Fact Sheet: The New Morningstar Rating™ for Funds

Investor Benefits

- Provides more focused comparison groups to help investors build multi-fund portfolios
- Is more 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 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. It now provides more focused comparison groups and better captures fund manager skill.

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.

	Original Morningstar Rating™ for Funds	New Morningstar Rating™ for Funds
Rating Groups	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.	More focused comparison groups—funds are ranked and rated within the Morningstar Categories (see accompanying list).
	Different share classes of each fund are rated separately; each share class counts as a distinct fund within the rating distribution scale.	Share classes are evaluated separately, but a fund with multiple share classes is counted only once 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.	Funds are rated using these 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.
Adjusting for Risk	Risk is measured by the fund's average underperformance relative to the 90-day Treasury bill.	Risk is measured as the amount of variation in the fund's performance, with more emphasis on downward variation.

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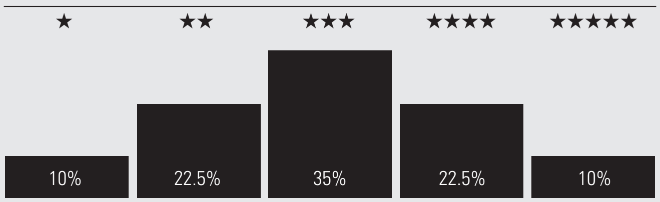
How Does It Work?

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[1]:

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 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 Multisector
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

[1] 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.

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

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.