A Look at the Potential Impact of the Upcoming Change to the Morningstar Analyst Rating Methodology on U.S.-Domiciled Funds

Morningstar Research
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Executive Summary

We recently announced our plans to update the methodology we follow in assigning Morningstar Analyst Ratings to mutual funds, exchange-traded funds, and other managed investments we cover. Here we examine the aggregate impact the methodology change would have if it were applied pro forma to U.S.-domiciled funds that have been assigned an Analyst Rating. (We will separately examine the pro forma impact to non-U.S. funds in similar pieces that we plan to publish in the weeks ahead.)

Study Approach

To analyze the potential impact of the ratings enhancement, we applied the updated methodology pro forma to funds and ETFs that have been assigned an Analyst Rating. We did so by taking the funds' current People, Process, and Parent Pillar ratings and running them through the updated methodology. For more information on the updated methodology, see here. https://www.morningstar.com/articles/935412/looking-forward-to-changes-to-our-forward-looking-ratings

After running the pillar ratings through the updated methodology, we compared those pro forma ratings against the existing Analyst Ratings and tallied up the results in the following impact analysis. It is worth noting that this pro forma analysis is subject to change, as analysts review their assumptions—including the pillar ratings they've assigned—in the normal course.

Key Takeaways

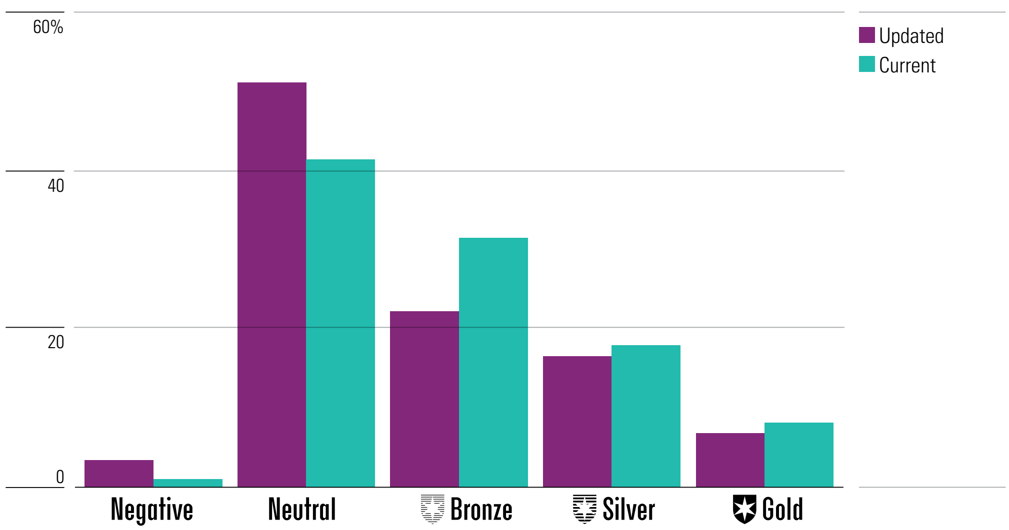
- Roughly 43% of funds and ETFs would see a rating change; many rating changes stem from tailoring ratings to each share class by taking fee differences into account.
- Downgrades would outnumber upgrades by a roughly two-to-one margin.
- The percentage of active funds rated Gold, Silver, or Bronze would fall; share classes that embed advice and sales fees also would see more downgrades than upgrades.
- The percentage of index funds earning Gold, Silver, or Bronze ratings would rise; in general, "unbundled" share classes would be likeliest to be named Morningstar Medalists.
- Most ratings changes would be one rung and involve funds currently rated Bronze (45% of all changes), Silver (27%), and Neutral (17%).

- Around half of funds with multiple share classes would see multiple ratings across the classes.
- Only about 26% of funds with above-average or high fees would receive a Gold, Silver, or Bronze ratings, compared with around 50% today.
- Once implemented, we do not expect the updated methodology to result in more-frequent ratings changes than now.

Impact Analysis: Big Picture

Pro forma, the distribution of Analyst Ratings would shift away from Gold, Silver, and Bronze ratings and toward Neutral and Negative ratings under the updated methodology. Around 1,000 more share classes would receive Neutral and Negative ratings compared with today, with downgrades outnumbering upgrades by a margin of around two to one. All told, roughly 43% of funds and ETFs would see a rating change.

Exhibit 1 Distribution of Analyst Ratings: All Share Classes of All Covered Funds



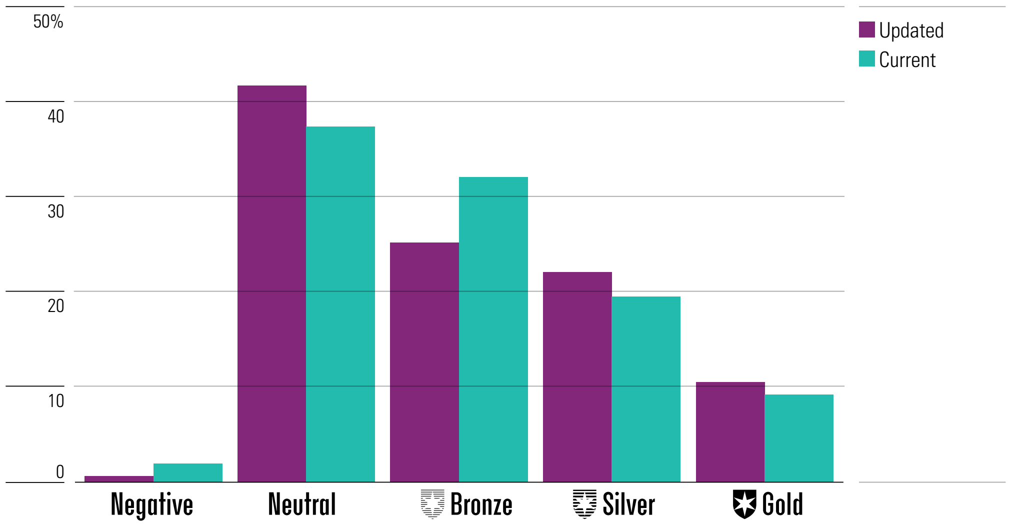
Source: Morningstar.

