

Stewardship Grade for Mutual Fund Firms Methodology

Morningstar Methodology Paper
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Introduction

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 a fund based on the degree to which the fund's 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 analyses 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, a comprehensive, forward-looking rating that is expected to launch in fall 2011. For fund firms receiving Stewardship Grades, the Stewardship Grade will determine the Parent rating for all funds in the family. (Parent is one of five pillars that Morningstar analysts will consider when determining an Analyst Rating for an individual fund. The remaining pillars are Process, Performance, Price, and People.) Funds from firms earning A and B Stewardship Grades will have Parent ratings of Positive; those earning C Stewardship Grades will have Neutral Parent ratings; 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.

Stewardship Grade Components

The Stewardship Grade methodology considers components that, when combined, intend to forecast whether a fund firm is likely to be a good caretaker of investors' capital over the long term.

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

Morningstar analysts evaluate and assign grades from A (the best grade) to F (the worst grade) to each of these areas, and they combine the component grades to arrive at an overall Stewardship Grade for a family of funds. A local committee of Morningstar fund analysts, which actively studies industry stewardship practices in its market and beyond, reviews the grades to ensure that the methodology is fairly and consistently implemented.

Corporate Culture

This component looks at a wide range of factors to assess how seriously a firm takes its fiduciary duty to its fund shareholders. Firms that put the interests of their fund shareholders before their own profits are more likely to deliver good outcomes for shareholders, in Morningstar's view. A 2011 study of Morningstar's Stewardship Grades showed that funds offered by firms with strong corporate cultures delivered better results for their shareholders, as measured by risk-adjusted and cash-weighted investor returns.

To determine the extent to which a firm's corporate culture is fundholder-focused, Morningstar analysts consider the following:

- Is the fund company focused on investing or on gathering assets?
- Does the fund company foster a thoughtful, repeatable investment process?
- Does the fund company's product line reflect its investment expertise?
- Is the fund company straightforward with investors through clear, pertinent disclosure and responsible marketing?
- Do talented investors spend their careers at the fund firm?
- Are the firm's funds a good value proposition overall?

To answer these questions, Morningstar's fund analysts typically interview a variety of fund-company personnel, including analysts, portfolio managers, chief investment officers, distribution chiefs, compliance personnel, and top executives. These meetings help the analysts understand the fund firm's past successes and failures, as well as priorities for the future.

Morningstar's analysts also consider how fund firms stack up on various quantitative factors, such as fund manager tenure and turnover, fund performance, fund expenses, and fund launches, mergers, and closings. This analysis helps put the fund companies' practices into context.

Manager Incentives

To determine whether a fund manager's own financial interests are aligned with fund shareholders', Morningstar primarily considers whether a fund's managers invest in fund shares alongside shareholders. In addition, Morningstar analyzes the fund's manager-compensation plan to determine if it rewards strong long-term performance. A pay plan that exhibits industry best practices may boost the grade of a firm with less-than-stellar manager ownership of fund shares, while a pay plan containing factors that could work against shareholders' best interests could move an overall Manager Incentives grade lower.

Manager Ownership of Fund Shares

Fund managers who invest in the funds they run demonstrate conviction in their investment process and align their own financial interests with fund shareholders'. Morningstar analyzes fund-share ownership trends to determine whether a firm's managers meet the industry's highest standards. For non-U.S. fund firms, Morningstar surveys fund companies to determine the extent to which their fund managers' ownership illustrates industry best practices.

For U.S. fund firms, where funds report their managers' ownership annually to the SEC in the Statement of Additional Information, Morningstar will consider the percentage of the firm's fund assets where at least one of the fund's managers invests in fund shares more than $1 million, the highest ownership level reported to the SEC.

In all analyses of fund-ownership trends, Morningstar excludes types of funds where manager ownership would be difficult or impossible, including funds used only in insurance products, wrap accounts, or retirement plans. Morningstar also excludes fund of funds from the analysis.

Compensation Structure

Morningstar analyzes a fund manager's compensation-plan criteria to determine whether it rewards long-term performance or emphasizes asset growth. Incentive programs that encourage a focus on short-term performance (periods less than four years) or asset growth are viewed less favorably. For fund firms using more than one compensation plan, Morningstar's analysts will consider the plans collectively and determine the extent to which the plans reward managers who generate strong long-term performance for fund shareholders.

Outside the United States, Morningstar surveys fund companies about their compensation structures. In the U.S., fund firms report descriptions of their pay plans to the SEC annually in the Statement of Additional Information. Morningstar uses these details to determine whether a fund firm's Manager Incentives grade should be altered to best reflect the degree to which management's interests are aligned with fund shareholders.

Fees

This section assesses whether the fund firm's offerings are a good value for shareholders. Morningstar's analysis is based on a comparison of the firm's fund fees relative to those with similar strategies and share classes, and firms with low-cost funds earn the highest Fees grades. For fund firms outside the U.S., Morningstar considers funds' costs across share classes, as well as on an asset-weighted basis.

