Fact Sheet: The Morningstar Rating for Funds

Background
The Morningstar Rating™ for funds, often called the “star rating,” debuted in 1985 and was quickly embraced by investors and advisors. Using a scale of one to five stars, the original rating allowed investors to easily evaluate a fund’s past performance within four broad asset classes. For the first time, it introduced the concept of risk- and cost-adjusted return to the average investor.

Over time, investors moved from owning one or two funds to assembling diversified portfolios of funds. This meant they were more likely to need a specific type of fund, such as mid-cap value, to complement their other holdings. For this reason, in 1996 Morningstar created its Category Rating™, which rated funds within their smaller and more focused Morningstar Categories, and encouraged investors to use it along with the broader-based star rating.

In 2002, Morningstar enhanced the star rating with new peer groups and a new measure of risk-adjusted return. The peer groups for the rating were changed to the smaller category groups instead of the broad asset classes. At that time, Morningstar also eliminated the separate category rating.

What It Means for Investors
The Morningstar Rating™ is a quantitative assessment of a fund’s past performance—both return and risk—as measured from one to five stars. It uses focused comparison groups to better measure fund manager skill.

As always, the Morningstar Rating™ is intended for use as the first step in the fund evaluation process. A high rating alone is not a sufficient basis for investment decisions.

Category-Based Rating Groups
The rating allows investors to distinguish among funds that use similar investment strategies. The use of smaller rating groups minimizes the possibility of a “tail wind” effect boosting or hurting the ratings of funds that invest in specific areas of the market. For example, under the original methodology, persistent outperformance by the value investment style resulted in high ratings for most value funds, and relatively lower ratings for most growth-oriented funds.

Multiple Share Classes
Because the comparison groups are smaller, in 2002 Morningstar also changed its treatment of funds with multiple share classes. Although they share the same portfolio, share classes are evaluated separately because their individual expense structures produce different returns. For the rating distribution scale, however, a single portfolio counts only once, regardless of the total number of share classes. This prevents a single portfolio from dominating any portion of the rating scale.

Overall Rating
A provision is made for funds that change investment categories. In such cases, the fund’s historical information is given less weight, depending on the magnitude of the change. Doing so ensures the fairest comparisons and minimizes the incentive for fund companies to change a fund’s style in an attempt to receive a better rating.

<table>
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<tr>
<th>Rating Groups</th>
<th>Original Morningstar Rating™ for Funds</th>
<th>Current Morningstar Rating™ for Funds</th>
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<td>Broad comparison groups—funds were rated within four asset class-based categories: U.S. stock funds, international stock funds, taxable bond funds, and municipal bond funds.</td>
<td>More focused comparison groups—funds are ranked and rated within the Morningstar Categories (see accompanying list).</td>
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<td>Different share classes of each fund were rated separately; each share class counted as a distinct fund within the rating distribution scale.</td>
<td>Share classes are evaluated separately, but a fund with multiple share classes is counted only once within the rating distribution scale.</td>
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<td>Funds were rated for up to three time periods (three, five, and 10 years). These ratings were weighted and combined to produce the overall Morningstar Rating.</td>
<td>Funds are rated using these same time periods. However, when a fund changes Morningstar investment categories, its historical rating is given less weight, based on the magnitude of the category change.</td>
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Adjusting for Risk
Risk was measured by the fund’s average underperformance relative to the 90-day Treasury bill.

Risk is measured as the amount of variation in the fund’s performance, with more emphasis on downward variation.
Enhanced Risk Measure

In 2002, Morningstar also enhanced its treatment of risk. The original methodology defined risk as underperformance relative to the 90-day Treasury bill. If a fund’s return exceeded this benchmark each month, the fund was deemed to be riskless. Yet funds with highly variable returns are likely to eventually produce losses, even if they’re currently enjoying a run of success. Internet funds provide a perfect example. Because they outperformed the Treasury bill for many successive months, they exhibited little downward risk in 1999; but they suffered huge losses in subsequent years.

The Morningstar Rating™ is based on “expected utility theory,” which recognizes that investors are

- a) more concerned about a possible poor outcome than an unexpectedly good outcome and
- b) willing to give up some portion of their expected return in exchange for greater certainty of return. The rating accounts for all variations in a fund’s monthly performance, with more emphasis on downward variations. It rewards consistent performance and reduces the possibility of strong short-term performance masking the inherent risk of a fund.

When and Where

The enhanced Morningstar Rating™ for funds was implemented in Morningstar’s U.S. products in July 2002, beginning with the performance period ending June 30, 2002. Historical star ratings did not change.