This shift would stem at least partly from assigning Analyst Ratings to individual share classes. To this point, we have assigned the same rating to each of a fund's share classes irrespective of fee differences. Going forward, we would vary the ratings we assign to share classes by taking these fee differences into account. All things being equal, more-expensive share classes of funds would receive lower ratings and vice versa for cheaper share classes.

The effect of assigning ratings to individual share classes in this fashion becomes apparent when we remove multiple fund share classes from the analysis. When we limit to one share class per fund (that is, the share class tagged "oldest share class"), the distribution would shift toward Neutral and

Negative but not quite to the same degree, with around 42% of funds receiving such ratings (versus 55% of all share classes).

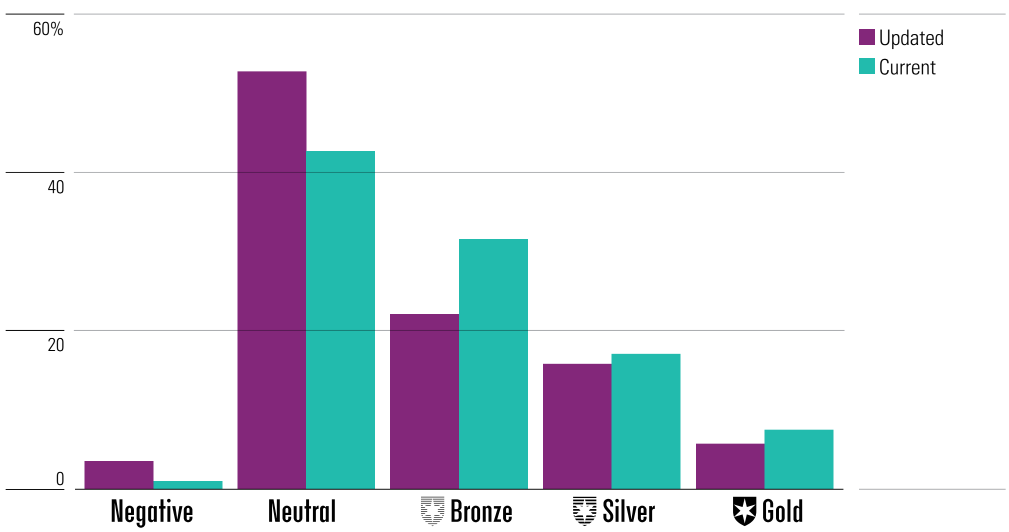
Exhibit 2 Distribution of Analyst Ratings: Oldest Share Class of Each Covered Fund



Source: Morningstar.

The distribution of Analyst Ratings assigned to active funds would shift in a way that mirrors the overall rated universe. This is explained by the fact that active funds dominate our coverage universe, accounting for roughly 96% of the share classes that we have assigned Analyst Ratings to.

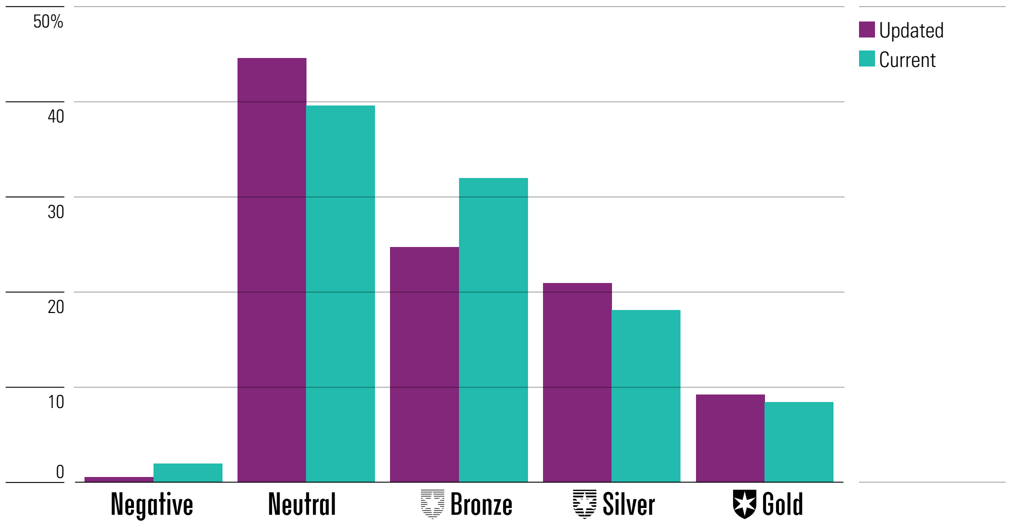
Exhibit 3 Distribution of Analyst Ratings: All Share Classes of All Covered Active Funds



Source: Morningstar.

However, this shift would be less pronounced if we limit the analysis to one share class per active fund.

