

# Fact Sheet: Morningstar® Target-Date Fund Series Rating and Research Reports

## Investor Benefits

- ▶ Shines a light on best practices in target-date funds, which will be many investors' primary means of retirement savings.
- ▶ Gives investors the ability to quickly and easily assess a fund company's lineup of target-date funds through an overall rating.
- ▶ Allows investors to evaluate target-date series in five key areas: people, parent, performance, portfolio, and price.
- ▶ Provides investors with insight into how a target-date series' asset allocation may differ from category norms.

## Purpose

Morningstar Target-Date Fund Series Rating and Research Reports are designed to help individual investors, financial advisors, plan sponsors, and other interested fiduciaries make informed decisions when evaluating a series of target-date funds.

Target-date funds are marketed as a one-decision, comprehensive investment option that investors can hold through their retirement years. The funds tend to invest more aggressively in the decades before retirement and shift their asset mixes so they are more conservative in the years immediately preceding and following retirement. The mutual fund industry refers to this shift in assets as a fund's "glide path."

Target-date funds are by no means a uniform investment type. Depending on the glide-path philosophy, the subasset classes used, the nature and quality of the underlying investments, and a host of other factors, target-date funds can display markedly different risk and return characteristics. With its broad expertise in evaluating individual mutual funds and mutual fund families, Morningstar hopes to create a clearer picture of the target-date universe.

Morningstar Target-Date Fund Series Rating and Research Reports use both quantitative and qualitative assessment methods to analyze target-date fund performance. The Target-Date Fund Series Rating and Reports take a holistic, peer-based approach to evaluating target-date fund series so investors can:

- Quickly identify the highest- and lowest-achieving target-date fund series
- Make meaningful comparisons across the target-date universe
- Gain insight into the factors most relevant to target-date fund series performance
- Assess the suitability of target-date fund series for investors with widely varying needs

## Scope

Morningstar conducts quantitative scoring across all open-end target-date series that meet our minimum standards for history and comprehensiveness. Initially, we will assign qualitative ratings and create reports for 20 target-date fund series.

## Rating

Morningstar evaluates two qualitative and three quantitative components for each target-date fund series. Fund series are assigned one of five ratings for each component: Top, Above Average, Average, Below Average, and Bottom. A maximum rating of Top implies that a target-date fund series outshines its average peer for the given component. Conversely, a minimum score of Bottom suggests that the target-date fund series is substantially weaker than its typical peer on that particular measure. Based on the five component ratings, each target-date fund series earns an overall rating that is assigned along the same rating scale of Top, Above Average, Average, Below Average, and Bottom.

The five components evaluated by Morningstar analysts are:

*People*

*Parent*

*Performance*

*Portfolio*

*Price*

## Qualitative Components

Morningstar believes that the organizational expertise and integrity of fund companies are crucial to the long-term success of their funds. We believe that stewardship is especially important when investing for the long term. Many of the qualitative components of our target-date research borrow from (but are not identical to) aspects of the Morningstar Stewardship Grades<sup>SM</sup> for mutual funds. The qualitative scores are based on the expertise of Morningstar's fund analysts and information compiled from public filings.

**People (20%)**

This section takes a qualitative look at the management team responsible for the target-date series and its incentives.

*Management (15%)*

For this section, Morningstar's analysts study the fund series' management team and determine how well we think it will serve shareholders over the long term. We look at the named managers on the target-date funds and those responsible for setting the funds' asset allocation. And in cases where the target-date funds are funds of funds, we also consider the managers of the underlying funds.

*Manager Incentives (5%)*

We look at fund managers' pay plans to see if they are structured so that each manager's primary incentive is to deliver strong long-term returns to shareholders. We also look to see if managers have made sizable financial commitments to the funds they run through direct ownership of fund shares.

**Parent (20%)**

This section evaluates four aspects: Corporate Culture, Board Oversight, Target-Date Transparency, and Regulatory History.

*Corporate Culture (10%)*

This section evaluates whether fund companies consistently put shareholders before profits. Fund firms with industry-leading corporate cultures employ talented investors who rarely leave (except to retire), are forthcoming about their investment successes and failures, and stress long-term returns when marketing their funds to shareholders.

