Morningstar Analyst Rating™ for ETFs

Questions and Answers
September 2016

When will Morningstar launch its Morningstar Analyst Rating™ for ETFs in each market?

Morningstar will launch its Morningstar Analyst Ratings for ETFs later this year in the United States, Canada, Europe, and Asia. Morningstar has been assigning Analyst Ratings to ETFs in Australia since 2014.

How many ETFs will receive an Analyst Rating, and how many ETFs have been rated so far?

Later this year we will publish Analyst Ratings for approximately 300 ETFs, including 100 U.S.-domiciled ETFs, 30 in Canada, 100 in Europe, and 40 that are either domiciled or cross-listed in Asia. We currently rate approximately 50 Australia-domiciled ETFs.

What is the difference between the Morningstar Rating™ and the Morningstar Analyst Rating for ETFs?

The Morningstar Rating, most commonly referred to as the "star rating," is a purely quantitative, backward-looking measure of past performance. It is based on a fund's risk- and cost-adjusted performance over three-, five-, and 10-year periods and helps investors to quickly and easily assess a fund's track record relative to its peers. In contrast, the Analyst Rating is a qualitative, forward-looking measure, based on analyst research, and can be used in conjunction with the quantitative Morningstar Rating.

How many ETFs currently have a quantitative Morningstar Rating?

Funds with at least three years of monthly performance history receive a Morningstar Rating. Globally, about 2,400 ETFs in Morningstar's database currently have a Morningstar Rating as of September 2016. Morningstar introduced the Morningstar Rating for funds in 1985.

What does it mean if an ETF receives an Analyst Rating?

The vast majority of the ETFs that will receive an Analyst Rating would likely be considered as potential core portfolio building blocks by a broad spectrum of investors. Investors increasingly view these ETFs as potential substitutes for traditional mutual funds in building their portfolios. As such, we are expanding the universe of fund types and strategy types that we rate to reflect the fact that investors' opportunity set is growing, and that many investors are becoming ever more agnostic regarding vehicles, such as mutual funds and ETFs, and strategies, including active, passive, and in-between.

What does it mean if an ETF receives a high Morningstar Rating and a Negative Analyst Rating?

It means the fund has outperformed its peers based on risk- and cost-adjusted total returns over the trailing three-, five-, and 10-year periods, but that our analysts don't think it will be able to sustain that performance. The quantitative Morningstar Rating for funds is backward-looking and measures a fund's past risk- and cost-adjusted performance against its peers, so a high Morningstar Rating indicates the fund has outperformed its peers based on returns. The qualitative Morningstar Analyst Rating is forward-looking based on analyst research, so a

Negative Analyst Rating means our analysts think the fund won't outperform its peers going forward.

What does it mean if two ETFs with similar pillar ratings have different Morningstar Analyst Ratings?

Analysts evaluate five pillars when assigning an Analyst Rating: parent, people, performance, price, and process. The pillars are not equally weighted, so two funds with similar pillar scores may receive different Analyst Ratings. The approach serves not as a mathematical formula, but as a robust analytical framework ensuring consistency across Morningstar's coverage universe. Two ETFs with similar pillar ratings may have different Analyst Ratings for a variety of reasons. For example, two ETFs tracking the same benchmark might both be managed by experienced, capable teams that have sound processes and robust systems in place and both be sponsored by strong parent firms. They may, however, have materially different fee levels relative to one another. While both funds' fees might be low relative to their Morningstar Category peers, we may rate them differently to indicate a greater degree of conviction in our favorable assessment of the more inexpensive fund over its more richly priced peer, in cases where the funds, as described above, are otherwise in many regards substantially similar.

What is the ratings scale for the Analyst Rating for ETFs?

The ratings scale is the same as the scale for the Analyst Rating for funds. The Analyst Rating for ETFs is an extension of the current Analyst Ratings for funds.

The five-tiered scale is as follows:

- Gold: Best-of-breed fund that distinguishes itself across the five pillars and has garnered the analysts' highest level of conviction.
- Silver: Fund with notable advantages across several, but perhaps not all, of the five pillars—strengths that give the analysts a high level of conviction.
- Bronze: Fund with advantages that outweigh the disadvantages across the five pillars and with sufficient level of analyst conviction to warrant a positive rating.
- Neutral: Fund that isn't likely to deliver standout returns but also isn't likely to significantly underperform.
- Negative: Fund that has at least one flaw likely to significantly hamper future performance and which analysts consider an inferior offering to its peers.

