Fact Sheet: The Morningstar Stewardship Grade for Stocks

Where to Find the Stewardship Grade for Stocks

- Morningstar® StockInvestor
- Morningstar® DividendInvestor
- Morningstar® GrowthInvestor
- Morningstar® Stocks500 Book and other Morningstar Publications

Morningstar created the Stewardship Grade for stocks to help investors identify and compare companies that consistently align their interests with those of shareholders. The grades reflect our analysts' assessment of a company's demonstrated commitment to shareholders, and fall into four broad areas:

Transparency

Without adequate and reliable accounting practices in place and financial disclosure that is truly transparent, investors may be placed at a distinct disadvantage. As such, our analysts evaluate a company's accounting practices and financial disclosure, aiming to identify firms that provide investors with insufficient or potentially misleading information. Key areas of interest include whether a firm utilizes aggressive accounting methods, overuses "one-time" charges, institutes major changes in accounting procedures or reporting controls that may have been intended to hide something, or fails to provide sufficient enough information for investors to make an educated investment decision.

Board Independence

In theory, shareholders (who are the owners of publicly-traded companies) delegate their control to a board of directors that is responsible for overseeing the management team hired to run the firm and is expected to act in the best interests of all shareholders. In practice, many boards fall short of this objective. Our analysts take a hard look at a company's board of directors, highlighting firms where the chairman of the board is also the CEO, where related-party transactions are an impediment to board independence, or where directors lack the qualifications or independence to truly act in the best interests of all shareholders.

Incentives & Ownership

Investors are better served when companies align the long-term interests of management with those of its shareholders, primarily through the use of appropriate incentives and required levels of ownership. Our analysts penalize firms that lack clear goals and objectives for their compensation practices, change stated goals and/or performance benchmarks mid-stream, or do not sufficiently tie compensation to corporate performance. While we prefer to see managers and directors taking meaningful equity stakes in the companies they represent, we want to make sure that they aren't giving away too much of the firm in stock options or restricted stock.

Shareholder Friendliness

This final category assesses the power of shareholders relative to management by looking at key issues like voting control, the existence of cumulative or majority voting rights in board elections, the ability of shareholders to recommend and/or approve changes to a company's structure or policies, and the existence of takeover defenses or other limits on shareholders ability to protect their rights as owners of the firm.

Morningstar stock analysts base the Stewardship Grades on public filings, previous management actions, conversation with company officials, and their own expertise.

Scope

Morningstar currently has Stewardship Grades in place for over 1,500 companies. While the extent of our coverage may fluctuate from time to time, we plan to eventually have grades in place for all of the companies that we follow.

How Morningstar Assigns the Stewardship Grades for Stocks

To determine each company's Stewardship Grade, Morningstar's stock analysts evaluate four broad categories, with a mixture of deductions and bonuses for different types of behavior on the part of management and a company's board of directors.

Transparency

1 Does the firm engage in aggressive accounting practices? For example, has there been a major change to accounting practices, such as revenue recognition, during the past three years that may have been intended to hide something?

2 Does the company overuse "one-time" charges or write-offs? Does it consistently disregard GAAP earnings and point to pro forma numbers (i.e., figures "excluding charges...")? Has the firm recently changed segment reporting information in order to alter the performance of one or more of its categories or product lines?

3 Has the company recently restated earnings for any reason other than compliance with an accounting rule change? Has it recently had an unanticipated delay

in making regulatory filings or reporting quarterly results that calls its internal controls into question?

4 Does the company choose not to provide a balance sheet with its quarterly earnings release?

5 Bonus/Demerit: Does the company's disclosure go above and beyond what is required and what its competitors provide?; or, Is the company intentionally vague about its operations or results, and operating in an environment where disclosure and transparency is limited, making an adequate assessment of the firm's business and future prospects difficult?

Board Independence

6 Are the chairman of the board and the CEO the same person?

7 Bonus: If the chairman and the CEO roles are combined, does the board have a lead independent director that can actively challenge the authority of the chairman/CEO?

8 While exchange listing standards and government regulations may require boards to have a majority of independent directors, does the board possess the independence and qualifications to act in shareholders' best interests both in conducting its regular business and during a potential crisis?

9 Has the board or management engaged in significant related-party transactions that cast doubt on its ability to act in shareholders' best interests?

10 Does the company operate in an environment where external forces (holding companies, trade unions, governments, et al) could exert undue influence over the actions of the board, forcing it to not always act in the best interest of shareholders?

Incentives & Ownership

11 Has the board agreed to a compensation structure that rewards management for being employed, rather than for making value-enhancing decisions?

12 Do the goals set out for top management by the board's compensation committee make sense for the company? Do they correspond to the stated long-term strategy of the firm? Is the board's disclosure of such goals sufficient enough to allow you to answer the preceding questions?

13 Has the board granted so-called "retention" bonuses during a management crisis, re-defined management goals mid-stream, awarded "discretionary" bonuses when management failed to meet performance benchmarks, re-priced options, and/or bestowed other "extraordinary" perks on the management team?

14 Is the CEO's equity stake in the company too small to align his or her interests with those of shareholders'? Are the stock ownership and retention guidelines the board has established for top executives too lenient to ensure that management has a meaningful investment in the firm longer term?

15 Do board members receive a majority of their compensation in cash, rather than stock? Are the stock ownership and retention guidelines the board has established for directors too lenient to ensure that board members have a meaning-ful investment in the firm longer term?

16 Over the past three years, has the firm given away more than 3% of shares annually as options?

Shareholder Friendliness

17 Does the company have a concentration of voting rights that effectively prevent public shareholders from exerting meaningful influence?

18 Bonus: Is there cumulative voting (i.e., are shareholder votes equal to shares owned times number of directors)?

19 Bonus: Does the firm allow for "majority" voting in director elections? (Majority election standards enable shareholders to vote directors out of office or to prevent nominees from assuming office. In this sense, majority voting can be likened to a limited form of veto).

20 Has a majority vote of shareholders on a proposal been thwarted by any of the following: (a) management

inaction; (b) management interference in the ballot process; or (c) the existence of a supermajority provision?

21 Does the company have takeover defenses in place that, if exercised, would significantly dilute existing shareholders or favor the interests of management over shareholders in a takeover situation?

22 Do the corporate governance codes and other legal statutes of the jurisdiction in which the company is headquartered permit shareholders to seek regulatory action in order to protect and enforce their ownership rights?

23 Bonus: Does the board and management have a substantial track record of doing right by shareholders? Considering their track record, along with the board's and management's disclosure, shareholder-friendliness, and incentive structure, can they be trusted to put shareholders' interests ahead of their own in the future?

Morningstar's stock analysts will continue to ask the hard questions when it comes to gauging how well companies adhere to the standards we have set out for them with respect to transparency, board independence, executive compensation, shareholder friendliness, and overall stewardship of investors' capital. As regulations and general corporate practices evolve, we may, however, need to adjust our questions from time to time in order to better reflect the changes in the environment.

Once our analysts have assessed how well a company adheres to the standards that we have established, the stock is assigned a letter grade from A (best) to F (worst):

A	Excellent
B	Good
C	Fair
D	Poor
F	Very Poor

All stocks are graded on an absolute basis. There is no "curve." Therefore, if a company engages in practices that a Morningstar analyst thinks do not reflect good stewardship of investors' capital, it will receive a poor grade regardless of how other firms may have scored.