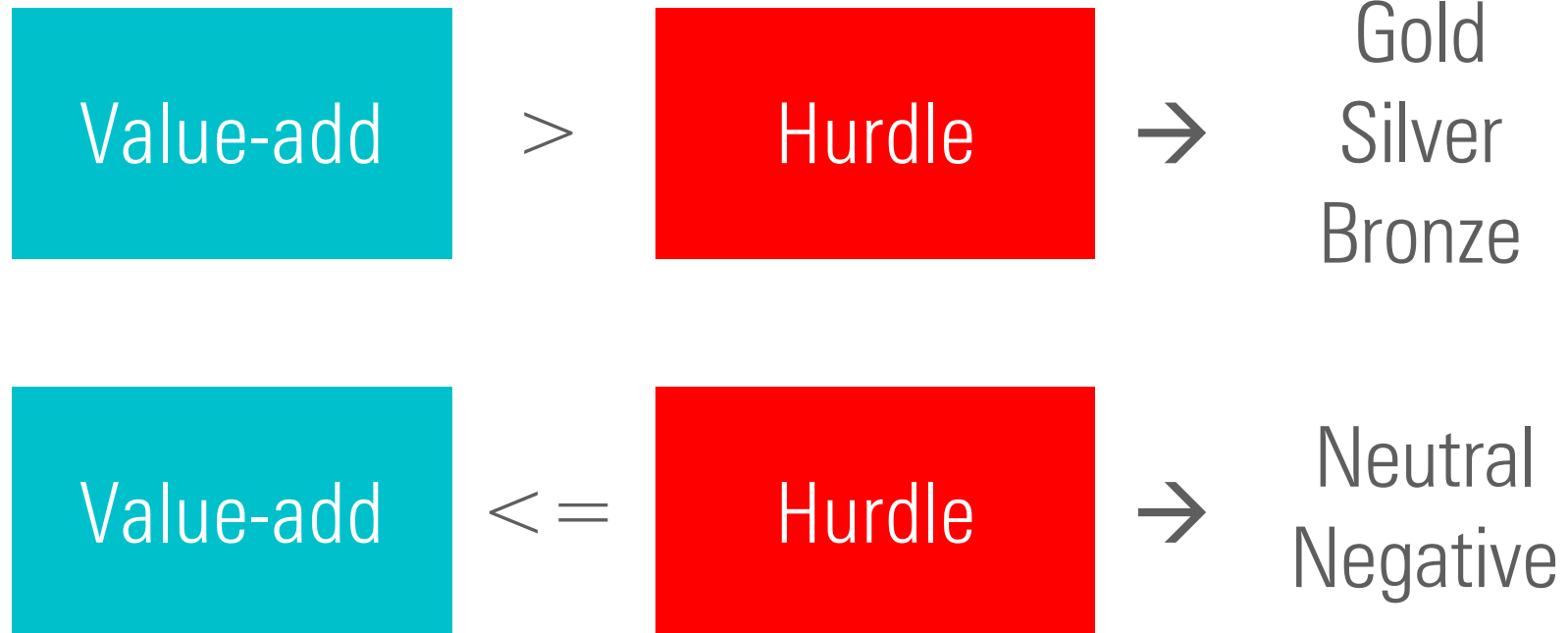
= Value-add

Fund's Est. Pre-fee CAPM Alpha

How We're Doing It: Assigning Ratings to Active Funds*

Fund's Est. Pre-fee CAPM
Alpha vs M* Category Idx.

