Significant Restructure Methodology

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Introduction

Mutual funds frequently change Morningstar categories. For the most part, these changes are part of the fund’s normal investment process. An allocation fund might favor cash and bonds more than stocks for a prolonged period, thereby moving from the Moderate Allocation category to the Conservative Allocation category. Or a stock fund might favor bigger companies, so that the fund moves from the Mid-Cap Growth category to the Large Growth category.

Morningstar addresses these routine category changes in the following fashion –

1) For all trailing performance that is calculated vs. category, assume that the fund has always occupied the new category
2) For the star rating calculation, ranks, risks, and MPT statistics assume that the fund has always occupied the new category
3) For calendar-year rankings, assign the fund to the category that it occupied on December 31st of that year

On occasion, a fund will switch categories due to a significant change in its investment process. A significant change is a change that abruptly leads to a substantially different portfolio.

In such cases, the fund’s star rating is treated differently than with a routine category change. The star rating and ranks are reset and calculations begin at the date of the significant restructuring, ignoring performance before that date. All other calculations, including the trailing and historical performance, risks, MPT statistics, monthly premium and discount, and the 12-month yield, assume that the fund has always occupied the new category, as with a routine category change. Morningstar’s policy is to note the significant restructuring date written on public filings. Any category changes or effects on performance calculations, however, will take effect on the following month end date. For example, if the significant restructure date is May 1st, any changes to categories, ratings, ranks, risks, and MPT statistics would be effective as of May 31st.
Methodology

Determination of the significant restructuring event is made by Morningstar’s Fund Research staff. The key elements of a significant restructuring are – 1) the change is abrupt, rather than gradual; 2) the change leads to the sale of most of the fund’s holdings; 3) the new holdings are substantially different in character than are the old holdings; and 4) after certain legal structure changes in the fund.

Examples—

1) Due to portfolio trades, the Acme Growth Fund moves from being classified as a Large Blend Fund to being a Large Growth Fund.

   ► Not a significant restructuring. Fails to satisfy criteria #1, #2, and #3.

2) Between 2006 and 2010, The Acme Global Fund gradually increases its holdings in foreign securities from 30% to 80% of holdings.

   ► Not a significant restructuring. Fails to satisfy criteria #1.

3) The Acme Short Treasury Fund renames itself as the Acme Short Government Fund and abruptly swaps 60% of its portfolio, trading short Treasuries for short U.S. Government Agency notes.

   ► Not a significant restructuring. Fails to satisfy criteria #3.

4) The Acme Short Treasury Fund renames itself as the Acme Long Government Fund and abruptly swaps 60% of its portfolio, trading Treasuries for long U.S. Government Agency notes.

   ► Significant restructuring event. Rating and rank suspended.

5) The Acme Global Fund moves from being a hedge fund to being an open end fund.

   ► Significant restructuring event. Rating and rank suspended.
Methodology (continued)

For U.S. funds, hedge funds, separate accounts, unit investment trusts, and collective investment trusts that become open end funds will be considered as having undergone a significant restructuring. In these cases, funds will be considered as having undergone a significant restructuring even if the category does not change. Other situations, such as legal structure changes involving funds that fall under the Investment Company Act of 1940, will not automatically be considered significant restructures. Thus, a closed end fund or exchange-traded fund becoming an open end fund will generally constitute a legal structure change, but not a significant restructuring.

Morningstar considers two principles when deciding whether a legal structure change also qualifies as a significant restructure:

1) The amount of publicly available information on the former legal structure. If a fund that is not required to disclose a large amount of public information becomes a public security, it will be considered a significant restructure.

2) The similarity in investment characteristics between the former and current legal structures. Examples of investment characteristics are the liquidity terms given to shareholders, permissible leverage, and tax treatments.

Significant restructurings are typically accompanied by either a change in a fund’s name and/or a change in prospectus language. On occasion, though, a fund’s original prospectus may be written broadly enough so that a fund can undergo a significant restructuring without changing either its name or prospectus. However, a change in the fund’s name and/or prospectus are not in and of themselves indicators of a significant restructuring event. Rather, the actual indicator is the change in portfolio. Thus, Morningstar may wait to observe one or more future portfolios after a fund changes its name and/or prospectus before applying the significant restructure label.
Frequently Asked Questions

How is the Significant Restructure Event Identified?
Twice a year, Morningstar generates a category review calculation that identifies funds that may change categories. The Morningstar Funds Research team reviews each case to judge if the fund should stay in its current category, should become a routine category change, or should be a significant restructuring due to a change in investments. Additionally, Morningstar may initiate a special review for significant restructures upon learning of change in legal structure or investment strategy.

Can Fund Companies have a say in the Process?
If a fund company feels that a fund is a candidate for the Significant Restructure Event, it can notify Morningstar and that fund will be reviewed by the Morningstar Funds Research team as part of the category review process.

If a fund company feels that Morningstar’s review process reaches the incorrect conclusion, the fund company can file an appeal through the appeal process. There is no appealing a rejected appeal.