Why are you covering Neutral- and Negative-rated ETFs?

Coverage decisions are based upon a variety of factors, including investment merit, asset size, and investor interest. Unlike other firms, our ratings scale identifies mediocre and poor funds, which is helpful to investors who may already hold these funds in their portfolios. Morningstar's goal is to ensure that investors have access to our analysts' research on a broad spectrum of funds that are important to them. We plan to cover both large ETFs and smaller ETFs with distinguishing characteristics. Our analysis of the five pillars will likely determine that some ETFs—for a variety of reasons—are either fundamentally impaired or might otherwise fail to

outperform their respective peer groups on a risk-adjusted basis over a full market, but which are sufficiently relevant to investors to warrant coverage.

How many ETFs do you expect to have a positive Analyst Rating as a percentage of your overall global coverage? How many Gold-rated ETFs? Silver? Bronze? How many ETFs do you expect to have a Neutral or Negative rating as a percentage of your overall global coverage?

We do not explicitly target a specific number or portion of Gold, Silver, Bronze, Neutral, or Negative ratings within our universe of rated funds. The ratings are a function of our analysts' judgment, and we won't mandate any fixed percentages. We will rate each fund on its individual merits. Our methodology is focused on what kinds of funds should receive each rating level, without imposing a grading curve.

We would expect that our Analyst Ratings for ETFs will generally skew positive, while our coverage determination includes factors independent of the global Analyst Rating methodology, such as investment merit, asset size, and investor interest.

How does the methodology for Analyst Ratings compare between ETFs and mutual funds?

The Analyst Rating for ETFs is an expansion of the Analyst Rating for funds methodology. The purpose of Morningstar's qualitative, analyst-driven research on ETFs and index mutual funds is to identify those funds that we believe should be able to outperform a relevant peer group, within the context of the level of risk taken, over the longer term.

The pillars of our analysis are the same regardless of whether we are rating a passively managed index fund, ETF, or an actively managed fund. However, their relative impact on our overall assessment of a fund differs when it comes to analyzing and rating index funds and ETFs.

Keeping costs—both explicit ones, such as the expense ratio, and implicit ones, like the cost of portfolio turnover—at a minimum is paramount in the context of running an index-tracking fund. As such, it should come as no surprise that the top-rated funds that we analyze are among the lowest-cost options in their Morningstar Categories, not just versus their actively managed peers but also relative to competitive index fund and ETF options.

Although costs are critical, they are just one component of our holistic assessment of these funds. We also closely scrutinize their performance relative to their peers in their Morningstar Categories, which include actively managed funds as well as other index funds and ETFs. And we carefully analyze these funds' underlying benchmarks to understand how their portfolios will be built and the techniques that their sponsors employ to track them with precision. Stewardship plays a vital role in our analysis. We tend to favor parent firms that put investors' interests ahead of commercial goals and that align fund managers' incentives accordingly. The skills and experience of the people managing the fund are also an important factor in our

analysis. In the management of index funds and ETFs, every 0.01 percent of performance counts, so it is vital to have a seasoned team in place.

We assign Gold, Silver, and Bronze—our Morningstar Medalist ratings—for those funds that are best-suited to deliver precise tracking of sensibly constructed indexes at a low cost over a long period of time, backed by experienced managers and sponsored by firms that are good stewards of investors' capital. These are the index funds and ETFs that our analysts believe will outperform their peer groups, within the context of the level of risk taken, over the longer term.

How often will you review and update the Analyst Ratings?
We will review and update our Analyst Ratings and research reports at least once a year.

Which Morningstar products will have the new Analyst Ratings?
The Analyst Ratings for ETFs will be available in Morningstar's flagship platforms for investors, including individual investor website Morningstar.com®, global investment analysis platform Morningstar Direct℠, and global practice and portfolio management solutions Morningstar® Advisor Workstation℠ and Morningstar Office℠. The Analyst Ratings for ETFs are also available for licensing through Morningstar® Data.

Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. Analyst Ratings are based on Morningstar analysts' current expectations about future events and therefore involve unknown risks and uncertainties that may cause Morningstar's expectations not to occur or to differ significantly from what was expected. Morningstar does not represent its Analyst Ratings to be guarantees nor should they be viewed as an assessment of a fund's or the fund's underlying securities' creditworthiness.