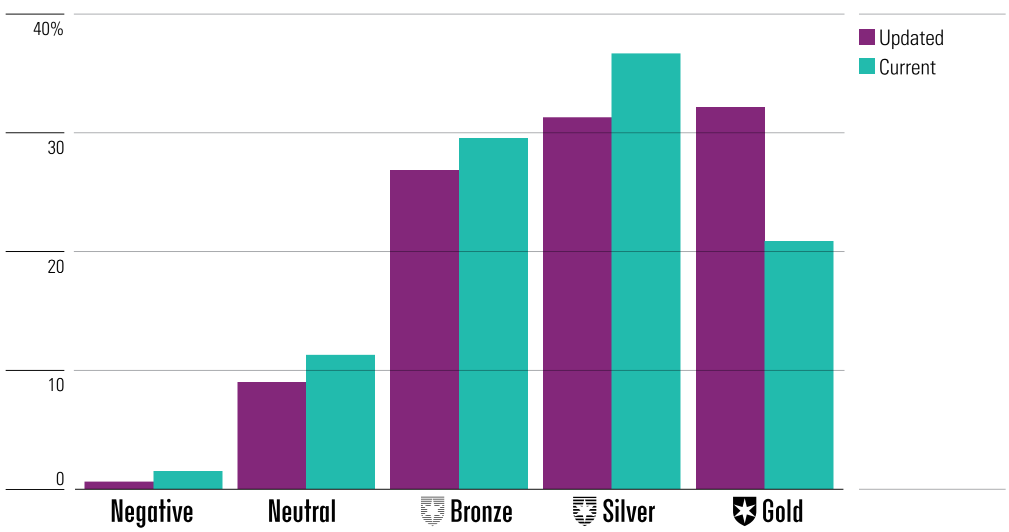
Exhibit 4 Distribution of Analyst Ratings: Oldest Share Class of Each Covered Active Fund



Source: Morningstar.

Unlike active funds, index funds would see more upgrades than downgrades under the updated methodology. The main reason for this is that the updated methodology further emphasizes low cost, which is a trait the index funds we cover often boast.

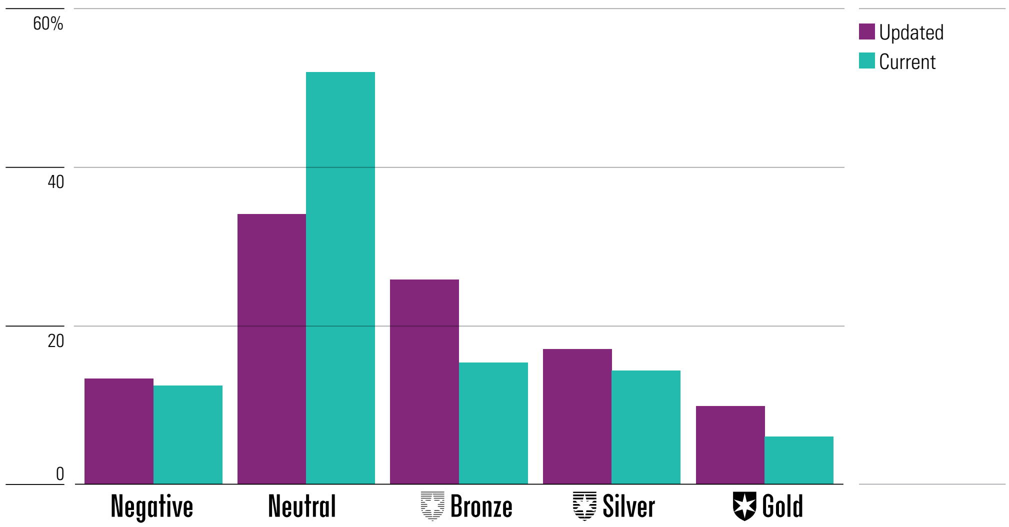
Exhibit 5 Distribution of Analyst Ratings: All Share Classes of All Covered Index Funds



Source: Morningstar.

It's worth keeping in mind that our coverage tends to emphasize the cheapest, more-established index funds, explaining why our ratings have skewed toward Gold, Silver, and Bronze. However, if we widen out to consider not just index funds that we cover but also those that we don't cover (these funds receive a forward-looking Morningstar Quantitative Rating), the diversity of ratings becomes clearer. Under the updated methodology, around 53% of all index fund share classes would receive a Gold, Silver, or Bronze Analyst Rating or Quantitative Rating, versus around 36% of such funds today.

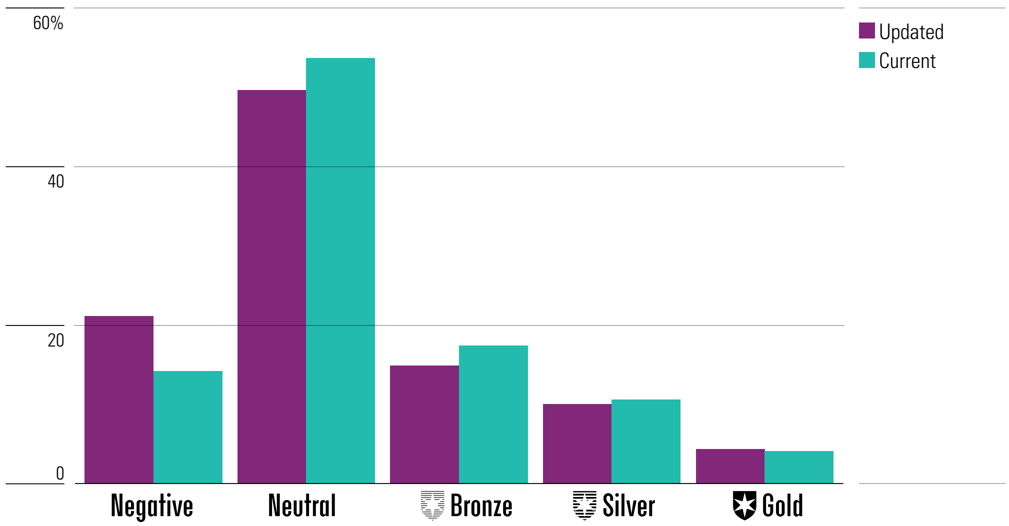
Exhibit 6 Distribution of Analyst Ratings and Quantitative Ratings: All Share Classes of All Index Funds



Source: Morningstar.

