

The Morningstar Rating™ for Funds

Investor Benefits

- ▶ Provides focused comparison groups to help investors build multi-fund portfolios
- ▶ Is sensitive to manager skill and fund quality and less sensitive to recent overall performance of the category
- ▶ Gives investors the ability to quickly and easily identify funds that are worthy of further research, those with superior risk-adjusted returns

Background

The Morningstar Rating™ for funds, often called the “star rating,” debuted in 1985 and was quickly embraced by investors and advisors. Using a scale of one to five stars, the original rating allowed investors to easily evaluate a fund’s past performance within six broad asset classes. For the first time, it introduced the concept of risk- and cost-adjusted return to the average investor. Over time, investors moved from owning one or two funds to assembling diversified portfolios of funds. This meant they were more likely to need a specific type of fund, such as mid-cap value, to complement their other holdings. For this reason, in 1996 Morningstar created its Category Rating™, which rated funds within their smaller and more focused Morningstar Categories, and encouraged investors to use it along with the broader-based star rating.

In 2002, Morningstar enhanced the star rating with new peer groups and a new measure of risk-adjusted return. The peer groups for the rating were changed to the smaller category groups instead of the broad asset classes.

What It Means for Investors

The Morningstar Rating™ is a quantitative assessment of a fund’s past performance—both return and risk—as measured from one to five stars. It uses focused comparison groups to better measure fund manager skill. As always, the Morningstar Rating™ is intended for use as the first step in the fund evaluation process. A high rating alone is not a sufficient basis for investment decisions.

Category-Based Rating Groups

The rating allows investors to distinguish among funds that use similar investment strategies. The use of smaller rating groups minimizes the possibility of a “tail wind” effect boosting or hurting the ratings of funds that invest in specific areas of the market. For example, under the original methodology, persistent outperformance by the value investment style resulted in high ratings for most value funds, and relatively lower ratings for most growth-oriented funds.

Multiple Share Classes

Because the comparison groups are smaller, in 2002 Morningstar also changed its treatment of funds with multiple share classes. Although they share the same portfolio, share classes are evaluated separately because their individual expense structures produce different returns. For the rating distribution scale, however, a single portfolio counts only once, regardless of the total number of share classes. This prevents a single portfolio from dominating any portion of the rating scale.

Overall Rating

A provision is made for funds that change investment categories. In such cases, the fund’s historical information is given less weight, depending on the magnitude of the change. Doing so ensures the fairest comparisons and minimizes the incentive for fund companies to change a fund’s style in an attempt to receive a better rating.

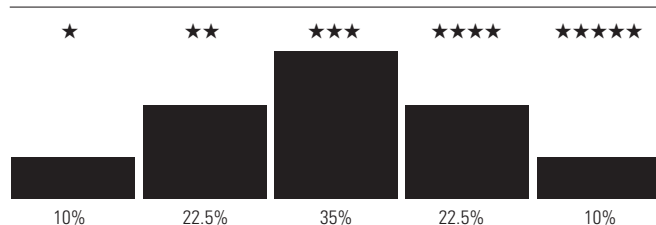
Enhanced Risk Measure

In 2002, Morningstar also enhanced its treatment of risk. The original methodology defined risk as underperformance relative to the 90-day Treasury bill. If a fund’s return exceeded this benchmark each month, the fund was deemed to be riskless. Yet funds with highly variable returns are likely to eventually produce losses, even if they’re currently enjoying a run of success. Internet funds provide a perfect example. Because they outperformed the Treasury bill for many successive months, they exhibited little downward risk in 1999; but they suffered huge losses in subsequent years.

The Morningstar Rating™ is based on “expected utility theory,” which recognizes that investors are a) more concerned about a possible poor outcome than an unexpectedly good outcome and b) willing to give up some portion of their expected return in exchange for greater certainty of return. The rating accounts for all variations in a fund’s monthly performance, with more emphasis on downward variations. It rewards consistent performance and reduces the possibility of strong short-term performance masking the inherent risk of a fund.

How Does It Work?

The Morningstar Rating™ for funds methodology rates funds based on an enhanced Morningstar Risk-Adjusted Return measure, which also accounts for the effects of all sales charges, loads, or redemption fees. Funds are ranked by their Morningstar Risk-Adjusted Return scores and stars are assigned using the following scale:



Funds are rated for up to three periods—the trailing three-, five-, and 10-years. For a fund that does not change categories during the evaluation period, the overall rating is calculated using the following weights¹:

Age of fund	Overall rating
At least three years, but less than five	100% three-year rating
At least five years, but less than 10	60% five-year rating 40% three-year rating
At least 10 years	50% 10-year rating 30% five-year rating 20% three-year rating

Current Morningstar Categories

- Large Value
- Large Blend
- Large Growth
- Mid-Cap Value
- Mid-Cap Blend
- Mid-Cap Growth
- Small Value
- Small Blend
- Small Growth
- Communications
- Consumer Discretionary
- Consumer Staples
- Equity Energy
- Financial
- Health
- Industrials
- Natural Resources
- Real Estate
- Technology
- Utilities
- Miscellaneous Sector
- Leveraged Net Long
- Conservative Allocation
- Moderate Allocation
- Aggressive Allocation
- Convertibles
- Target-Date 2000-2010
- Target-Date 2011-2015

- Target-Date 2016-2020
- Target-Date 2021-2025
- Target-Date 2026-2030
- Target-Date 2031-2035
- Target-Date 2036-2040
- Target-Date 2041-2045
- Target-Date 2050 +
- Retirement Income
- World Allocation
- Foreign Large Value
- Foreign Large Blend
- Foreign Large Growth
- Foreign Small/Mid Value
- Foreign Small/Mid Growth
- World Stock
- Diversified Emerging Markets
- Latin America Stock
- Europe Stock
- Japan Stock
- Pacific/Asia (ex Japan) Stock
- China Region
- Diversified Pacific/Asia
- Global Real Estate
- Bear Market³
- Currency³
- Long-Short
- Market Neutral
- Equity Precious Metals

- Commodities Agriculture
- Commodities Broad Basket
- Commodities Energy
- Commodities Industrial Metals
- Commodities Miscellaneous
- Commodities Precious Metals
- Long Government
- Intermediate Government
- Short Government
- Inflation-Protected Bond
- Long-Term Bond
- Intermediate-Term Bond
- Short-Term Bond
- Ultrashort Bond
- Bank Loan
- High Yield Bond
- Multisector Bond
- World Bond
- Emerging Markets Bond
- Muni National Long
- Muni National Intermediate
- Muni Short
- High Yield Muni
- Muni Single State Long
- Muni Single State Intern
- Muni California Long
- Muni California Intern
- Muni Massachusetts
- Muni Minnesota

- Muni New Jersey
- Muni New York Long
- Muni New York Intern
- Muni Ohio
- Muni Pennsylvania

¹ When a fund changes investment categories, its historical information is given less weight, depending on the magnitude of the change.

² While the 10-year formula seems to give the most weight to the 10-year period, the most recent three-year period actually counts the most because it is included in all three rating periods.

³ Ratings are not assigned to funds in the Bear Market and Currency categories because the funds in these categories take very different approaches to generating returns.