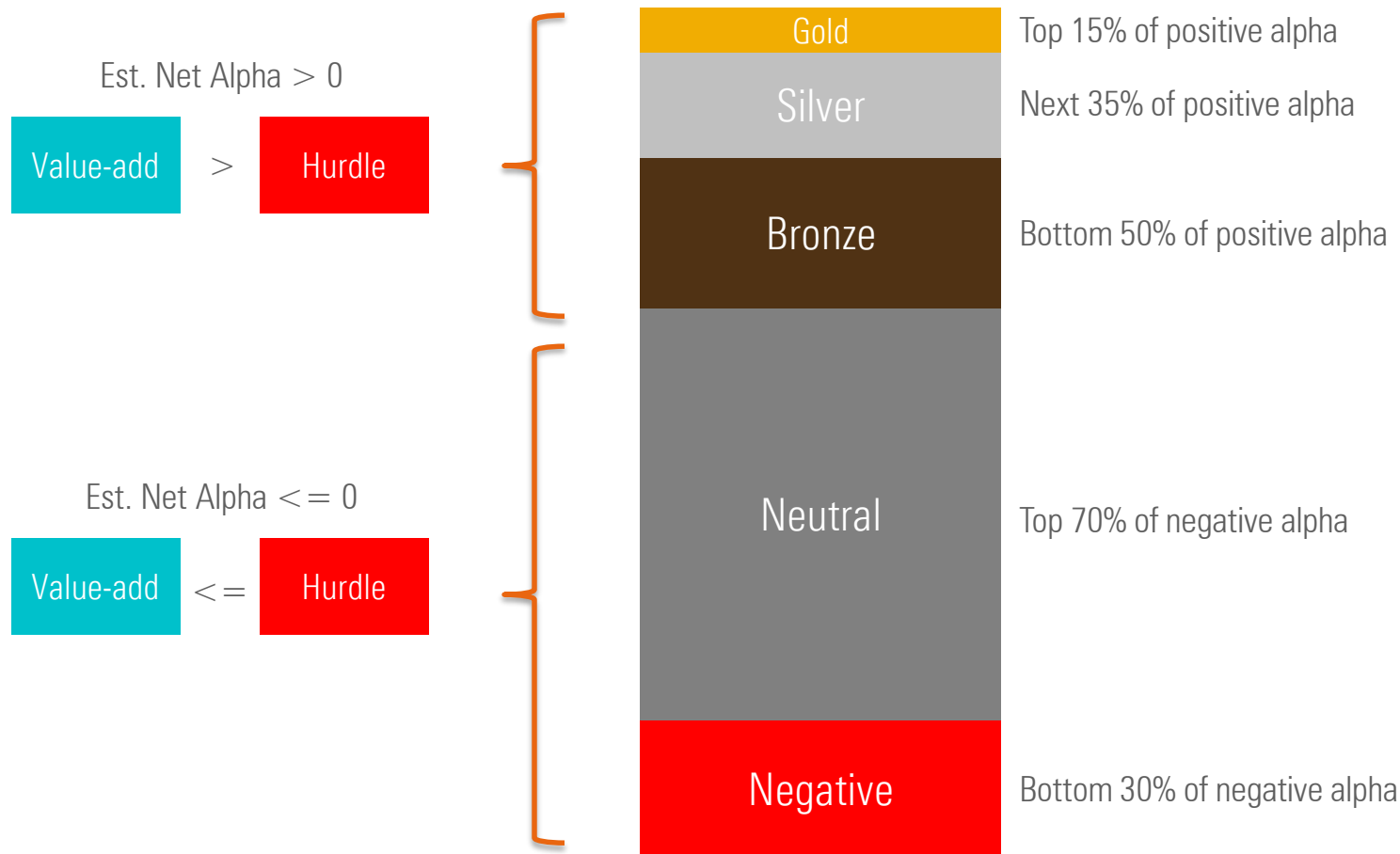
Fund's
Expense Ratio



* Includes funds classified "strategic beta"

How We're Doing It: Assigning Ratings to Active Funds

- ▶ Translate our net-of-fee alpha estimate into an Analyst Rating



How We're Doing It: Assessing an Index Fund's Potential

Potential

Conviction



Pillar

Est. Potential Pre-Fee Alpha

Pillar Weighting

Pillar Rating

People

0.10%

x

10%

x

High

+ Process

0.10%

x

80%

x

Average

+ Parent

0.10%

x

10%

x

Above-avg.

=

Value-add

Fund's Est. Pre-fee CAPM Alpha

How We're Doing It: Assigning Ratings to Index Funds

Fund's Est. Pre-fee CAPM
Alpha vs M* Category Idx.

Value-add

-

Fund's
Expense Ratio

Hurdle

=

Net Alpha

How We're Doing It: Assigning Ratings to Index Funds

Fund's Est. Net CAPM
Alpha vs M* Category Idx.