In similar fashion, we can also widen out the analysis of all share classes of all funds that have received an Analyst Rating (that is, covered by analysts) or a Quantitative Rating (not covered by analysts) to see how the distribution of ratings would change under the updated methodology. In summary, the distribution would shift away from Gold, Silver, and Bronze ratings and toward Neutral and Negative ratings, with about 29% of share classes earning a medalist rating under the updated methodology.

Exhibit 7 Distribution of Analyst Ratings and Quantitative Ratings: All Share Classes of All Funds



Source: Morningstar.

Impact Analysis: Detail

We can drill down further to examine the potential impact of applying the updated methodology to rated funds.

By Rating

Though many fund share classes would retain the same Analyst Rating under the updated methodology, a significant number would see a rating change. Roughly speaking, 30% to 50% of funds rated Gold, Silver, Bronze, and Negative would keep the same rating. By contrast, more than 80% of share classes rated Neutral would retain that rating.

Exhibit 8 Where Current Analyst Ratings End Up: % Breakdown of Pro Forma Ratings by Current Rating, All Share Classes of All Covered Funds

	Updated				
Current	Gold	Silver	Bronze	Neutral	Negative
Gold	49.4	32.7	12.7	5.2	0.0
Silver	12.6	35.5	27.7	24.0	0.2
Bronze	1.4	21.8	38.8	35.9	2.0
Neutral	0.1	1.4	9.7	82.8	5.9
Negative	0.0	0.0	0.0	70.5	29.5

Upgrade
No Change
Downgrade

Source: Morningstar, Inc.

Many of the ratings changes would stem from assigning the Analyst Rating to individual share classes. (Today we assign the same Analyst Rating to all fund share classes, irrespective of fee differences.) This is evident when we remove multiple share classes, narrowing the analysis to one share class per fund.

Exhibit 9 Where Current Analyst Ratings End Up: % Breakdown of Pro Forma Ratings by Current Rating, Oldest Share Class of Each Covered Fund

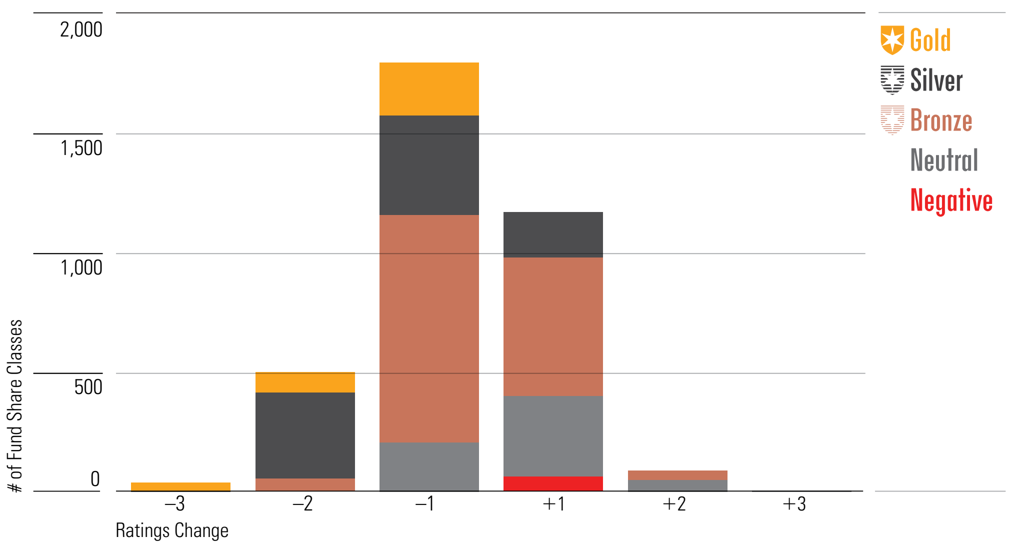
Current	Updated: Gold	Silver	Bronze	Neutral	Negative
Gold	64.5	33.7	1.7	0.0	0.0
Silver	18.4	42.7	27.1	11.8	0.0
Bronze	2.8	30.0	46.3	20.5	0.3
Neutral	0.1	2.7	13.0	83.3	0.9
Negative	0.0	0.0	0.0	91.4	8.6

Upgrade / No Change / Downgrade

Source: Morningstar, Inc.

Most of the ratings changes would involve funds currently rated Bronze (45% of changes), Silver (27%), and Neutral (17%).

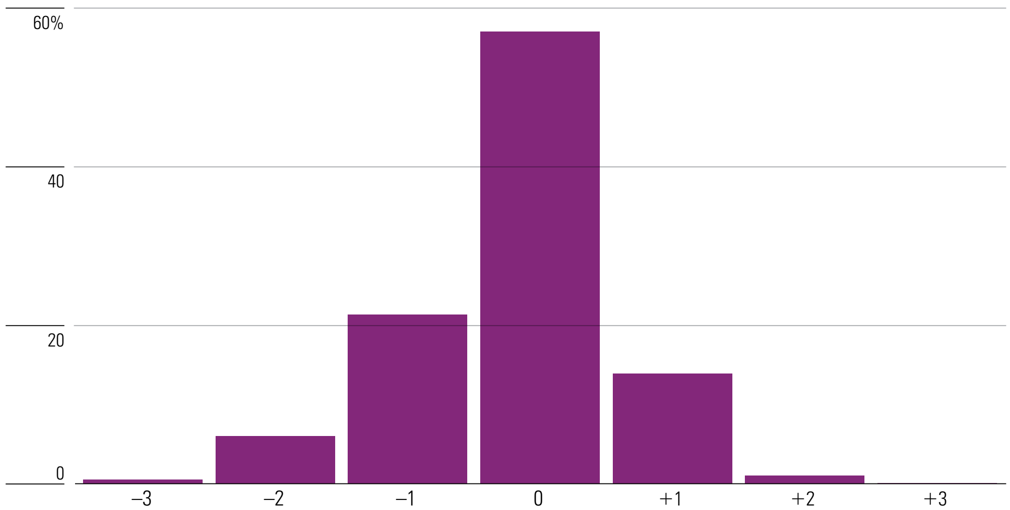
Exhibit 10 Distribution of Analyst Rating Changes by Current Rating: All Share Classes of All Covered Funds (Pro Forma)



Source: Morningstar.

