Fact Sheet: The Morningstar Rating™ for Exchange-Traded Funds

Benefit Summary

- Allows investors and advisors to directly compare exchange-traded funds and conventional open-end funds
- Helps investors quickly identify ETFs with superior risk-adjusted returns
- Provides an informative and meaningful peer group comparison

Since 1985, the Morningstar Rating™ for funds has given investors and advisors a way to evaluate the risk-adjusted return for a mutual fund compared to its peer group. Often called the "star rating," this measure is a quantitative assessment of past performance—both return and risk—as measured from one to five stars.

In March 2006, Morningstar began rating exchange-traded funds (ETFs) with the same methodology so investors could directly compare an ETF to a similar open-end fund. Investors and advisors use the Morningstar Tax Cost Ratio℠ and expense ratios to highlight differences in taxes and fees between ETFs and conventional open-end funds, and now they can use the Morningstar Rating to compare risk-adjusted returns.

The first exchange-traded funds appeared in the marketplace in the early 1990s, offering investors a way to purchase a portfolio of stocks on an exchange throughout the day. More ETFs were launched during the next decade, and a substantial number now have three years of performance and are rated.

Methodology

The Morningstar Rating for exchange-traded funds uses the same methodology as the Morningstar Rating for funds. Ratings are based on risk-adjusted returns for the three-, five-, and 10-year time periods, and then the overall rating is a weighted average of the available time-period ratings. ETFs are rated against a peer group of the open-end funds in the same Morningstar Category.

Morningstar calculates risk-adjusted returns for all funds by starting with total return and then adjusting for sales charges, the risk-free rate, and risk. Morningstar uses total returns based on net asset values, instead of market prices, for the ETF rating. These returns are most comparable to open-end fund returns and do not rely on market data that could potentially be stale.

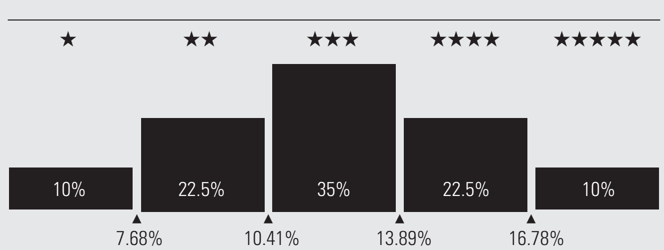
Morningstar first adjusts total returns for sales charges. Although the trading commission will vary for different investors, all investors must pay something to purchase or sell an ETF. For the rating, Morningstar models the trading commissions for an ETF like the sales loads on open-end funds by using a 0.2% front load and a 0.2% deferred load for each time period. These loads represent Morningstar's estimate of the average retail commission paid ($20, a common fee for brokerage firms) and the average investment amount ($10,000, per the SEC's guidelines for expense projections).

Next, Morningstar adjusts for both the fund's excess return over the risk-free rate and for risk. These steps in the rating methodology are identical for ETFs and open-end funds, and the result is Morningstar Risk-Adjusted Return. Morningstar's risk adjustment is based on expected utility theory. Morningstar measures the amount of variation in the fund's monthly returns and how investors would trade off return for less risk.

In the final step, Morningstar assigns ratings to ETFs by comparing them to their open-end peers, as explained below, thereby making the ETF ratings directly comparable to the open-end ratings. The open-end universe is larger and it forms a more representative peer group for comparisons than ETFs alone.

When and Where

The Morningstar Rating for exchange-traded funds was introduced in March 2006, with performance data through February 28, 2006. The rating is recalculated every month and is available in all Morningstar products.



How Does It Work?

Morningstar rates open-end funds against their category peers using risk-adjusted returns and the bell curve distribution shown on the left. The breakpoints between each rating level are recorded, and then Morningstar rates ETFs by comparing their risk-adjusted returns to these breakpoints. For example, the illustration shows sample breakpoints for the large-growth category for the three-year time period. An ETF in the large-growth category with a risk-adjusted return of 14.00% would receive a 4-star rating for that time period.

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