Lower of Est. Cat. Median
Net CAPM Alpha or Zero

Net Alpha

>

Median Fund Net
Alpha or Zero

→

Gold
Silver
Bronze

Net Alpha

< =

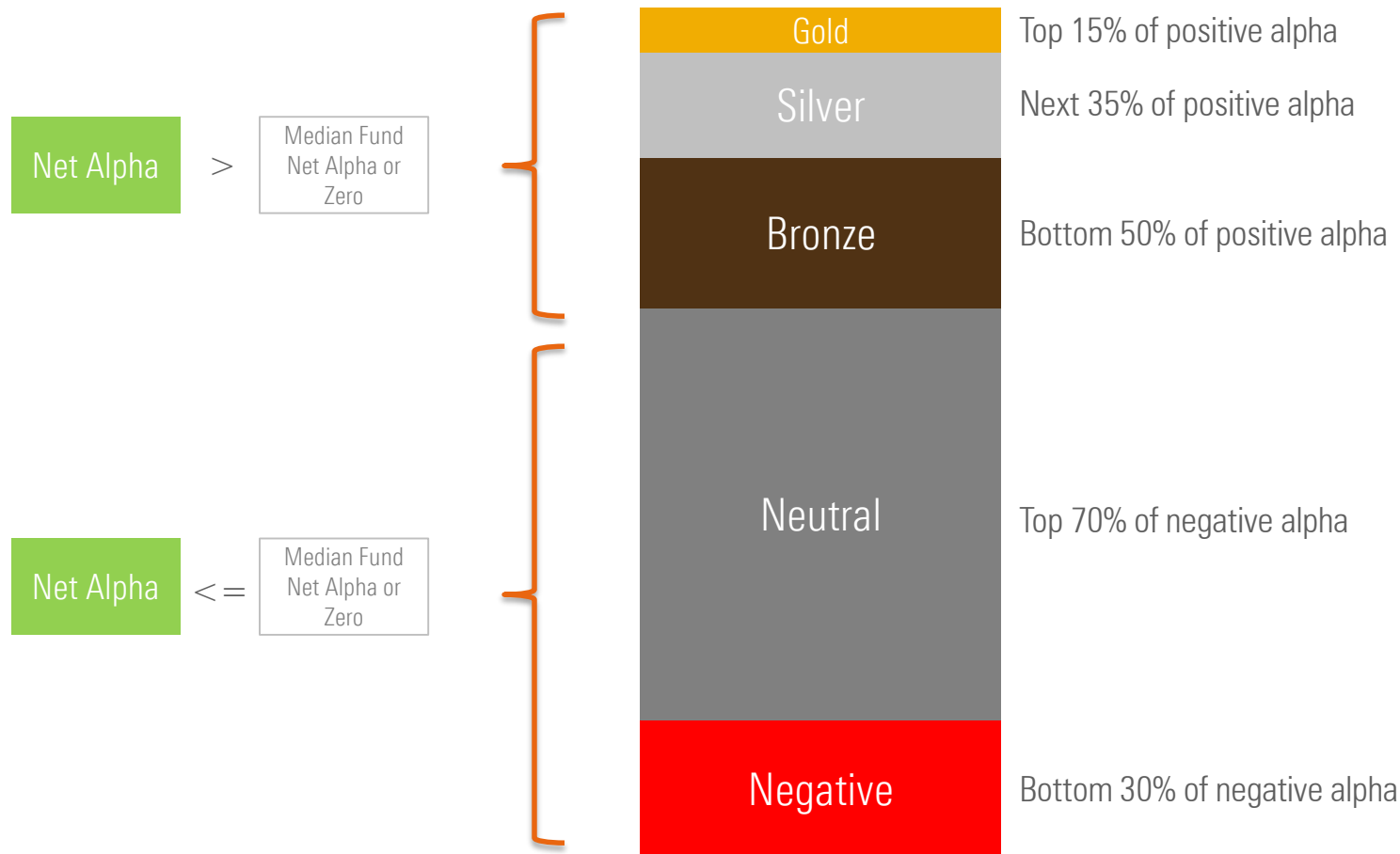
Median Fund Net
Alpha or Zero

→

Neutral
Negative

How We're Doing It: Assigning Ratings to Index Funds

- ▶ Translate our net-of-fee alpha estimate into an Analyst Rating



Conclusion: Before vs. After

	Before	After
Pillars	People, Process, Parent, Performance, Price	People, Process, Parent
Pillar ratings scale	Positive, Neutral, Negative	High, Above-average, Average, Below-average, Low
Fees	Price pillar scores feeds into overall rating	Deduct expenses from fund's est. value-add before fees
Litmus test for active	Performance vs. category average or BM	Performance vs. category BM
Ratings-setting	Apply same rating to all fund share classes	Vary ratings by share class, taking fee diffs. into account

