

Morningstar Stewardship Grade for Fund Firms

Purpose

The Morningstar Stewardship Grade™ for mutual fund firms is designed to help investors further research, identify, and compare fund companies that do a good job—or a poor job—of aligning their interests with those of fund shareholders.

The Stewardship Grade goes beyond the usual analysis of strategy, risk, and return. It helps investors to assess funds based on the degree to which the funds' parent—the management company offering the fund—has its interests aligned with those of fund shareholders. The methodology also examines whether shareholders can expect their interests to be protected from potentially conflicting interests of the management company.

The Stewardship Grade tries to capture some of the intangibles associated with making an investment decision. While the grades are not intended to serve as buy/sell signals in isolation, when combined with other Morningstar analyst commentary—such as an assessment of a fund's strategy and management—they can help determine the difference between a great investment and one to avoid.

The grades are based on analysis by Morningstar's fund researchers, Morningstar's proprietary data, and information compiled from public regulatory filings.

Separate From the Star Rating

The methodology for the Stewardship Grade is completely different from the Morningstar Rating™ for funds (the "star rating"), and a fund family's Stewardship Grade has no impact on its funds' star ratings. The Morningstar Rating is a quantitative assessment of a fund's past performance—both return and risk—as measured from 1 to 5 stars. The Stewardship Grade is determined using some quantitative measures, but it is primarily based on Morningstar's qualitative analysis of a fund family's stewardship of fundholders' capital.

The Stewardship Grades do inform the Morningstar Analyst Rating™ for mutual funds. For fund firms receiving Stewardship Grades, the Stewardship Grade will determine the Parent rating for all funds in the family. Funds from firms earning A and B Stewardship Grades will have Parent

ratings of Positive; those earning C Stewardship Grades will have a Neutral Parent rating; and funds from firms earning D and F Stewardship Grades will have Negative Parent ratings.

For funds not under Stewardship Grade coverage, their Parent ratings of Positive, Neutral, or Negative will be based on an analysis of the fund firm that's consistent with the Stewardship Grade methodology.

Scope

Morningstar analysts have issued Stewardship Grades to individual U.S. mutual funds since 2004; more than 1,000 mutual funds from more than 40 fund firms received the grades. Morningstar Canada has issued Stewardship Grades to fund families since 2010.

Beginning in mid-2011, all U.S. Stewardship Grades will be issued at the fund-firm level using the methodology described below. Morningstar Canada also will make slight changes to its methodology, to be consistent with what's described below, though Canadian fund firms will not be graded on Board Quality as their governance structure differs from that used in the United States.

Scoring

Each fund firm is assigned a letter grade from A (best) to F (worst) based on the combined scores in each of the five components. All fund firms are graded on an absolute basis. There is no "curve."

Components

Morningstar analysts' evaluation of the following five components determines the grade for each fund firm:

- ▶ Corporate Culture
- ▶ Board Quality (U.S. fund firms only)
- ▶ Manager Incentives
- ▶ Fees
- ▶ Regulatory History

Corporate Culture (41% of overall U.S. grade)

This component looks at a wide range of factors to assess how seriously a firm takes its fiduciary duty to its fund shareholders. Morningstar analysts consider the following:

- ▶ Is the fund company focused on investing or on gathering assets?

Morningstar Stewardship Grade for Fund Firms

- ▶ Does the fund company foster a thoughtful, repeatable investment process?
- ▶ Is the fund company straightforward with investors through clear, pertinent disclosure and responsible marketing?
- ▶ Do talented investors spend their careers at the fund firm?

Board Quality (17% of overall U.S. grade)

Morningstar analysts assess the quality of the funds' board of directors (or boards, if the funds are overseen by more than one group of directors).

- ▶ Does the board consistently act in shareholders' best interests?
- ▶ Has the board negotiated fair fees on shareholders' behalf?
- ▶ Has the board approved a sensible group of funds that the fund firm is capable of running well?

Manager Incentives (25% of overall U.S. grade)

Morningstar assesses two distinct aspects:

- ▶ **Fund Ownership:** Do the managers have significant investments in the funds they oversee? In the U.S., Morningstar's assessment will be based primarily on manager-ownership levels reported annually to the SEC, and firms that reflect the industry's best manager-investment practices will earn full credit. Outside the U.S., where fund-ownership disclosure requirements are limited, Morningstar surveys fund companies for this information.
- ▶ **Compensation Structure:** Do the compensation plans reward long-term performance or emphasize asset growth? Incentive programs that encourage a focus on short-term performance or asset growth are viewed less favorably.

Fees (17% of overall U.S. grade)

This section assesses one aspect:

- ▶ Are the fund firm's offerings a good value for shareholders? Morningstar's assessment will be based on a comparison of the firm's fund fees relative to those with similar strategies and share classes. In the U.S., Morningstar will determine the fund family's average fee level percentile rank, which results from peer-based comparisons, to determine the firm's fee rating for the Stewardship Grade. Outside the U.S., asset-weighted expenses are also considered. Management companies with fees that are among the industry's best value propositions will earn full credit.

Regulatory History

Morningstar examines any regulatory problems at the fund company in recent years. Serious breaches of fiduciary duty can result in a deduction of points toward a family's overall score. In the event of any breaches, Morningstar will review the remedies in place and the scope of, and commitment to, reform.

Where to Find the Stewardship Grade

Morningstar DirectSM
Morningstar OfficeSM
Morningstar[®] Advisor WorkstationSM
Morningstar[®] Principia[®]
Morningstar.com (and regional affiliates)
Morningstar[®] Mutual FundsTM
Morningstar[®] FundInvestorTM