

# Morningstar Medalist Rating Enhancement – Oct. 29, 2024

## Frequently Asked Questions

### **What is changing?**

#### **How is the Morningstar Medalist Rating framework changing?**

We are changing the way we estimate how much value a managed investment can add before fees. This estimate is an important input into the Medalist Rating framework.

Specifically, we subtract a managed investment's fees from our estimate of how much value it can add before fees. The difference, which represents how much value a managed investment can add after fees, determines the Medalist Rating we assign.

As such, the change in the way we estimate how much value a managed investment can add before fees is significant. Pro forma, we expect about 20% of global managed investments to see a rating change due to this change.

#### **Is Medalist Rating coverage changing as a result of this methodology update?**

No, overall ratings coverage will not reduce as a result of this change. The Medalist Rating will still cover 450,000 managed investments monthly.

#### **What does it mean when you say you're changing the way you estimate how much "value" a managed investment can add before fees?**

In this context, we define value as a managed investment's potential pre-fee CAPM alpha versus its assigned category benchmark. We refer to this as the "Alpha Potential Estimate" (APE). We derive an Alpha Potential Estimate for each Morningstar Category and type of fund (i.e., active vs. passive), with certain exceptions, and then assign that Alpha Potential Estimate to the managed investments of that type in that category. We're changing the way we derive the Alpha Potential Estimate.

#### **How does the "Alpha Potential Estimate" relate to your estimate of how much value a particular managed investment can add before fees?**

Once we have assigned an Alpha Potential Estimate to a managed investment, we multiply it by the numeric values corresponding to the People, Process, and Parent pillar ratings we assign to that managed investment as part of our evaluation. Those numeric

values are +2, +1, 0, -1, and -2 for "High", "Above Average", "Average", "Below Average", and "Low" pillar ratings, respectively.

We multiply those products by each pillar's weighting in the framework. For an active strategy, those weightings are 45%, 45%, and 10% for People, Process, and Parent pillars, respectively. For a passive strategy, they're 10%, 80%, and 10%, respectively. We then sum those products to arrive at an overall estimated pre-fee alpha for that managed investment.

#### **In what way does your estimate of how much value a particular managed investment can add before fees affect the Medalist Rating you assign to it?**

We subtract a managed investment's fees from its overall estimated pre-fee alpha to derive its overall estimated net alpha. That overall estimated net alpha determines the overall Medalist Rating—Gold, Silver, Bronze, Neutral, or Negative—we assign to it.

We assign Gold, Silver, or Bronze ratings to managed investments we expect to generate a positive net alpha and Neutral or Negative ratings to the rest.

#### **How do you currently estimate how much value a managed investment can generate before fees?**

Currently, we derive the Alpha Potential Estimate by calculating rolling 36-month regressions of each fund's pre-fee returns versus its Morningstar-assigned benchmark, repeating for all other funds in the peer group through their history (we include data as far back as 2000 where available). Distributions for active and passive funds are calculated separately.

From this history, we form a distribution ranging from the lowest to the highest pre-fee alphas. To derive APE, we calculate the difference between the pre-fee alphas at the 25th and 75th percentiles of the distribution and then divide that difference in half.

We have referred to this as the "semi-interquartile range", which has served as the pre-fee alpha multiplier in the process described above.

**How will you estimate how much value a managed investment can generate before fees under the enhanced approach?**

Under the enhanced approach, we will continue to form separate distributions of historical pre-fee alphas for (1) passively managed vehicles and (2) actively managed vehicles in the manner described. But going forward we will replace semi-interquartile range with a different method that more fully accounts for the shape of the alpha distribution.

To do so, for actively managed vehicles, we will divide the number of positive alphas in the distribution by the total number of observations. This ratio indicates the frequency with which funds have generated positive pre-fee alpha versus their benchmark index over time. We then multiply this ratio by the median positive alpha in the distribution, the median alpha representing the likely magnitude of positive alpha when it's been generated over time.

For passively managed vehicles, we will divide the number of negative alphas in the combined distribution of actively and passively managed vehicles by the total number of observations. We then multiply this ratio by the median of all alphas in the passive distribution that are above the lesser of (1) zero or (2) the median alpha of the entire passive distribution.

This product will replace semi-interquartile range as the Alpha Potential Estimate that we incorporate in the Medalist Rating framework.

