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The Stars Have Come Out for Exchange-Traded Funds

Fund Spy
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Introducing the Morningstar Rating™ for ETFs.

In an effort to shed a little light on the choice between exchange-traded funds and conventional mutual funds, Morningstar has introduced star ratings for ETFs. Starting today, you can find them on individual ETF reports on Morningstar.com, as well as in other Morningstar products. We think the ratings will provide investors with a familiar tool to gauge ETFs' risk-adjusted returns and compare them with those of conventional mutual funds, as well as other ETFs.

Star Gazing

Like the star rating for traditional funds, the Morningstar Rating for ETFs is a purely objective, mathematically derived measure based on funds' past risk/return profiles. For the most part, this is the same star rating you're probably familiar with, though we made some accommodations for the unique nature of ETFs. We're adjusting ETF returns for brokerage commissions, just like we adjust traditional open-end fund returns for sales charges. We treat ETF commissions like front- and back-end loads of 0.2%. (That assumes investors paid a $20 commission on a $10,000 investment, or $40 to buy and sell.) Investors can pay lower or higher brokerage fees when trading ETFs, but they can't avoid them, so we deemed it appropriate to factor commissions into the rating.

Because many ETF categories remain too thinly populated to make meaningful comparisons, we rate ETFs against the conventional open-end funds in their respective categories as well as other ETFs in their peer groups. Thus, an investor can readily compare how a conventional index fund such as Vanguard 500 Index (VFINX) compares with its ETF competitors, such as the SPDR (SPY).

Comparability is also one of the reasons we're using ETFs' NAV total returns—as opposed to their market price total returns—as the basis for the ratings. ETF market prices, which are set throughout the day by supply and demand, tend to stick pretty close to their NAVs, which are set at the end of the trading day. Furthermore, market prices can be stale for ETFs that don't trade often, making the ETFs' NAV return a better indicator of performance in those cases.

Constant as a Star

Beyond those notable differences, it's the same old rating. Funds have to be three years old to be rated, and we adjust ETF returns for both excess return over the risk-free rate of return and for risk. The Morningstar risk adjustment is based on expected utility theory, which assumes that investors are more concerned about potential losses than unexpected gains and are willing to sacrifice some of their returns for more certainty. Accordingly, we measure the amount of variation in the ETFs' monthly returns, penalizing funds more for downside variation. Each month, we first rank all the open-end funds by category using risk-adjusted returns. Then we see where ETFs' risk-adjusted returns fall on the bell curves for their respective categories.

The Results So Far

By and large, the ETF ratings are consistent with those of their conventional counterparts. More than 60% of the ETFs with records long enough to earn ratings end up in the 3- to 4-star range. Given that they are all index funds that strive to match the return and risk profile of their asset classes, that seems appropriate. The oldest and largest ETF, the SPDR, gets 3 stars overall, same as its largest traditional and ETF rivals, Vanguard 500 and iShares S&P 500 Index (IVV). Meanwhile, Nasdaq 100 Trust (QQQQ), the most actively traded ETF, earns 2 stars, which befits the tech-heavy portfolio's boom-or-bust nature. The largest international ETF, iShares MSCI EAFE (EFA), received 4 stars, which matches the three-year rating (the ETF is less than five

years old, so it only has a three-year rating) of traditional open-end rivals, such as Fidelity Spartan International Index (FSIIX), but lagged the rating of Vanguard Total International Stock Index (VGTSX). The latter difference is due largely to the Vanguard fund's hefty stake in emerging markets, which have been hot in recent years.

Don't Get Star Struck

Be careful not to read too much into these new ratings, though. As with the Morningstar Rating for open-end mutual funds, there are some caveats about using the ETF ratings to select investments. The ETF ratings are based on historical returns, so they are a better indicator of where ETFs have been than where they are going. They're a useful tool for identifying funds worthy of further research, but shouldn't be considered buy or sell signals. In the case of ETFs, you should also look closely at expense ratios and turnover in order to make sure you are minimizing fees and trading costs. After all, the whole point of indexing is to reduce costs and thereby compound your return at a greater rate. It's also important to understand how an ETF's target index is constructed and how well the fund's advisor tracks that benchmark.

Disclosure: Barclays Global Investors (BGI), which is owned by Barclays, currently licenses Morningstar's 16 style-based indexes for use in BGI's iShares exchange-traded funds. iShares are not sponsored, issued, or sold by Morningstar. Morningstar does not make any representation regarding the advisability of investing in iShares that are based on Morningstar indexes.