

Fact Sheet: The Morningstar Rating™ for Hedge Funds

Investor Benefits

- ▶ Gives accredited investors the ability to quickly and easily identify hedge funds that may be worthy of further research—those with superior risk-adjusted returns.
- ▶ Allows investors to compare hedge funds by Morningstar Category to aid in portfolio construction.
- ▶ Provides investors with a familiar tool that is also used for mutual funds, stocks, and variable annuities.

The Morningstar Rating™ for Hedge Funds is a quantitative assessment of risk-adjusted past performance that grades funds on a scale of 1 to 5 stars. The Morningstar Rating, often referred to as the “star rating,” is a familiar tool that helps investors evaluate the risk-adjusted returns of hedge fund composites.

It also helps identify management teams that are adding value over time, compared with others in their Morningstar Category™. As always, the Morningstar Rating is intended for use as a first step in the investment evaluation process.

The Morningstar Rating for Hedge Funds is based on the same methodology that Morningstar uses to rate other investments, such as open-end mutual funds, closed-end funds, and variable annuity subaccounts. (For more information about the calculation, please see the paper titled “The New Morningstar Rating for Funds Methodology.”) However, there are both important similarities and differences between the two rating systems.

Similarities

- ▶ Star ratings are assigned to hedge funds in a bell curve distribution.
- ▶ The Morningstar Rating uses an enhanced risk-adjusted return measure based on “expected utility theory,” which accounts for all variations in a hedge fund’s monthly performance, with more emphasis on downward variation.
- ▶ The rating is an objective grade of demonstrated performance. It is not designed to try to anticipate future performance.

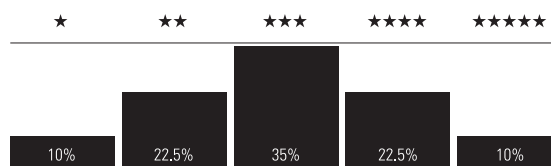
- ▶ Hedge funds are ranked against others in the same Morningstar Category. Categories are assigned by Morningstar’s hedge fund research team based on a variety of quantitative and qualitative techniques (See “Morningstar Category System for Hedge Funds” fact sheet.)
- ▶ Hedge funds are rated for up to three time periods (three, five, and 10 years). These ratings are weighted and combined to produce the overall Morningstar Rating.
- ▶ Morningstar will not calculate ratings for categories or time periods that contain fewer than five hedge funds.

Differences

- There are some differences between the hedge fund rating methodology and the rating methodologies for other investments because of the unique way that hedge fund managers calculate and report investment performance.
- ▶ All hedge fund performance data is reported to Morningstar directly from the manager. In some cases we cannot verify if the data provided is accurate.
 - ▶ Morningstar rates hedge funds based on total returns that have already been adjusted for investment management fees. Hedge funds provide data to Morningstar that is reported net of all fees, which is standard in the industry. Also, some hedge funds report performance data to Morningstar via net asset values (NAVs) while others report total monthly returns. In calculating the rating, NAVs provided by the manager are converted into total return values.
 - ▶ Hedge funds may have different share classes that report in different currencies. If the fund reports performance in a currency other than U.S. dollars, Morningstar converts the total return to U.S. dollars at the spot exchange rate.
 - ▶ Morningstar does not rate hedge funds of funds at this time. Hedge fund of funds make up approximately 40% of Morningstar’s hedge fund database, and we have not developed a subcategorization system to further define funds of funds. For example, one fund of funds may select underlying hedge fund managers from an array of underlying investment strategies to provide investor diversification benefits. Another fund of funds may select underlying hedge fund managers in only a select underlying strategy (e.g., emerging market equity hedge funds) in order to provide manager diversification but not strategy diversification.

The Morningstar Rating

The Morningstar Rating methodology ranks hedge funds by their Morningstar risk-adjusted return scores, and stars are assigned using the following scale:



Categories Used for Star Ratings

The Morningstar Rating for Hedge Funds ranks funds against peers using similar investment strategies, as defined by these Morningstar categories.

Morningstar Hedge Fund Categories					
Equity U.S. U.S.–Small Cap Europe Developed Asia Emerging Global Short	Debt Global	Event Distressed Corporate Actions	Arbitrage Debt Equity Convertible	Global Trend Following Non-Trend Following	Multi-Strategy Multi-Strategy

► Morningstar applies an “unsmoothing” algorithm in its rating for hedge funds, due to the way that some hedge funds report returns. Many hedge funds hold illiquid or difficult-to-price securities. The lack of readily available market prices may give hedge fund managers “flexibility” in how they value such positions when calculating returns that they report to hedge fund databases. Some have argued that hedge fund managers take advantage of this flexibility to “manage” their reported returns. Whether or not returns are managed, illiquid securities in a portfolio will often lead to smoothed time series of returns, which have an appearance of lower risk than is really the case.

Smoothed returns series exhibit serial correlation. To get a more accurate picture of how much risk a series of hedge fund returns indicates, we apply a statistical “unsmoothing” procedure to remove first order serial correlation and use the resulting unsmoothed series to estimate risk-adjusted return.

This unsmoothing calculation also requires that a fund provide Morningstar 38 months to qualify for an overall rating and 62 months to qualify for a five year rating and 122 months to qualify for a 10 year rating.

No Rating

Hedge funds that do not have ratings can be divided into two groups: those that do not qualify to be rated and those that did not participate.

Does Not Qualify

- A hedge fund will not get a Morningstar Rating if:
- It is less than 38 months old
 - The category contains fewer than five hedge funds that are eligible for a rating

When and Where

The new Morningstar Rating for Hedge Funds is based on monthly performance data and will be recalculated monthly.

The new rating is currently available to Morningstar Licensed Data clients; in Morningstar Direct, a Web-based institutional research platform; and in Morningstar Advisor Workstation Office Edition, a Web-based investment planning system for independent financial advisors. Ratings are also available to accredited investors who are Premium members of Morningstar.com, Morningstar’s Web site for individual investors. ■■