

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

When will Morningstar launch its Analyst Rating for Funds and Global Fund Reports in each market?

We launched the new Analyst Ratings in the United States, Canada, Europe, and Asia on Nov. 15, 2011. The new ratings will launch in Australia, New Zealand, and our United Kingdom/OBSR products in 2012.

We launched the Global Fund Reports for a subset of the newly rated funds in the United States on Nov. 15, 2011 and expect to introduce the Global Fund Reports for other markets in 2012.

How many funds will receive an Analyst Rating and how many funds have been rated so far?

We launched approximately 350 Analyst Ratings for U.S. funds and about 150 ratings for Canadian funds on Nov. 15, focusing on funds that have garnered the most investor interest and assets. By the end of 2012, we plan to assign the new Morningstar Analyst Rating to about 1,500 U.S. funds. Our U.S. coverage will collectively represent more than 75% of U.S. industry assets. In addition to the largest funds, our analyst team will devote a portion of its coverage universe to smaller funds with distinguishing characteristics.

We currently have Morningstar Qualitative Ratings for more than 1,000 funds domiciled across Europe and Asia. We'll transition all of those fund ratings to the Morningstar Analyst Rating for funds on Nov. 16. We'll transition the OBSR-rated funds in the UK and rated funds in Australia and New Zealand in early 2012.

Morningstar has more than 100 fund and ETF analysts worldwide, and provides data on nearly 120,000 mutual fund share classes.

How will you determine which funds you will assign an Analyst Rating and accompanying Global Fund Report?

The analyst teams determine relevant coverage based on investment merit, investor interest, and asset size to ensure they cover funds that matter most to investors.

What is the difference between a Morningstar Rating™ and a Morningstar Analyst Rating™ for funds?

The Morningstar Rating, most commonly referred to as the "star rating," is a purely quantitative, backward-looking measure of past performance. It is based on a fund's risk- and cost-adjusted performance over three-, five-, and 10-year periods and helps investors to quickly and easily assess a fund's track record relative to its peers. In contrast, the Analyst Rating is a qualitative, forward-looking measure, based on analyst research, and can be used in conjunction with the quantitative Morningstar Rating. We think of the Morningstar Rating as an achievement test and the Morningstar Analyst Rating as more of an aptitude test. Together with the fund reports, they provide investors with a powerful tool to assess funds and make informed decisions.

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

How many funds currently have a quantitative Morningstar Rating?

Funds with at least three years of monthly performance history receive a Morningstar Rating. Globally, about 74,140 funds in Morningstar's open-end mutual fund database currently have a Morningstar Rating as of Sept. 30, 2011. Morningstar introduced the Morningstar Rating for funds in 1985.

What does it mean if a fund receives a high Morningstar Rating and a negative Morningstar Analyst Rating?

It means the fund has outperformed its peers based on risk- and cost-adjusted total returns over the trailing three-, five-, and 10-year periods, but that our analysts don't think it will be able to sustain that performance. The quantitative Morningstar Rating for funds is backward-looking and measures a fund's past risk- and cost-adjusted performance against its peers, so a high Morningstar Rating indicates the fund has outperformed its peers based on returns. The new qualitative Morningstar Analyst Rating for funds is forward-looking based on analyst research, so a negative Analyst Rating means our analysts think the fund won't outperform its peers going forward.

What does it mean if two funds with similar pillar scores have different Analyst Ratings?

The pillars are not equally weighted, so two funds with similar pillar scores may receive different Analyst Ratings. The approach serves not as a mathematical formula, but as a robust analytical framework ensuring consistency across Morningstar's coverage universe.

What is the ratings scale for the new Analyst Rating?

The five-tiered scale for the Analyst Rating has three positive levels—Gold, Silver, and Bronze—in addition to Neutral and Negative ratings. Morningstar analysts reserve the top three tiers for funds Morningstar's analyst team thinks have sustainable advantages that position them well versus peers and/or relevant benchmark on a risk-adjusted basis over a full market cycle of at least five years. The new Morningstar Analyst Rating scale is as follows:

- Positive Ratings:
 - Gold: Best-of-breed fund that distinguishes itself across the five pillars and has garnered the analysts' highest level of conviction;
 - Silver: Fund with notable advantages across several, but perhaps not all, of the five pillars—strengths that give the analysts a high level of conviction;
 - Bronze: Fund with advantages that outweigh any disadvantages across the five pillars, and sufficient level of analyst conviction to warrant a positive rating;
- Neutral: Fund that isn't likely to deliver standout returns, but also isn't likely to significantly underperform; and
- Negative: Fund that has at least one flaw that is likely to significantly hamper future performance, and is considered an inferior offering to its peers.



Gold



Silver



Bronze

Neutral

Negative

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

Why are you covering Neutral- and Negative-rated funds?

Unlike other firms, our ratings scale identifies mediocre and poor funds, which is helpful to investors who may already hold these funds in their portfolios. Morningstar's goal is to ensure that investors have access to our analysts' research on a broad spectrum of funds that are important to them. We plan to cover both large funds and smaller funds with distinguishing characteristics.

How many funds do you expect to have a positive rating as a percentage of your overall global coverage? How many Gold-rated funds? Silver? Bronze? How many funds do you expect to have a Neutral or Negative rating as a percentage of your overall global coverage?

The ratings are a function of our analysts' judgment, and we won't mandate any fixed percentages. We intend, however, for positive ratings to be a high bar to reach. In practice, a relatively small percentage of available funds receive our top rating under our current methodologies. For example, less than 3% of all funds offered in the United States qualify for our existing "Analyst Pick" designation.

We will rate each fund on its individual merits. Our methodology is focused on what kinds of funds should receive each rating level, without imposing a grading curve.

That said, because our initial focus will be on the biggest and best funds, we expect that our initial coverage will skew more positively than these percentages and become more balanced over time as we ramp up.

Will funds in Europe and Asia with a current Morningstar Qualitative Rating be re-assessed under the new Analyst Rating scale? How about OBSR-rated funds? And funds currently rated in Australia and New Zealand?

Yes, we have transitioned the ratings we assign to European and Asian funds from the current scale of Elite, Superior, Standard, Inferior, and Impaired to the new ratings scale of Gold, Silver, Bronze, Neutral, and Negative. In 2012, we plan to transition OBSR-rated funds to the global scale, along with the qualitative ratings we assign to Australian and New Zealand funds.

What's the methodology for the new Analyst Ratings?

The Morningstar Analyst Rating evaluates funds on five key pillars, considering both numeric as well as qualitative factors. This approach notably puts only partial weight on past performance and backward-looking risk measures and does not dismiss funds that have underperformed or have limited track records. It will also be more responsive to significant changes at a fund or parent organization. The five pillars are:

- People: Quality of a fund's investment team, based on factors including its experience, stability, structure, communication, and alignment of interests with fund shareholders;
- Process: Quality of investment process—in terms of both security selection and portfolio construction—and whether it is sensible, clearly defined, and repeatable. In short, does the fund have a competitive advantage? Also judges whether the process is effectively implemented and whether the portfolio is consistent with the stated process;

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

- Parent: Quality of the parent organization, including capacity and risk management, recruitment and retention of talent, incentive pay, and culture of stewardship;
- Performance: Evaluation of long-term returns, consistency of performance in different market conditions, and performance relative to manager changes and changes in asset size; and
- Price: Evaluation of expense ratios, performance fees, and trading costs, within the context of the relevant sales channel and market or cross-border region.

How often will you review and update the Analyst Ratings?

Morningstar's fund analysts will review the Analyst Ratings annually for all funds, and more often for the largest and highest-rated funds. The frequency depends on the local market, the size and type of fund, and the current fund rating. If there is a material change to one of the five pillars that has the potential to affect the rating, we will re-assess it as soon as possible and may place the fund Under Review. We will review the Analyst Rating for larger funds more frequently.

What does the new Morningstar Global Fund Report contain? How often will the reports be updated?

The Morningstar Global Fund Report is a seven-page detailed report that offers the most relevant data and analysis surrounding the five pillars, a written analysis of the fund and explanation of the Analyst Rating, and a wealth of graphics, data, and other statistics. Our analysts will update the reports regularly.

Which products will have the new Analyst Ratings and Reports?

- Morningstar.com®: The new Analyst Ratings for funds are available for free on most of Morningstar's individual investor websites worldwide.
- Morningstar.com Paid Premium Membership: The Analyst Rating plus a written analysis of the fund and an explanation of the Analyst Rating, along with the most significant data surrounding the five pillars.
- Morningstar® Principia® Mutual Funds Advanced, Morningstar® Advisor WorkstationSM (with premium add-on for fund research), and Morningstar OfficeSM: The Analyst Ratings and the in-depth Morningstar Global Fund Reports for funds available for sale in the United States. Local advisor software platforms will have the same information for the corresponding fund universe.
- Morningstar DirectSM: The Analyst Ratings and in-depth Global Fund Reports for all the funds that Morningstar covers worldwide.
- Morningstar® EssentialsTM and Data Feeds: The Analyst Ratings, as well as related images and supporting data, will be available for licensing.

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

When will the new Analyst Ratings and Global Fund Reports be available in all these products?

We launched the new Analyst Ratings in Morningstar Direct, Morningstar Office, and on our U.S., Canadian, European, and Asian investment research websites on Nov. 15, 2011, along with the new Global Fund Reports for U.S. funds in Morningstar Direct and Morningstar Office. Morningstar will roll out the new ratings and reports in other products over the next several months. We'll add the new reports for Canadian, European, and Asian funds as they become available. The new ratings and reports will launch in Australia, New Zealand, and our U.K.-based OBSR products in 2012.

Will Morningstar still publish its Analyst Picks and Pans in the United States and Canada?

No. The new Analyst Ratings are replacing our Analyst Picks and Pans lists. Funds that receive a Gold rating will be considered Morningstar analysts' highest-conviction "picks" in our coverage universe. We expect that all of our current Analyst Picks will receive a positive rating of Gold, Silver, or Bronze.

How many Analyst Picks and Pans do you currently have?

Before we transitioned our Analyst Picks and Pans to the new Analyst Ratings, we had about 170 Analyst Picks and about 70 Analyst Pans.

How have the Analyst Picks performed?

As far as the performance of the Analyst Picks, over the trailing five years, more than two thirds of Analyst Picks in each of the broad asset classes have beaten their category averages. Here's the breakdown: 88% for balanced funds, 69% for international-stock funds, 86% for municipal-bond funds, 89% for taxable-bond funds, and 70% for U.S.-stock funds.

Also, over the trailing five years, our Analyst Picks for domestic-equity funds have returned an annualized negative 0.29% compared with negative 1.18% for the S&P 500. Our Analyst Picks for international-stock funds have returned negative 1.69% compared with negative 3.46% for the MSCI EAFE Index (Europe, Australasia, Far East). Among bonds, our taxable-bond fund Picks returned 6.55% compared with 6.53% for the Barclays Aggregate, and for municipal-bond funds, our Picks returned 4.29% annualized compared with 4.16% for the Barclays Municipal Bond Aggregate.

Will fund companies be able to license the new Analyst Ratings?

Yes, fund companies will be able to license the Analyst Ratings for marketing materials after a rating has been published. Morningstar will not charge fund groups to be rated, and its decision to rate and report on a specific fund is made solely by the analyst team based on factors such as investor interest and asset size.

Morningstar Analyst Rating for Funds and Global Fund Reports

Questions and Answers

November 2011

Will fund firms be allowed to promote specific pillars rather than the overall Analyst Rating?

Globally, fund firms will be required to license the Analyst Rating and may not just reference one pillar. This is similar to our process for licensing Morningstar Ratings, where firms are required to display the overall rating if they display any of the other time periods.

Will fund companies have to use the new Analyst Rating with the backward-looking Morningstar Rating in their advertisements?

No, we will not require fund firms to display both the Analyst Rating and the Morningstar Rating in the same advertisement.

Will Morningstar convert the current ratings scale for target-date funds, 529 college-savings plans, and Stewardship Grades to the new Analyst Ratings scale?

We adjusted our methodology for the Stewardship Grades for funds in the United States so that it better supports the new Analyst Rating for funds and Global Fund Reports. In November, we began replacing the individual fund grades with parent-level Stewardship Grades using an A to F grading scale for more than 20 fund firms, and aim to complete the full shift to the new methodology in 2012. The parent-level Stewardship Grades will be part of the Parent pillar in the new Analyst Rating.

Separately, Morningstar's Analyst Ratings for 529 college-savings plans and target-date fund series in the United States (which currently follow a rating scale of Top, Above Average, Average, Below Average, and Bottom) will adopt the new Analyst Rating scale of Gold, Silver, Bronze, Neutral, and Negative over time.

Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. Analyst Ratings are based on Morningstar analysts' current expectations about future events and therefore involve unknown risks and uncertainties that may cause Morningstar's expectations not to occur or to differ significantly from what was expected. Morningstar does not represent its Analyst Ratings to be guarantees nor should they be viewed as an assessment of a fund's or the fund's underlying securities' creditworthiness.