

# 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.

## Original 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.

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.

## Current 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 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.

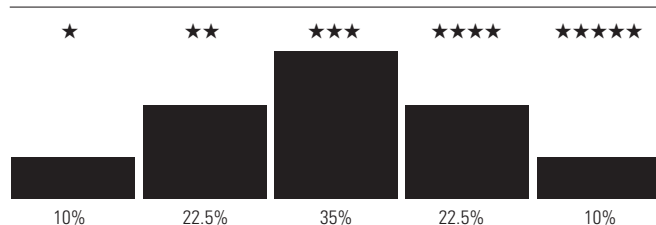
### Adjusting for Risk

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.

**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 weights<sup>1</sup>:

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  
Specialty Communications  
Specialty Financial  
Specialty Health  
Specialty Natural Resources  
Specialty Real Estate  
Specialty Technology  
Specialty Utilities  
Conservative Allocation  
Moderate Allocation  
Convertibles

Moderate Allocation  
Target-Date 2000-2014  
Target-Date 2015-2029  
Target-Date 2030 +  
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  
Diversified Pacific/Asia  
Global Real Estate  
Bear Market<sup>3</sup>  
Currency<sup>3</sup>

Long-Short  
Specialty 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 National Short  
High Yield Muni  
Muni Single State Long

Muni Single State Interm  
Muni Single State Short  
Muni California Long  
Muni California Int/Sh  
Muni Massachusetts  
Muni Minnesota  
Muni New Jersey  
Muni New York Long  
Muni New York Int/Sh  
Muni Ohio  
Muni Pennsylvania

<sup>1</sup> When a fund changes investment categories, its historical information is given less weight, depending on the magnitude of the change.  
<sup>2</sup> 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.  
<sup>3</sup> 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.

**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.