More than 80% of share classes experiencing a ratings change would see a one-rung move, with changes from Gold to Silver, Silver to Bronze, Bronze to Neutral, and Negative to Neutral most commonplace.

Exhibit 11 Distribution of Analyst Rating Changes: All Share Classes of All Covered Funds



Source: Morningstar.

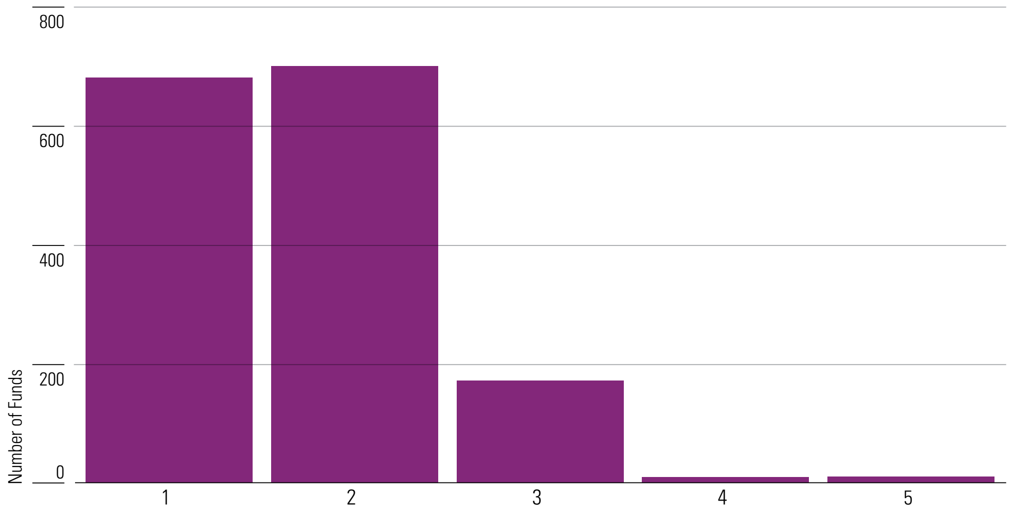
While the impact analysis did not assess the frequency of ratings changes under the updated methodology, we do not expect it to rise substantially. This is because ratings would change only when an analyst conducts a formal review, which typically happens on an annual basis. The updated methodology would not cause Analyst Ratings to change between formal analyst reviews.

By Fund

Formerly, we assigned the same Analyst Rating to all fund share classes irrespective of fee differences. Going forward, we'll tailor ratings to each share class by taking those fee differences into account. This means that Analyst Ratings might vary across the share classes of a single fund.

We recently were assigning Analyst Ratings to 1,567 funds with multiple share classes. Under the updated methodology, we expect that 683 of those funds, or 44%, would receive the same Analyst Rating across the share classes. (In these situations, the fee differences between share classes aren't so large as to pull costlier share classes into lower rating rungs.) 703 funds would receive two different Analyst Ratings across their share classes, and 181 funds would receive three or more different ratings.

Exhibit 12 Distribution of Covered Funds by Number of Different Analyst Ratings Assigned to Multiple Share Classes (Pro Forma)



Source: Morningstar.

This means it would be more the exception than the rule to see three or more Analyst Ratings across a fund's various share classes. In nearly 90% of cases, there would be two at most.

By Share Class Type

Here we analyze the potential impact of applying the updated methodology by share class type. To review, here's a breakdown of our U.S. coverage universe by share class type:

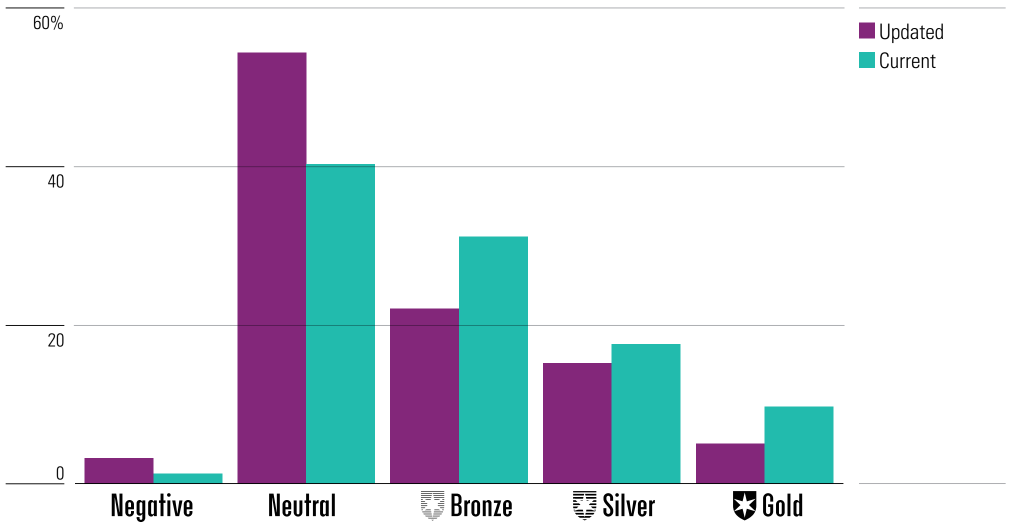
Retirement:	2,286 share classes
Institutional:	1,815 share classes
A shares:	1,095 share classes
C shares:	1,055 share classes
Other:	2,153 share classes

The following is an analysis of the way the Analyst Ratings distribution would change under the updated methodology. (Note that while the updated methodology does take the fees of each share class into account, the analysts will not incorporate loads or other types of commissions into their assessments, same as now.)