**How do the enhanced Alpha Potential Estimates compare to the current Alpha Potential Estimates you currently utilize in the Medalist Rating framework?**

The updated Alpha Potential estimates are generally lower than the current Alpha Potential Estimates we utilize in the ratings framework.

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**Why is the framework changing?**

**Why are you making this change to the Medalist Rating framework?**

We're making this change because we believe it will yield more accurate estimates of how much value managed investments are likely to generate before fees. This should make the Medalist Rating more effective in forecasting future returns and, in turn, help investors who use the Medalist Rating to achieve better outcomes.

**How accurate has the current approach been in forecasting how much value managed investments will generate before fees?**

The current approach has been reasonably accurate in forecasting how much value managed investments generate before fees. But its reliance on the dispersion of pre-fee alpha (as represented by the semi-interquartile range of historical pre-fee alphas) doesn't fully take the shape of the pre-fee alpha distribution into consideration, which can detract from the forecasts' precision when the distribution is skewed.

**Is Morningstar making this change because the Medalist Rating wasn't performing as well as hoped?**

No. In fact, the Medalist Rating has done a good job of sorting funds based on future performance, with higher-rated funds tending to outperform lower-rated funds on average over various time horizons we've tested. Nonetheless, we saw an opportunity to further improve the methodology in ways that we believe should translate to even better performance in the future. That explains why we're making the change.

**What gives you confidence this change will improve the efficacy of the Medalist Ratings?**

We feel confident this change will enhance the efficacy of the Medalist Ratings based on extensive testing of the revised approach that we've conducted. That testing confirmed that the revised approach to deriving the Alpha Potential Estimate would yield more precise estimates of managed investments' pre-fee alpha and that, in turn, would burnish the Medalist Ratings' overall predictiveness.

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### **What does this enhancement mean for clients?**

#### **How many managed investments do you expect will see a change to their Medalist Rating due to the methodology change?**

Pro forma, we expect almost 20% of managed investments will see a change to their Medalist Rating.

#### **Do you expect most of the Medalist Rating changes to be upgrades or downgrades?**

We expect about 85% of the Medalist Rating changes to be downgrades.

#### **Do you expect the distribution of Medalist Ratings to change as a result of this methodology change?**

Yes, we expect the distribution of Medalist Ratings will shift away from Gold, Silver, and Bronze ratings and towards Neutral and Negative ratings.

Currently, we assign Gold, Silver, or Bronze ratings to around 30% of managed investment vehicles globally. Pro forma, we expect that to shrink to 23% after we make the methodology change, with the share of managed investments assigned a Neutral or Negative rating rising from 70% to 77%.

#### **Why do you expect most of the Medalist Rating changes will be downgrades?**

In many peer groups, the distribution of pre-fee alphas skews negative, with less than 50% of observations being positive.

The current approach focuses only on the historical dispersion of pre-fee alphas (represented by half the difference between the 25th and 75th percentiles of the distribution) and, therefore, does not take this skewness into consideration.

The enhanced approach will take skewness into consideration and this will have the effect of lowering the Alpha Potential Estimate in the many peer groups where the distribution skews negative.

When the Alpha Potential Estimate is lower pursuant to the enhanced approach, it has the effect of lowering our estimate of a

managed investment's overall pre-fee alpha, as the Alpha Potential Estimate is the multiplier in the calculation by which we derive that estimate. And when we subtract fees from that reduced overall pre-fee alpha estimate, it yields a lower net alpha estimate. Since expected net alpha determines a managed investment's Medalist Rating, this explains why lower the Alpha Potential Estimate would lead to ratings downgrades.

#### **Do you expect certain types of managed investments to be more heavily impacted by this methodology change than others?**

Yes, we expect the following types of managed investments to be more heavily impacted by this methodology change:

- Managed investments that are actively managed
- Managed investments assigned Gold, Silver, or Bronze ratings
- Managed investments covered by an analyst

#### **Why do you expect the ratings change to have a bigger impact on Gold, Silver, and Bronze Ratings?**

We expect the rating change will have a bigger impact on managed investments rated Gold, Silver, and Bronze for a few reasons.