Impact Analysis: U.S. Coverage Universe

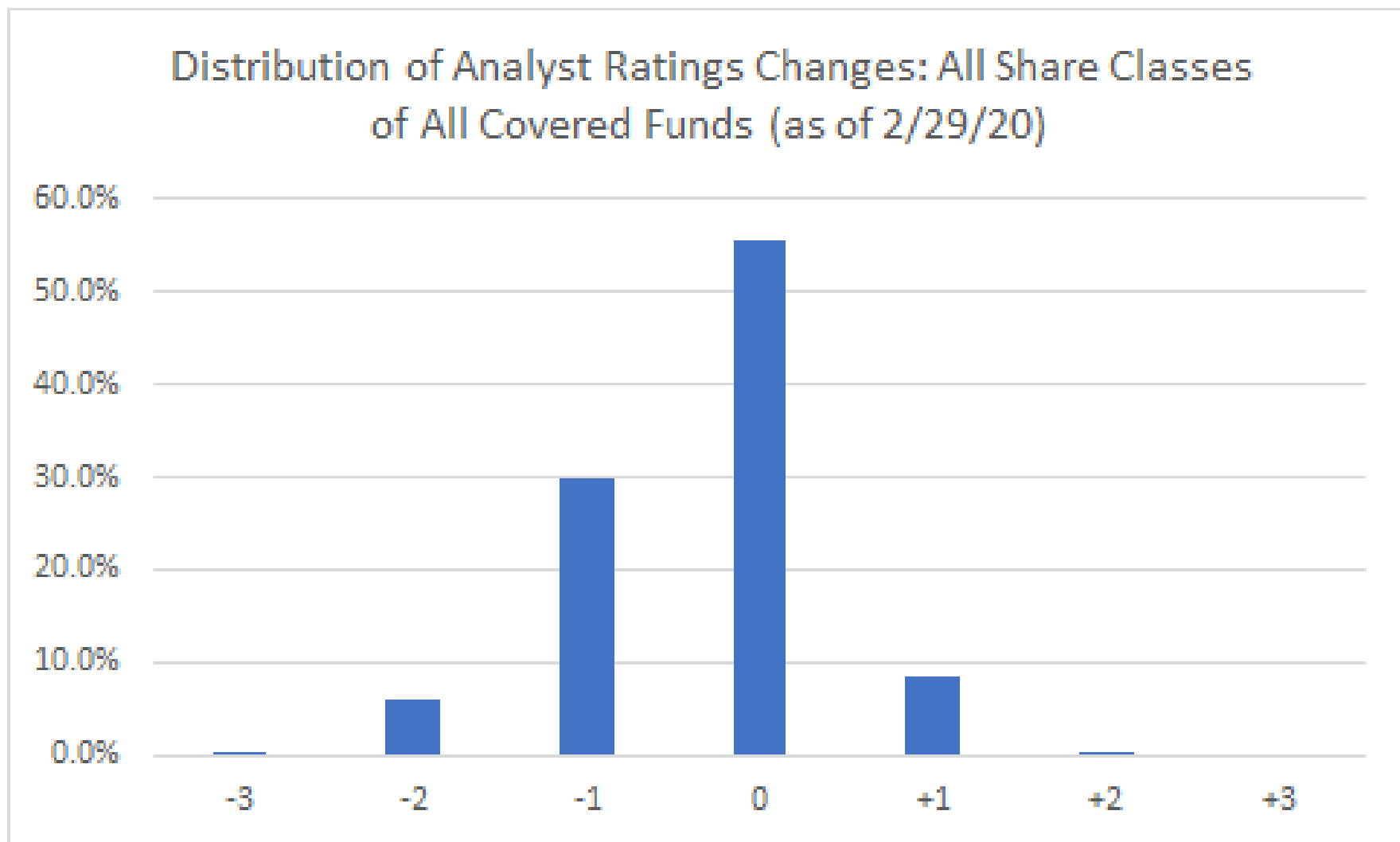
- ▶ ~45% of share classes have seen a rating change
- ▶ ~4x more downgrades than upgrades; most ratings changes are one-rung
- ▶ Ratings distribution would shift from medalists toward Neutral, Negative
- ▶ Most ratings changes due to assigning ratings to individual share classes
- ▶ “Bundled” share classes have seen the most downgrades
- ▶ ~17% of funds with above-average or high fees are medalists