Retirement

The ratings assigned to retirement share classes of covered funds would shift toward Neutral and Negative. Currently, around 59% of such share classes earn Gold, Silver, and Bronze ratings. Under the updated methodology, 42% of retirement share classes would receive such ratings.

Exhibit 13 Distribution of Analyst Ratings: Retirement Share Classes of All Covered Funds

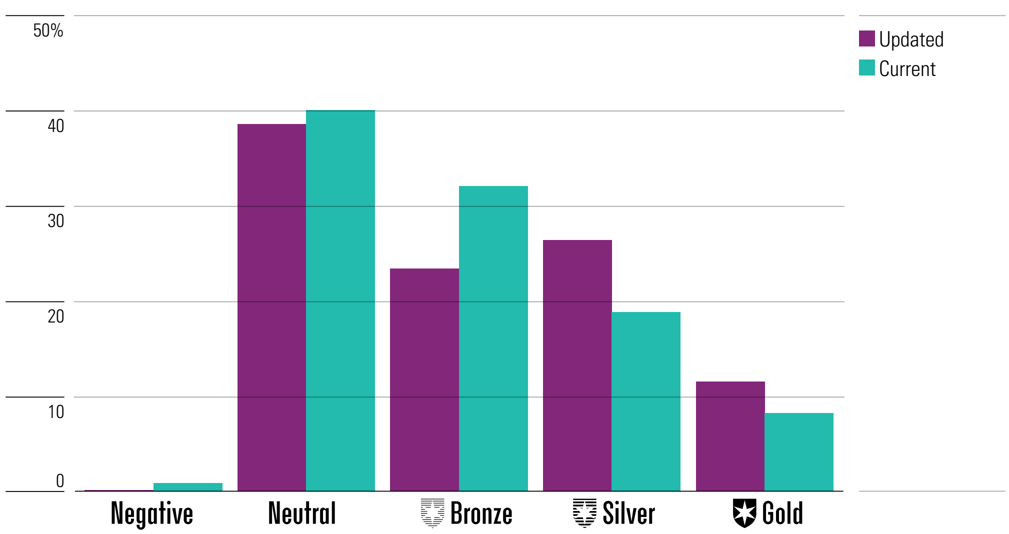


Source: Morningstar.

Institutional

The distribution of ratings assigned to institutional share classes would shift slightly toward Silver and Gold ratings from Neutral and Bronze. This updated methodology places a premium on cost, and institutional share classes tend to be less expensive, explaining why upgrades would slightly outnumber downgrades.

Exhibit 14 Distribution of Analyst Ratings: Institutional Share Classes of All Covered Funds

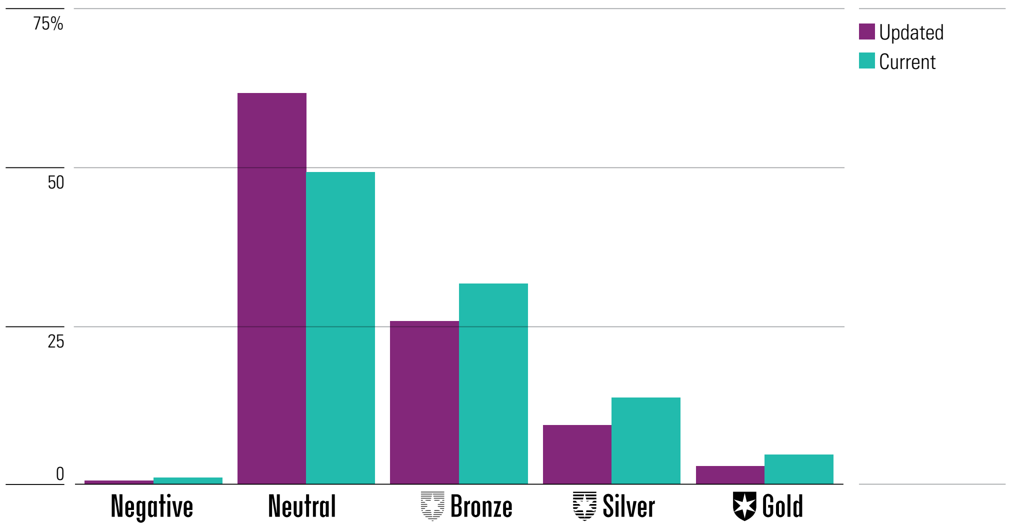


Source: Morningstar.

A Shares

A shares of rated funds would see more downgrades than upgrades under the updated methodology. All told, around 25% fewer A shares would receive Gold, Silver, or Bronze ratings, with a corresponding uptick in Neutral ratings. A shares commonly embed distribution and sales expenses, making them pricier. Since the updated methodology emphasizes cost, this explains the shift toward Neutral ratings.