1. We expect to lower the Alpha Potential Estimate in most categories, raising it in relatively few. As such, the general direction of Alpha Potential Estimates will be downward. This will have a greater impact on Gold, Silver and Bronze ratings because only managed investments expected to generate positive net alpha are eligible for such ratings. If the Expected Alpha Potential shrinks, then that will cause expected net alphas to fall by a corresponding amount as well. As that happens, some managed investments, especially those assigned Bronze ratings, could see their expected net-of-fee alpha flip from positive to negative.
2. We assign Gold, Silver, and Bronze ratings to managed investments expected to generate positive net alpha in accordance with our methodology. The specific rating

they're assigned depends on the size of the positive net alpha they're expected to generate and how that compares to other managed investments in their peer group. We assign Gold ratings to the top 15% of managed investments in a category based on expected net alpha; Silver to the next 35%; and Bronze ratings to the remaining managed investments. If the Alpha Potential Estimate changes, it will not change the sort order, but the expected net alpha of some managed investments will flip from positive to negative and as that happens the remaining funds will shift, with downgrades from Gold to Silver and Silver to Bronze explained by this effect.

#### **Why will the ratings change have a smaller impact on Neutral and Negative Ratings?**

We expect the ratings change to have a smaller impact on managed investments rated Neutral or Negative because managed investments assigned these ratings weren't expected to generate positive net alpha to begin with. That said, the expected net alpha of managed investments rated Neutral or Negative could become even more negative if the Alpha Potential Estimate is lower. But we don't anticipate none will see their estimated net alpha flip from positive to negative.

While some Neutral rated funds will see downgrades to Negative due to this change, the impact is mitigated by the relatively wide corridor for Neutral rated funds. We assign Negative ratings to the 30% of managed investments in a peer group expected to generate the lowest alphas and Neutral to the other 70%. While it's true that managed investments downgraded from Bronze to Neutral could shift the sort order of funds expected to generate negative net alpha, we anticipate there will typically be far more Neutral and Negative, which dilutes the impact of Bronze rated funds being downgraded to Neutral.

#### **Why are Medalist Ratings assigned by analysts likelier to be impacted by the change than ratings assigned by algorithm?**

Medalist Ratings assigned by analysts are likelier to be impacted because Gold, Silver, and Bronze ratings account for a larger share of Medalist Ratings assigned by analysts than Medalist Ratings assigned by algorithm.

As previously explained, Gold, Silver, and Bronze ratings are likelier to be impacted by the change in how we derive Alpha Potential Estimate than Neutral and Negative ratings. As such, Medalist Ratings assigned by analysts are more likely to be impacted than Medalist Ratings assigned by algorithm.

#### **Do you assign different Alpha Potential Estimates to managed investments in the same Morningstar Category based on whether they're assigned Medalist Rating by an analyst or an algorithm?**

No, we assign the same Alpha Potential Estimate to all managed investments of the same type (i.e., active or passive) in the same Morningstar Category, irrespective of whether they're assigned a Medalist Rating by an analyst or an algorithm.

#### **If you assign the same Alpha Potential Estimate to managed investments in the same Morningstar Category whether they're covered by an analyst or not, why do Gold, Silver, and Bronze ratings account for a larger share of Medalist Ratings assigned by analysts than Gold, Silver, and Bronze ratings assigned by an algorithm?**

Gold, Silver, and Bronze ratings account for a larger share of Medalist Ratings assigned by analysts largely because managed investments covered by analysts tend to boast longer track records, proven management teams, established parent firms, and lower fees when compared to managed investments covered by algorithm.

#### **Will this methodology change impact managed investments whose strategy is to track an index?**

Yes, this methodology change will impact managed investments whose strategy is to track an index. However, we do not anticipate it will have significant impacts on the Medalist Ratings assigned to such managed investments, as the changes to the Alpha Potential Estimates we derive are considerably smaller than those for actively managed strategies.

#### **When will this change take effect?**

The change will begin to take effect on October 29, 2024.

Managed investments assigned Medalist Ratings algorithmically could see ratings changes on that date. Managed investments assigned Medalist Ratings by analysts could see ratings changes the next time the analyst updates her analysis in the 12 months or so following October 29, 2024.

**Why will the ratings changes take effect sooner for Medalist Ratings assigned by algorithm than Medalist Ratings assigned by analysts?**

The changes will take effect sooner for Medalist Ratings assigned by algorithm because we update those ratings on a monthly cadence. By contrast, we update Medalist Ratings assigned by analysts only when the analyst conducts her next update. Analysts typically update their analysis every 12 months or so. As such, any ratings changes will occur more gradually for Medalist Ratings assigned by analysts.