In the U.S., Morningstar's assessment of funds' expense ratios is purely quantitative. Morningstar will determine the fund family's average Morningstar fee percentile rank, which results from peer-based comparisons and is calculated to determine each fund's Morningstar Fees Level of Low, Below Average, Average, Above Average. or High. The calculation is a straight average, where each fund share class offered by the firm carries equal weight.

Regulatory History

Morningstar examines any regulatory problems at the fund company in recent years. Fund firms do not earn points toward their total Stewardship Grade for this section because it's Morningstar's belief that complying with local industry regulations is a minimum expectation--not a best practice. As such, serious breaches of fiduciary duty can result in a deduction of points toward a family's overall Stewardship Grade score. In the event of any breaches, Morningstar will review the remedies in place and the scope of, and commitment to, reform. Scores may be raised back to zero over time as firms demonstrate better compliance controls.

Board Quality--U.S. Fund Firms Only

In the United States, where mutual funds are governed by boards of directors, the trustees represent fund shareholders' interests at the negotiating table with the fund's management. Each year, the trustees approve a fund's management contract with the advisor, or asset manager running the fund. They negotiate each fund's fees and determine which funds are launched, merged, liquidated, and closed. The trustees also look after much of the compliance effort and determine whether particular portfolio practices should be allowed, such as investing in derivatives or lending securities held in the portfolio.

For U.S. fund firms, Morningstar analysts assess how well fund shareholders have been served by the funds' board (or boards, if the funds are overseen by more than one group of directors). Morningstar evaluates the board's work primarily by analyzing publicly available information, but Morningstar's analysts also interview members of the fund's board when possible.

Morningstar's analysis focuses on these questions:

- Does the board consistently act in shareholders' best interests?
- Has the board negotiated fair fees on shareholders' behalf?
- Has the board challenged the funds' advisor when necessary to garner better outcomes for fund shareholders?
- Has the board approved a sensible group of funds that the fund firm is capable of running well?

Fund boards that exhibit the industry's best governance practices earn the highest grades for Board Quality.

Analyst Commentary

Morningstar's Stewardship Grades for mutual fund firms contain detailed analyst commentary on each methodology component. The commentary, which describes how the analyst arrived at the score for each of the components and how the fund firm compares with industry peers, is available through most of Morningstar's research software aimed at advisors and institutions.

Scoring--U.S. Mutual Fund Firms

Morningstar analysts began issuing Stewardship Grades to individual U.S. funds in 2004, maintaining coverage on more than 1,000 mutual funds offered by more than 40 fund families. After mid-2011, all Stewardship Grades will be issued at the fund-firm level using the methodology described above.

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."

Corporate Culture

Firms that exhibit the industry's most investor-focused corporate cultures earn full credit, or an A grade, for this component. Those that exceed the industry standard but do not demonstrate all of the industry's best practices earn B's. Firms with standard corporate cultures earn C's, while those trailing the industry norms earn D's or F's. Those letter grades translate into the following points toward a fund firm's overall grade:

A = 5
B = 3.75
C = 2.5
D = 1.25
F = 0

Manager Incentives

The points earned for Manager Incentives will be largely driven by the percentage of the firm's fund assets where at least one of a fund's managers has invested more than $1 million in fund shares (the highest ownership range reported to the SEC). Fund firms with more than or equal to 80% of their fund assets meeting this criterion are eligible for full credit, or an A, in this section. Firms with 60% to 79% of their assets meeting the requirement are eligible for a B, while firms with 40% to 59% of assets in funds with manager investment exceeding $1 million may receive a C. Fund firms in the 20% to 39% of assets range may earn a D, while those below 19% of assets with top-tier manager investment may receive an F.

Morningstar analysts may raise a fund firm's score and letter grade if the firm's manager-compensation plan, as described in the funds' Statements of Additional Information, exceeds the industry standard of aligning the fund managers' own financial incentives with those of shareholders. (Morningstar has observed that the most shareholder-friendly compensation plans are those that tie the majority of the managers' pay to delivering strong long-term returns

for fundholders.) Similarly, fund firms with pay plans that fall short of the industry standard may have their Manager Incentives grade lowered. The final letter grades correspond with these points toward the fund firm's overall Stewardship Grade:

A = 3
B = 2.25
C = 1.5
D = 0.75
F = 0

Fees

Morningstar awards credit in the Fees section based on a straight average of the fund firm's Morningstar Fee Level Percentile, which is based on a comparison of funds with similar investment objectives and share class structures. The Fees grade depends on the quintile where the average percentile falls.