Exhibit 15 Distribution of Analyst Ratings: A-share Classes of All Covered Funds

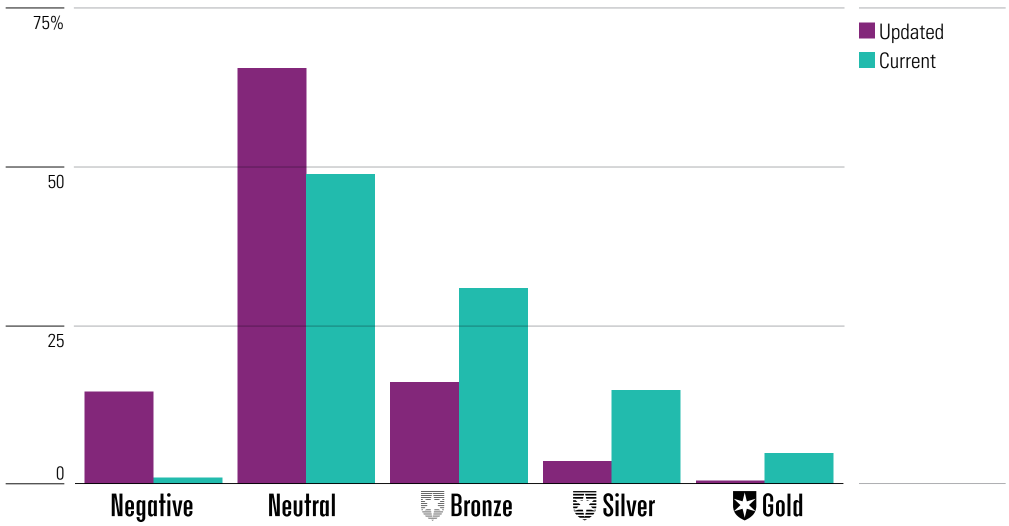


Source: Morningstar.

C Shares

The distribution of ratings assigned to C shares would move sharply toward Neutral and Negative. Indeed, the number of C shares rated Gold, Silver, or Bronze would fall around 40%. The reason for this is that C shares are pricey, and costly funds would fare even more poorly under the updated methodology. That said, note that around 20% of C shares would still be medalists, the bulk of them Bronze.

Exhibit 16 Distribution of Analyst Ratings: C-share Classes of All Covered Funds

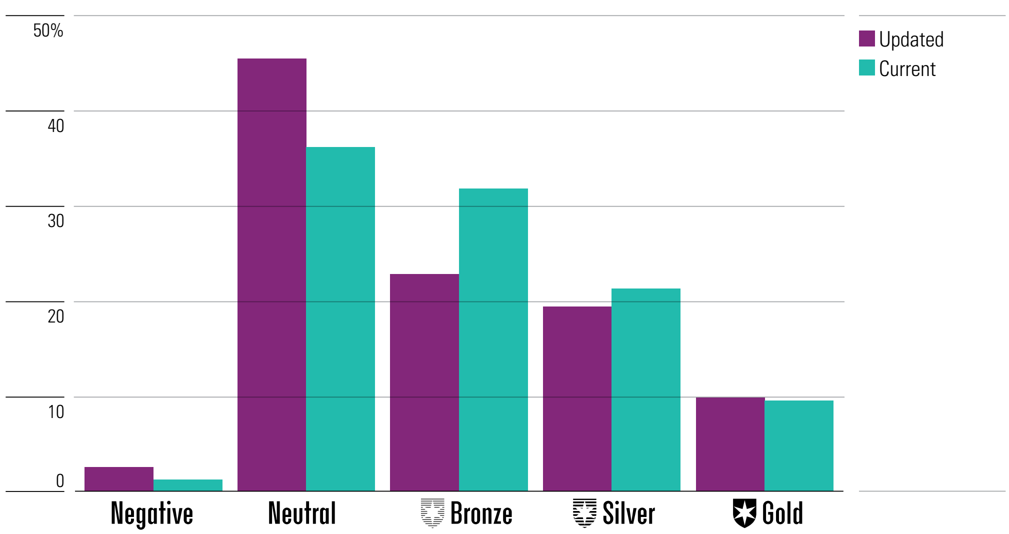


Source: Morningstar.

Other

Other share classes—which include no-load, investor, and other, less-common types—would also see the distribution of ratings shift toward Neutral and Negative. All told, the pool of share classes receiving Gold, Silver, and Bronze ratings would shrink by around 17%.

Exhibit 17 Distribution of Analyst Ratings: Other Classes of All Covered Funds

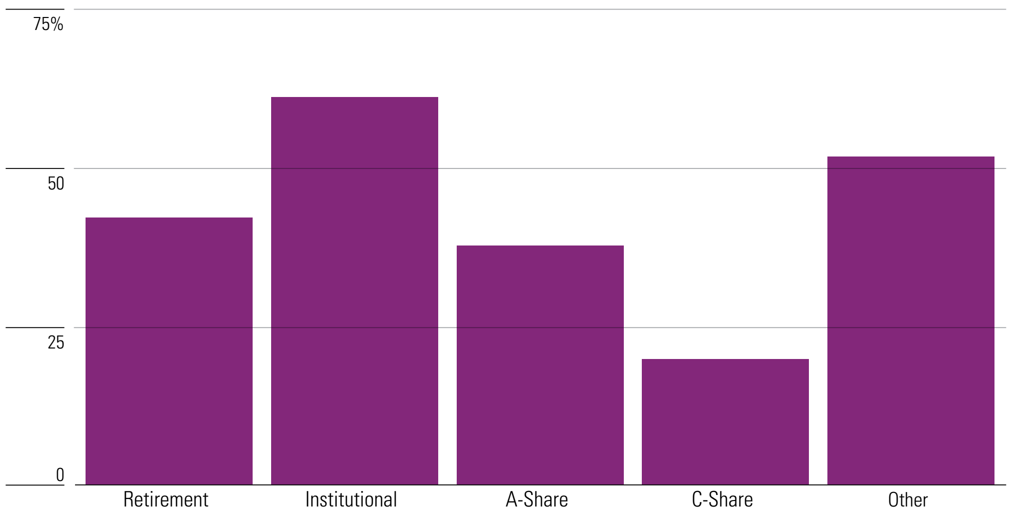


Source: Morningstar.

Comparing Across Share Class Types

The chart below compares the percentage of share classes that would receive Gold, Silver, or Bronze ratings under the updated methodology, by major share class type. Institutional share class funds would be much more likely to receive a medalist rating than other share types that embed various types of advice and sales fees.