**How will I know if my managed investment was impacted by the change to the Medalist Rating framework?**

You will know if your fund was impacted by the change in the Medalist Rating framework if none of the managed investment's pillar ratings have changed but the overall Medalist Rating has changed. In such a scenario, the rating change is likely explained by the change to the Alpha Potential Estimate that is applied to your managed investment.

**Will you provide users of the Medalist Ratings with information to help them anticipate the scope and impact of the impending change to the Medalist Rating framework?**

Yes, we will provide information to help users of the Medalist Rating anticipate the scope and impact of the impending change. This information will include a run-down of the anticipated percentage change to the Alpha Potential Estimate used in each Morningstar Category. It will also include a breakdown of the anticipated change to the Medalist Rating distribution in each Morningstar Category. In that way, a user can discern the extent to which Morningstar Categories and Medalist ratings may be impacted and, with that information, assess the methodology change's relevance to the managed investments they're interested in.

**Are you changing any other aspects of the Medalist Rating framework?**

We're making one other change, which will enhance the way we algorithmically assign process pillar ratings to managed investments whose strategy is to track a passive index.

The change we're making in how we algorithmically assign process pillar ratings to passive vehicles is unrelated to the change we're making to Alpha Potential Estimate.

For further information on the change, we're making in how we algorithmically assign process pillar ratings to passive vehicles, see the separate "Frequently Asked Questions" we've appended to this document.

**Will this methodology change affect the way you assign People, Process, and Parent pillar ratings to managed investments that you rate?**

No, apart from the separate change we're making to how we algorithmically assign process pillar ratings to passively managed vehicles, this methodology change will not affect the way we assign People, Process, and Parent pillar ratings to managed investments we rate.

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## General Questions

**What is the Medalist Rating?**

The Medalist Rating is the summary expression of Morningstar's forward-looking analysis of managed investment vehicles, such as open-end funds, closed-end funds, exchange-traded funds, and separately managed accounts. The Medalist Rating seeks to evaluate each managed investment vehicle relative to an appropriate benchmark and peer group.

**What types of vehicles does the Medalist Rating cover?**

The Medalist Rating covers global open-end funds, closed-end funds and exchange-traded funds, as well as separately managed accounts, model portfolios, and insurance product funds in some regions.

**How many managed investments have you assigned a Medalist Rating to?**

We have assigned a Medalist Rating to more than 450,000 managed investment vehicles globally.

### **Will you update the methodology document for this change?**

Yes, we will update the methodology document to reflect these changes upon the launch in October 2024. The current methodology is available on [Morningstar's Signature Research page](#). Unless otherwise defined here, all capitalized terms used in this FAQ are defined in the methodology.

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## **Passively Managed Equity Vehicles– Process Pillar Methodology Updates**

### **What is changing?**

#### **How is the Morningstar Medalist Rating framework changing?**

In addition to the changes outlined above to our Alpha Potential Estimate, we are also changing the way that we algorithmically assign Process pillar scores to passively managed equity vehicles.

We are moving from using a random forest model to algorithmically determine Process Pillar ratings, to a rules-based system.

We define passively managed vehicles as vehicles that passively track an index. For Medalist ratings on these vehicles, the Process pillar accounts for 80% of the overall Medalist Rating, with People and Parent representing 10% respectively.

#### **What type of ratings will be impacted by this change?**

Currently, we assign Process pillar scores in three ways:

- Directly, by the analyst (i.e., an analyst covers that vehicle)
- Indirectly, by the analyst (i.e., an analyst does not cover the vehicle concerned but covers another vehicle that tracks the same index, or an analyst covers a vehicle that follows a given StrategyID)

- Directly, by algorithm (i.e., an analyst does not cover the vehicle concerned or any other vehicles that track the same index).
- Under this third scenario, we are changing the way we assign Process Pillar scores to passive equity vehicles. Currently, we assign passive equity vehicles' Process Pillar scores based on an algorithmic assessment conducted by a random forest model. We will be changing this process to replace the random forest model with a rules-based system that is more tailored to focus on the attributes most relevant to an analyst's assessment of an index.

In this way, the algorithmic approach will better align with the analysts' approach, taken when assigning the Process pillar rating to passive equity vehicles they cover.

#### **Does this change apply to Strategic Beta vehicles?**

No. "Strategic beta" refers to managed investments that track an index that seeks to enhance returns or minimize risk relative to more traditional benchmarks. We treat these investments as actively managed investments and will continue to do so after this change. Consequently, Strategic Beta vehicles with Process pillar scores rated directly by algorithm will continue to be rated with the random forest model, as all active vehicles will be. For clarity, weights of 10%, 80%, and 10% for People, Process, and Parent pillars, respectively, will continue to be applied to Strategic Beta vehicles.