Impact Analysis: Where Ratings End Up

		New				
		Gold	Silver	Bronze	Neutral	Negative
Old	Gold	53.7%	40.0%	4.6%	1.7%	0.0%
	Silver	8.0%	38.8%	32.0%	21.1%	0.0%
	Bronze	0.1%	13.3%	35.6%	47.6%	3.5%
	Neutral	0.0%	0.3%	5.0%	83.0%	11.6%
	Negative	0.0%	0.0%	0.0%	23.8%	76.2%

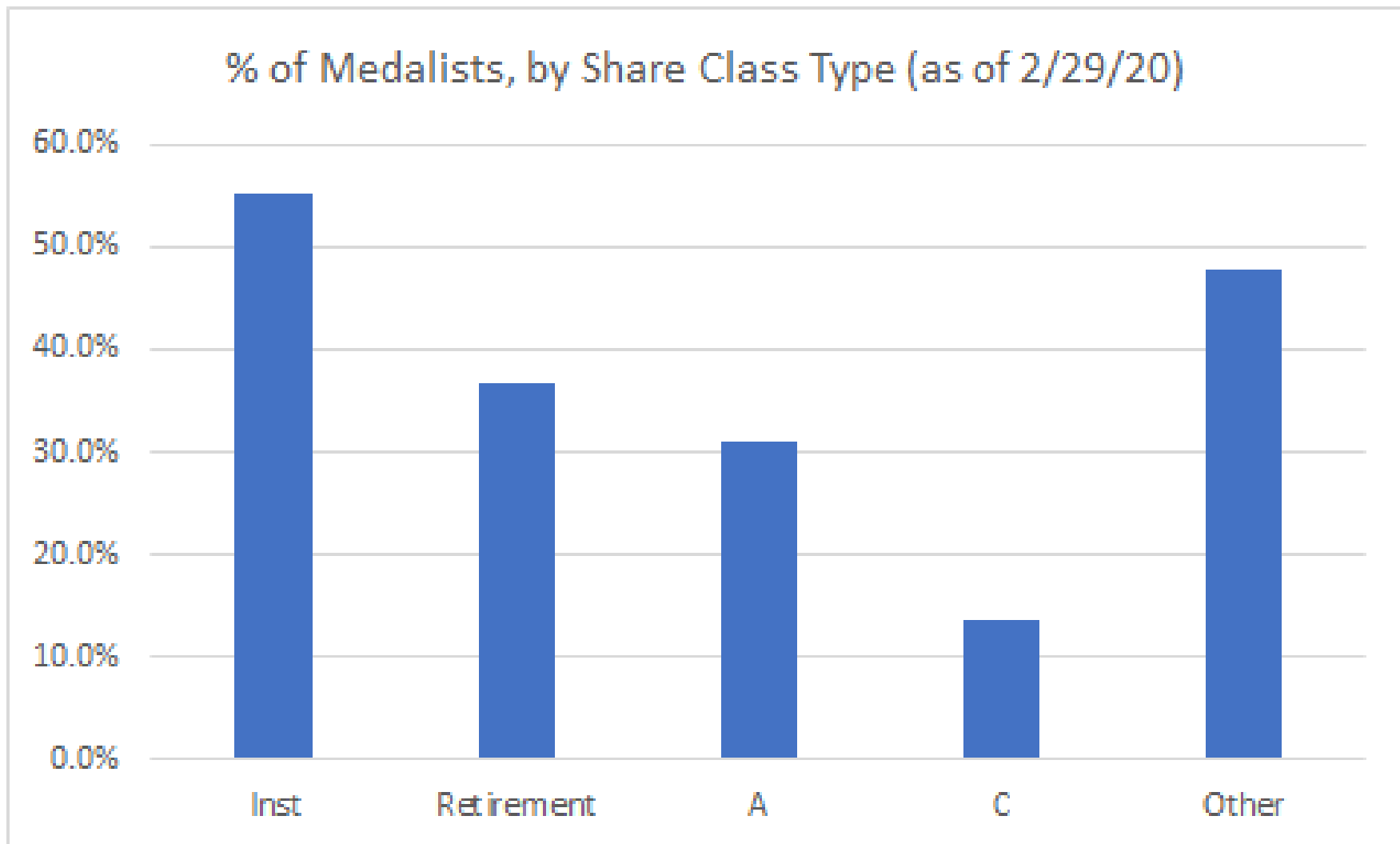
Source: Morningstar Direct

Impact Analysis: Distribution of Ratings Changes



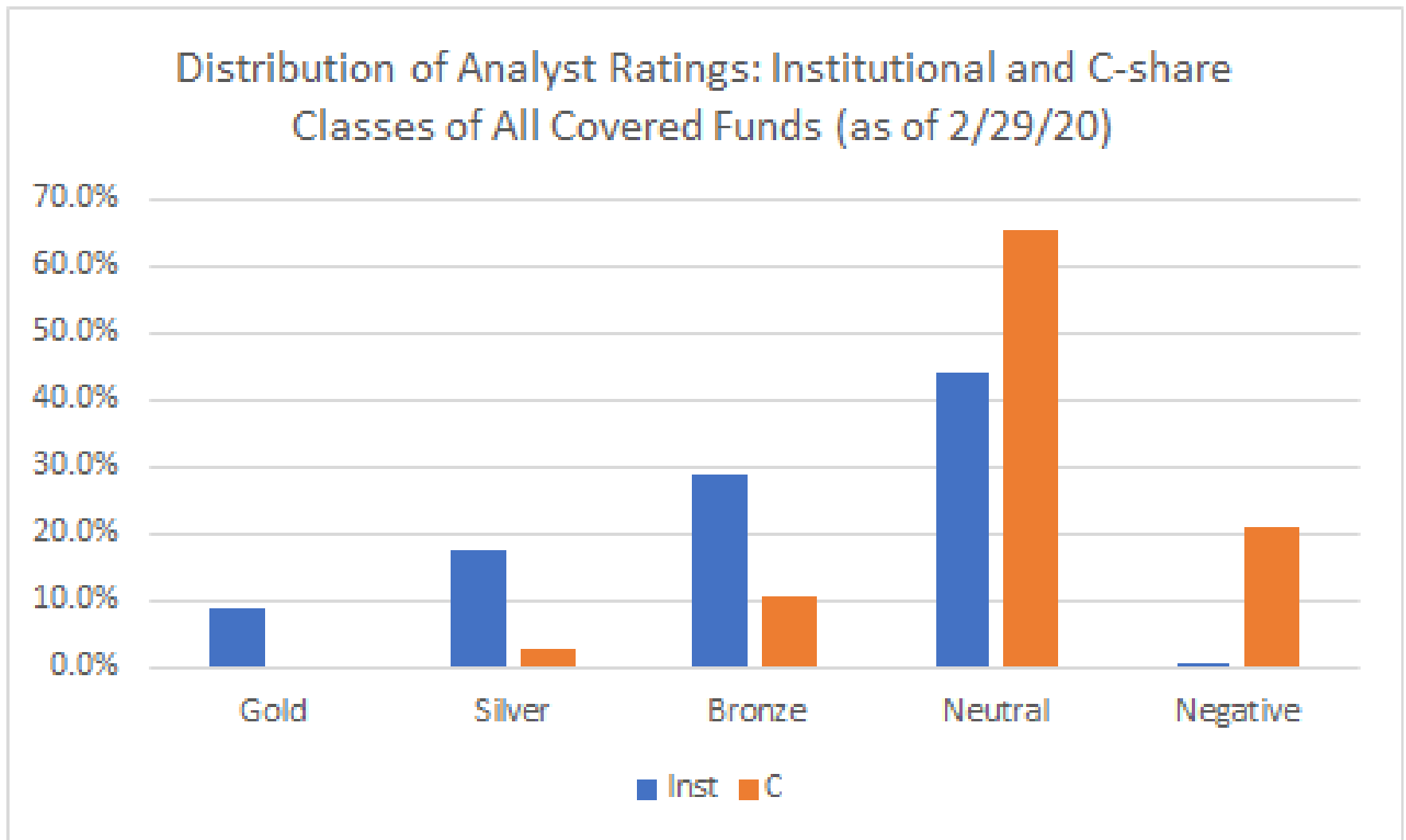
Source: Morningstar Direct

Impact Analysis: Percentage of Medalists by Share Class Type



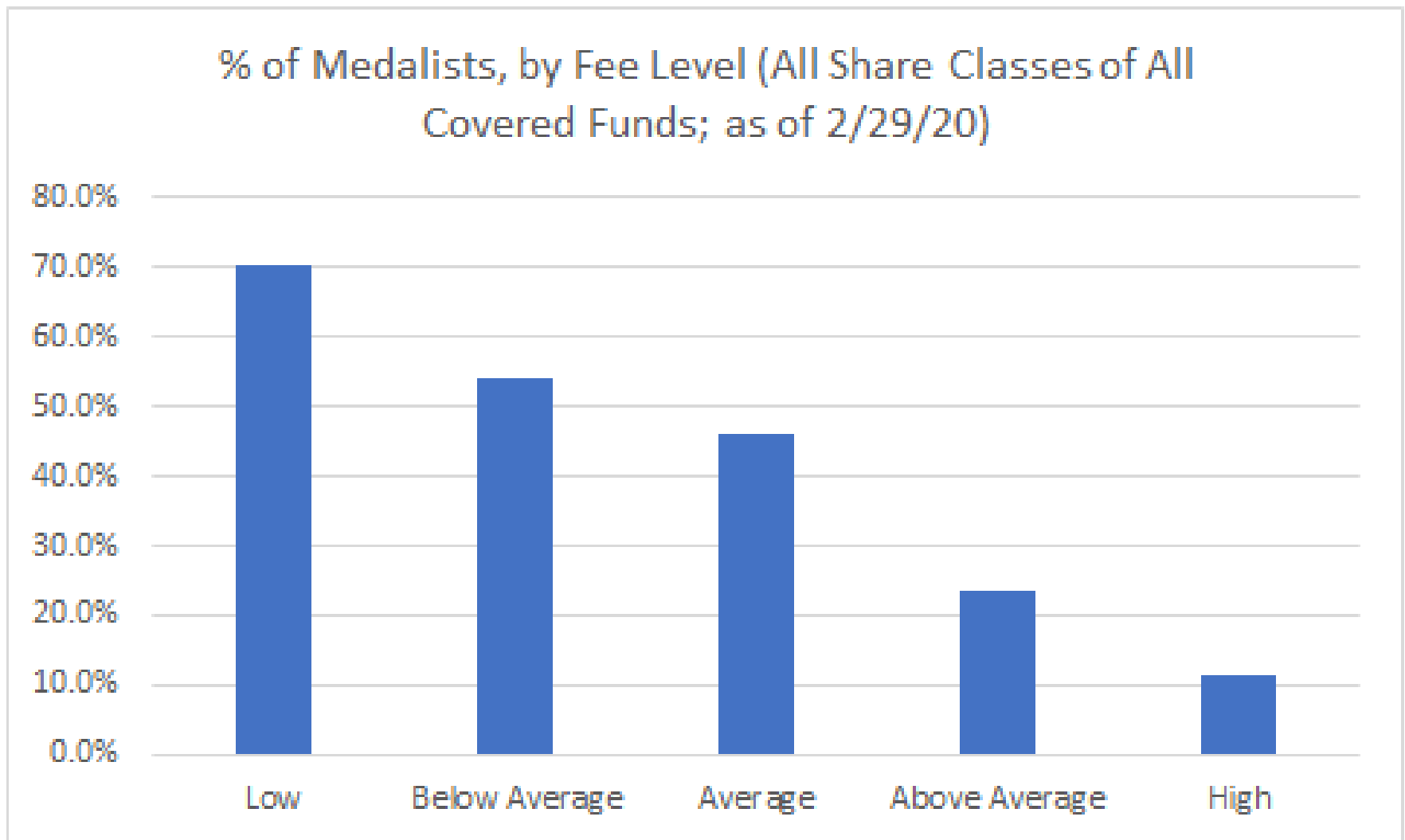
Source: Morningstar Direct

Impact Analysis: Institutional and C-share Class Funds



Source: Morningstar Direct

Impact Analysis: % of Medalists by Fee Level



Source: Morningstar Direct

Analyst Rating Enhancement: Summary

- ▶ The methodology enhancement should make the Analyst Ratings more effective and useful
- ▶ Updated ratings began appearing in Morningstar products on/about Oct. 31, 2019; updating process will continue through 4Q 2020
- ▶ There have been impacts, with downgrades outnumbering upgrades

Disclosures

This presentation is for financial professional use only.

The analyst identified on the cover page is employed by Morningstar Research Services LLC, a wholly-owned subsidiary of Morningstar, Inc.

The information, data, and opinions presented herein are provided solely for informational purposes and are not warranted to be correct, complete or accurate. The opinions expressed within are given in good faith, are as of the date of the presentation, are not statements of fact, and are subject to change. Data from third parties used herein are believed to be reliable sources. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages or other losses resulting from, or related to, the information, data, analyses or opinions or their use. The information contained herein is the property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar.