Fact Sheet: The New Morningstar Rating™ for Funds

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 rating allowed investors to easily evaluate a fund’s past performance within four 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.

Morningstar is now introducing an enhanced star rating based on the smaller category groups instead of broad asset classes, and will eliminate the separate category rating. The new star rating also uses an enhanced risk-adjusted return measure. 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.

What It Means for Investors
The Morningstar Rating™ remains an easy-to-understand assessment of a fund’s past performance—both return and risk—as measured from one to five stars.

Original Morningstar Rating™ for Funds
- Broad comparison groups—funds are rated within four asset class-based categories: U.S. stock funds, international stock funds, taxable bond funds, and municipal bond funds.
- Different share classes of each fund are rated separately; each share class counts as a distinct fund within the rating distribution scale.
- Funds are rated for up to three time periods (three, five, and 10 years). These ratings are weighted and combined to produce the overall Morningstar Rating.
- Risk is measured by the fund’s average underperformance relative to the 90-day Treasury bill.

New Morningstar Rating™ for Funds
- More focused comparison groups—funds are ranked and rated within the Morningstar Categories (see accompanying list).
- Share classes are evaluated separately, but a fund with multiple share classes is counted only once within the rating distribution scale.
- Funds are rated using the same time periods. However, when a fund changes Morningstar investment categories, its historical rating is given less weight, based on the magnitude of the category change.
- Risk is measured as the amount of variation in the fund’s performance, with more emphasis on downward variation.

Category-Based Rating Groups
The new rating will allow investors to better distinguish among funds that use similar investment strategies. It will also minimize 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 results in high ratings for most value funds, while growth-oriented funds are likely to receive lower ratings.

Multiple Share Classes
Because the comparison groups are smaller, Morningstar is also changing 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 now 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 now 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**

Morningstar is also enhancing 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 new 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 new 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.

**When and Where**

The new Morningstar Rating™ for funds will be implemented in all Morningstar’s U.S. products in July 2002, beginning with the performance period ending June 30, 2002. Historical star ratings will not change.

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**Current Morningstar Categories**

- Large Value
- Large Blend
- Large Growth
- Mid Value
- Mid Blend
- Mid Growth
- Small Value
- Small Blend
- Small Growth
- Specialty Communications
- Specialty Financial
- Specialty Health
- Specialty Natural Resources
- Specialty Real Estate
- Specialty Technology

- Specialty Utilities
- U.S. Hybrid
- Convertibles
- Europe
- Latin America
- Diversified Emerging Markets
- Pacific/Asia
- Pacific/Asia (ex Japan)
- Japan
- Diversified Foreign
- Diversified World
- International Hybrid
- Specialty Precious Metals

- Government Long-Term
- Government Intermediate-Term
- Government Short-Term
- General Long-Term
- General Intermediate-Term
- General Short-Term
- General Ultrashort-Term
- Specialty International Bond
- Specialty High-Yield
- Specialty Multi-sector
- Specialty Emerging Markets Bond

- Muni National Long-Term
- Muni National Intermediate-Term
- Muni Single State Long-Term
- Muni Single State Intermediate-Term
- Muni Short-Term

- Muni California Long-Term
- Muni California Intermediate-Term
- Muni New York Long-Term
- Muni New York Intermediate-Term

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**How Does It Work?**

The new 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 weights:

- Age of fund: 3 years, but less than 5: 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

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