#### **How will 100% analyst-driven ratings change because of this change?**

100% analyst-driven ratings will not experience a change as a result of this methodology update. Only algorithmically assigned Process pillar scores — denoted by a superscript 'Q' — are impacted.

#### **How will algorithmically assigned ratings change because of this change?**

For passively managed equity funds where the Process Pillar is assigned directly by algorithm, the random-forest model will be replaced with a rules-based system. As a result, the evaluation of a

vehicle's process pillar will shift from September to October, and Process Pillar Ratings may change based on the new data points utilized in the rules-based system.

#### **How big a change is this to the ratings process?**

While the framework through which we assign the overall rating is not changing, the method by which we algorithmically assign the Process pillar score for passively managed equity funds is shifting.

#### **How much will the Medalist Ratings change because of this methodology change?**

For passively managed vehicles, the Process Pillar is 80% of the weighted ratings equation, compared to 10% for People and 10% for Parent. Changes to Process Pillar ratings that follow from the move to a rules-based model may therefore have a material impact to a vehicle's overall Medalist rating. We expect 50% of passively managed equity vehicles to experience a Process pillar score change. Those changes, together with the impact from the revised Alpha Potential Estimates are expected to result in changes to 45% of overall Medalist ratings for passively managed equity vehicles.

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### **Why is methodology changing?**

#### **Why are you making these changes to the Morningstar Medalist Rating?**

Currently, the random forest model is trained on the body of Morningstar analyst decisions. The model evaluates the relationships between ratings that Morningstar analysts have assigned to managed investments, and the attributes of the managed investments assigned those ratings. The model then applies those learnings to the universe of managed investments that analysts do not directly cover, assigning ratings based on the attributes of the managed investment. The model seeks to emulate what the analyst would assign the managed investment, if they covered it directly.

This machine-learning technique is not tailored to particular types of managed investments, as it learns from the full corpus of ratings, many of which have been assigned to actively managed, not passively managed, vehicles.

By moving to a rules-based system that closely aligns to the approach analysts take when evaluating a passive equity vehicle's Process Pillar, we expect to improve the ability of the model to mimic analyst decision-making.

#### **How does this change make the Medalist Rating more relevant to investor decisions?**

We balance both accuracy and explainability in our mission to provide ratings on which investors can make actionable investment decisions. We find that this model provides more explainable ratings that closely mirror the approach our analysts take, while also providing gains in accuracy and efficacy on a pro forma basis.

#### **Are you making this change because the Medalist Rating wasn't performing as well as hoped?**

No, we're not making the change because the Medalist Rating wasn't performing as hoped. In fact, the Medalist Rating has done a good job of sorting funds based on future performance, with higher rated funds tending to outperform lower rated funds on average over various time horizons we've tested. Nonetheless, we saw an opportunity to further improve the methodology in ways that we believe should translate to even better rating performance in the future, and more explainable decisions by our model.

#### **What gives you confidence this change will improve the efficacy of the Medalist Ratings?**

We feel confident this change will enhance the efficacy of the Medalist Ratings based on extensive testing of the revised approach that we've conducted. That testing confirmed that the revised approach to assigning the Process pillar for passively managed equity vehicles provides precise evaluations of their investment process that, in turn, would burnish the Medalist Ratings' overall predictiveness. That testing also confirmed that the revised approach would yield a higher rate of agreement between analysts- and algorithmically assigned Process pillar ratings.

#### **Will you update the methodology document for this change?**

Yes, we will update the methodology document to reflect these changes upon the launch in October 2024. The current methodology is available on [Morningstar's Signature Research page](#). Unless otherwise defined here, all capitalized terms used in this FAQ are defined in the methodology.

## Australia Specific

### **How will this change impact ratings in Australia, compared to other markets?**

We expect slightly less change to ratings in the Australian market, compared to the global figures mentioned above. While globally, we expect approximately 20% of ratings to experience a change, we expect only 13% of ratings to shift in the Australian market— 11% of those being downgrades.

As noted globally, we expect the highest level of impact on funds that currently have a Medalist rating of Gold, Silver or Bronze. Specifically, we anticipate that approximately 30% of funds that currently hold those designations will be downgraded to Neutral, or Negative, in the Australian market.