Exhibit 18 Percentage of Share Classes That Would Receive Gold, Silver, or Bronze Ratings, by Share Class Type (Pro Forma)

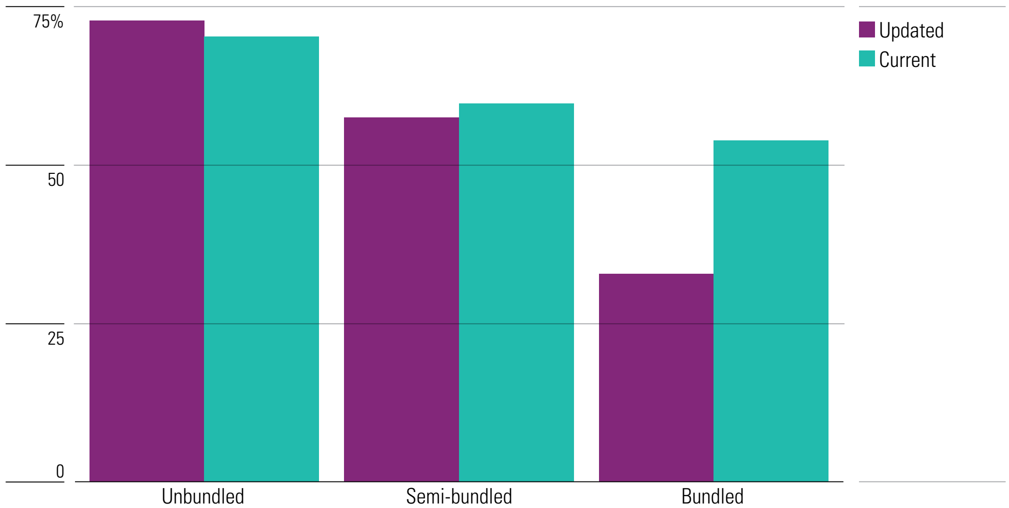


Source: Morningstar.

By Fee Type and Level

We can also examine the impact of applying the updated methodology through the Clean Share – Service Fee Arrangement data point. That data point denotes whether a fund's expense ratio pays just for the cost of money management (unbundled) or also pays for other services like advice and marketing. ("Semi-bundled" refers to arrangements where these additional services are paid for indirectly, "Bundled" to scenarios in which those fees are directly levied through fees like 12b-1.) The impact analysis reveals that unbundled share classes would most often receive Gold, Silver, and Bronze ratings under the updated methodology. Conversely, only around one third of bundled share classes would receive medalist ratings, a sharp drop from the current approach.

Exhibit 19 Percentage of Share Classes That Would Receive Gold, Silver, or Bronze Ratings, by Service Fee Arrangement

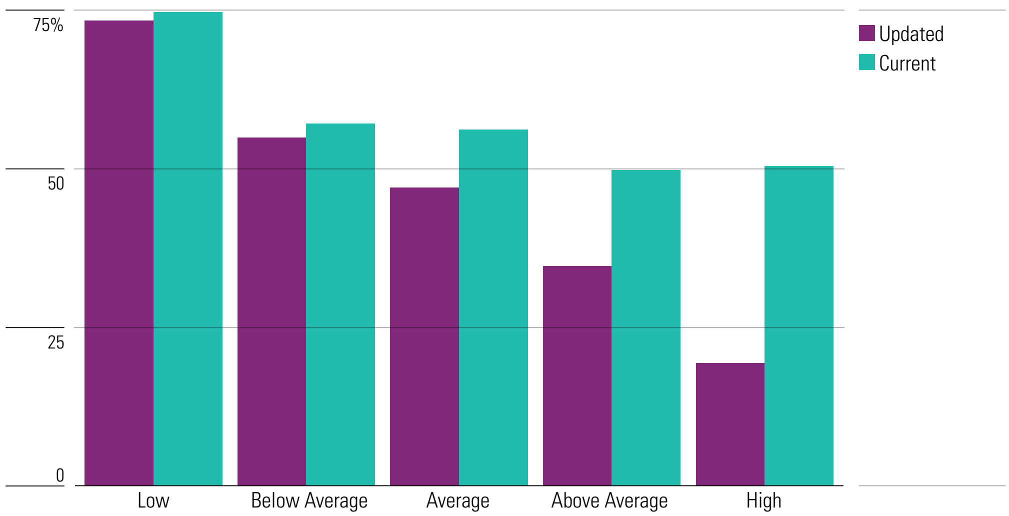


Source: Morningstar.

The Morningstar Fee Level data point indicates how the cost of a fund share class ranks within the context of its broad peer group. It takes the form of Low (cheapest 20% of share classes), Below Average (next 20%), Average (middle 20%), Above Average (next 20%), and High (priciest 20%).

While fee level rank isn't a direct input into the updated methodology, the impact analysis makes it evident that the more expensive a fund, the less often it would receive a Gold, Silver, or Bronze rating. Only around 26% of share classes with an Above Average or High rank would receive medalist ratings, compared with about 50% today.

Exhibit 20 Percentage of Share Classes That Would Receive Gold, Silver, or Bronze Ratings, by Fee Level



Source: Morningstar.

Conclusion

This analysis is pro forma, as it takes the People, Process, and Parent Pillar ratings analysts have assigned to U.S. funds and runs them through the updated methodology. It goes without saying that it's subject to change, as analysts will be reassessing those pillar ratings in the normal course of re-evaluating funds.

In the event analysts elect to lower their pillar ratings (subject to a ratings committee's oversight and consent), then the distribution of Analyst Ratings could shift even more decidedly to Neutral and Negative. On the other hand, if analysts upgrade their assessments, then the distribution could shift in the other direction.

This process will unfold gradually, with a subset of the Analyst Ratings universe slated to be rerated under the updated methodology on Oct. 31, 2019, and the remainder over the 11 to 12 months that follow.

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