*Board Oversight (5%)*

This section evaluates how well a fund series' board of directors governs on behalf of fund shareholders and, if necessary, exerts its independence from the asset-management company it has hired to run the funds. We consider three questions for this section:

1. Is the fund board sufficiently independent of the fund advisor? Does it have at least 75% independent directors and an independent chairman?

2. Do 75% of the independent directors have at least one year's fund-board compensation invested in the funds they oversee?
3. Has the board consistently acted in shareholders' best interests?

*Target-Date Transparency (5%)*

This section evaluates how well fund companies' publicly available materials explain the target-date funds' operation to current or potential shareholders.

*Regulatory History (maximum of 0%, minimum of -5%)*

We examine any regulatory issues at the fund company in recent years.

**Quantitative Components**

**Performance (20%)**

This criterion assesses how well a target-date fund has performed historically relative to its peers. Backward-looking views of target-date fund performance can be skewed by the relatively short performance histories of many series. Nevertheless, Morningstar believes that it is important to evaluate past performance because it can give clues as to how funds may perform in future market cycles.

To calculate the fund series' performance scores, Morningstar compares each target-date fund series' overall Morningstar Risk-Adjusted Returns (MRAR) with the average MRAR of the target-date universe. MRAR adjusts a fund's total return by deducting a "risk penalty" based on its month-to-month variation in return.

**Portfolio (20%)**

The portfolio score examines the quality of the underlying holdings in each target-date fund series, based on the Morningstar Rating™ for mutual funds (the "star rating") of those underlying funds. The star rating compares a fund's risk-adjusted performance with its peer group, as defined by its Morningstar open-end fund category. We calculate a weighted average star rating for the holdings in each target-date fund, then compute a simple average across the entire series.

On a portfolio-weighted basis, at least 50% of the underlying holdings in a target-date fund must earn a star rating (which requires a three-year history) in order for that fund to be included in the overall portfolio rating. Some target-date fund series do not use a fund-of-funds structure; in such cases we assign an NA for the portfolio score and rescale the remaining components of the overall rating.

#### **Price (20%)**

Morningstar research has shown that low expenses are an important predictor of future outperformance. This is especially the case in investments like target-date funds, which are intended to be held for the long term and where the advantage of lower costs can compound greatly over time.

Morningstar does not determine a target-date fund series' price rating by looking at a single share class across funds because this oversimplifies matters. We have found, for instance, that in some cases, the funds' lowest-cost institutional share class holds a tiny fraction of the overall assets in a target-date fund series. In order to get closer to the costs that actual investors pay, we select the lowest-cost share class that has at least 10% of the overall assets in the target-date fund series. The net prospectus expense ratios for that share class are then averaged across all the funds in the series.

#### **Overall Rating**

Based on the ratings for each of the five components, Morningstar analysts assign one of five ratings to the target-date series overall:

- Top
- Above Average
- Average
- Below Average
- Bottom

We review this overall rating quarterly when we update the text and analyze the data associated with each target-date fund series.

#### **Analyst Commentary (no rating associated with this section)**

The full Morningstar Target-Date Reports contain detailed analyst commentary on all aspects of the ratings, as well as additional analysis of nonrated aspects of target-date performance. For instance, Morningstar does not currently assign a score or rating to a target-date fund series' glide path, as we don't think there is a single right or wrong glide path. But we do describe glide paths and discuss what differentiates a series' path from others in the industry. This gives investors important context for understanding how a target-date funds series' glide path may contribute to its performance or affect its suitability for a given demographic or risk profile.

#### **Attribution Analysis (no rating associated with this section)**

Each report also contains an analysis of the target-date fund's performance relative to a custom benchmark over the past two years. Series that have a total attribution that is greater than zero have outperformed the benchmark, while series with negative totals have underperformed. From there, we show which factors—glide path, cost, and selection—caused the fund to beat or lag the index. Factors with positive numbers helped performance, and factors with negative numbers detracted from performance. The combination of the three factors equals the fund's total attribution relative to the index. ■■