Fund firms with average fee rank percentiles from 1 to 20 earn an A; those with average ranks of 21 to 40 earn B's; those with average ranks of 41 to 60 earn C's; those with average ranks of 61 through 80 earn D's; and those with average ranks exceeding 81 earn F's. The final letter grades correspond with these points toward the fund firm's overall Stewardship Grade:

A = 2
B = 1.5
C = 1
D = 0.5
F = 0

Regulatory History

The maximum score for the Regulatory History grade will be zero, but up to 2 points may be deducted from the fund firm's overall Stewardship Grade for those with serious regulatory violations. Scores may be raised back to zero over time as firms demonstrate better compliance controls. This section of the methodology will not carry a letter grade. Firms that have been compliant will earn Neutral ratings; those with points deducted will earn Negative ratings.

Board Quality

Grades for this section are awarded based on whether the fund board has served shareholders' interests well, as determined by a comprehensive analysis by Morningstar's analysts. Boards that lead the industry with respect to serving shareholders well earn A's. Those that exceed the industry standard but don't incorporate all best practices earn B's. Fund boards with standard governance earn C's, while those trailing the industry norms earn D's or F's.

The letter grades translate into the following points toward a fund firm's overall grade:

A = 2
B = 1.5
C = 1
D = 0.5
F = 0

Overall Stewardship Grade

Morningstar arrives at a firm's overall Stewardship Grade by combining the points earned in each of the five methodology components. For U.S. fund firms, the following points correspond with each letter grade:

A = 12 to 10.5
B = 10.25 to 7.5
C = 7.25 to 4.5
D = 4.25 to 1.5
F = 1.25 or fewer

Scoring--Canadian Mutual Fund Firms

Morningstar analysts began issuing Stewardship Grades to Canadian fund families in 2010, maintaining coverage on more than 25 fund families. After mid-2011, all Stewardship Grades will be issued at the fund-firm level using the methodology described above.

Scoring

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

Corporate Culture

Firms that exhibit the industry's most investor-focused corporate cultures earn full credit, or an A grade, for this component. Those that exceed the industry standard but do not demonstrate all of the industry's best practices earn B's. Firms with standard corporate cultures earn C's, while those trailing the industry norms earn D's or F's. Those letter grades translate into the following points toward a fund firm's overall grade:

A = 5
B = 3.75
C = 2.5
D = 1.25
F = 0

Manager Incentives

The points earned for Manager Incentives will be largely driven by the level of manager investment in the firm's funds, as reported to Morningstar in a survey. Firms that exhibit the highest level of co-investment receive an A grade for this component. Those with above-standard, but not industry-leading levels of co-investment earn B's. Firms with standard levels of co-investment earn C's, while those trailing industry norms receive D's or F's. In addition to earning credit for high absolute levels of co-investment, firms may also receive credit for having policies that require or encourage managers to invest in their own funds.

Morningstar analysts may raise a fund firm's score and letter grade if the firm's manager-compensation plan--also described in the Morningstar survey--exceeds the industry standard of aligning the fund managers' own financial incentives with those of shareholders. (Morningstar has observed that the most shareholder-friendly compensation plans are those that tie the majority of the managers' pay to delivering strong long-term returns for fundholders.) Similarly, fund firms with pay plans that fall short of the industry standard may have their Manager

Incentives grade lowered. The final letter grades correspond with these points toward the fund firm's overall Stewardship Grade:

A = 3
B = 2.25
C = 1.5
D = 0.75
F = 0

Fees

Morningstar awards credit in the Fees section based on a comprehensive analysis of the fund firm's fee schedules. In addition to assessing each fund's fees relative to category peers, Morningstar analysts give consideration to a firm's fees relative to other firms with similar distribution models. The analysts not only compare costs on average, but they also consider asset-weighted averages. Firms that have adopted fee structures that are not shareholder-friendly may have their Fees grades reduced.

Fund firms with the most-competitive fees earn an A; those with fees below the industry norm earn B's; those with standard fees earn C's; those with fees commonly exceeding the industry standard earn D's; and those with the industry's most-expensive funds earn F's. The final letter grades correspond with these points toward the fund firm's overall Stewardship Grade:

A = 2
B = 1.5
C = 1
D = 0.5
F = 0

Regulatory History

The maximum score for the Regulatory History grade will be zero, but up to 2 points may be deducted from the fund firm's overall Stewardship Grade for those with serious regulatory violations. Scores may be raised back to zero over time as firms demonstrate better compliance controls. This section of the methodology will not carry a letter grade. Firms that have been compliant will earn Neutral ratings; those with points deducted will earn Negative ratings.

Overall Stewardship Grade

Morningstar arrives at a firm's overall Stewardship Grade by combining the points earned in each of the four methodology components. For Canadian fund firms, the following points correspond with each letter grade:

A = 10 to 8.75
B = 8.5 to 6.25
C = 6 to 3.75
D = 3.5 to 1.25
F = 1 or fewer

Where to Find the Stewardship Grade

Morningstar Directsm
Morningstar Officesm
Morningstar® Advisor Workstationsm
Morningstar® Principia®
Morningstar.com® (and regional affiliates)
Morningstar® Mutual Fundstm
Morningstar® FundInvestorsm