
Morningstar Stewardship Grades for Mutual Funds—2011 Methodology Study

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Overview

- ▶ Launched grades in August 2004 to measure whether individual mutual funds are good stewards of investors' capital.
- ▶ Consider five areas in determining a final grade:
 - ▶ Corporate Culture
 - ▶ Fund Board Quality
 - ▶ Fund Manager Compensation
 - ▶ Fees
 - ▶ Regulatory History
- ▶ We encourage customers to consider Stewardship Grades as part of their investment research process, along with other Morningstar tools.

U.S. Stewardship Grade Coverage

- ▶ Maintain coverage on more than 1,000 mutual funds
 - ▶ Deeper coverage of big fund families
 - ▶ Fewer smaller families
 - ▶ Emphasis on families with Fund Analyst Picks
 - ▶ Broadened coverage in 2010
- ▶ Update grades annually or on an as-needed basis

Distribution of Morningstar Stewardship Grades, March 2011

Overall Stewardship Grade

Number of Funds

A	90
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B	359
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C	455
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D	145
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F	2
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2011 Study of Stewardship Grade Methodology

- ▶ First in-depth study of Stewardship Grade methodology
- ▶ Wanted to see which (if any) areas of methodology were predictive of good shareholder experiences
 - ▶ Morningstar Rating success ratio (3 or more stars = successful; 2 or fewer stars OR didn't survive = unsuccessful)
 - ▶ Total Return category rank
 - ▶ Investor Return category rank
- ▶ Tested grades from 2004 and 2007

Poor Stewards Less Likely to Survive

**2004 Overall Stewardship
Grade**

**% of Funds Merged or
Liquidated Since
December 2004**

A	7
B	8
C	19
D	25
F	33

Corporate Culture (40% of overall grade)

- ▶ What makes a fund company tick?
 - ▶ What is its history, who runs the firm, what is its expertise?
 - ▶ Do fund managers and analysts spend their careers at the firm or is there a lot of personnel turnover?
- ▶ Is the firm sales focused or shareholder focused?
 - ▶ Does it launch trendy funds?
 - ▶ Does it close funds that have grown too large?
 - ▶ Does it communicate well with shareholders?
 - ▶ Does it use redemption fees?
 - ▶ Does it use soft dollars?

Corporate Culture: Helps Predict Fundholder Success

2007 Corporate Culture Grade	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Investor Return Category Rank 2008-2010	Number of Funds
A	87	41.19	42.67	209
B	66	45.76	48.01	350
C	68	47.06	49.37	283
D	56	46.91	49.52	158
F	N/A*	N/A*	N/A*	N/A*

* No funds earned F grades

Board Quality (20% of overall grade)

- ▶ Is the fund board highly independent?
 - ▶ Independent chairmen and 75% independent directors make it more likely that the board will act independently.
- ▶ Do the independent directors invest in the funds they oversee?
- ▶ Does the board act in shareholders' best interest?
 - ▶ Negotiate for lower fees
 - ▶ Close funds that are too big
 - ▶ Push back on trendy fund launches
 - ▶ Fire underperforming management teams.

Board Independence: Did Not Predict Fundholder Success, but Sample is Biased

2007 Board Independence	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Fee Percentile Rank	Number of Funds
Independent Leadership	67	46.31	47.20	522
Interested Leadership	73	44.26	27.07	478

Board Ownership of Fund Shares: Boards Overwhelmingly Invest

2007 Credit for Investing in Fund Shares	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Fee Percentile Rank	Number of Funds
Yes	70	45.35	36.54	924
No	64	44.87	46.11	76

Board Service for Shareholders: Mixed Results

2007 Board Quality—Credit for Serving Shareholders Well	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average 2010 Fee Rank Percentile	Number of Funds
Full	80	44.60	29.04	292
Partial	65	45.76	39.32	597
None	65	46.43	50.45	111

Overall Board Grade: More Mixed Results

2007 Board Quality Grade	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average 2010 Fee Rank Percentile	Number of Funds
A	73	49.01	42.92	91
B	74	44.21	36.03	445
C	65	45.62	37.20	464

Manager Incentives (20% of overall grade)

- ▶ Do managers get paid to deliver strong long-term performance?
- ▶ Do managers invest meaningfully in the funds they manage?
 - ▶ More than \$1 million in a core fund
 - ▶ More than \$100,000 in a specialty fund

Manager Investment: Managers Who Invest in Funds Have Outperformed Peers

Ownership Level (as of December 2010)	Overall Morningstar Rating Average for Core Equity Funds	Average Longest Manager Tenure Years
More than \$1 million	3.51	12.06
Between \$500,001 and \$999,999	3.35	9.17
Between \$100,001 and \$500,000	3.20	7.51
Between \$50,001 and \$100,000	3.15	6.90
Between \$10,001 and \$50,000	3.08	5.60
Between \$1 and \$10,000	3.12	5.26
\$0	2.93	4.65

Manager Ownership of Fund Shares: Helps Predict Fundholder Success

Equity Funds 2007 Manager Ownership Grade	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Investor Return Category Rank 2008-2010	Number of Funds
Full	70	44.09	45.48	195
Half	65	47.54	49.22	118
Zero	63	46.17	48.99	312

Managers Paid to Deliver Strong Long-Term Returns: Helps Predict Fundholder Success

Equity Funds 2007 Pay Plan Credit	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Investor Return Category Rank 2008-2010	Number of Funds
Full	70	44.79	46.63	382
Half	58	47.21	49.72	231

Manager Incentives: Helps Predict Fundholder Success

Equity Funds 2007 Manager Incentives Grade	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Investor Return Category Rank 2008-2010	Number of Funds
A	79	42.11	43.30	117
B	62	47.46	48.66	185
C	67	44.58	47.50	167
D	59	47.61	50.29	144
F	N/A*	N/A*	N/A*	N/A*

*Too few funds earned F's

Fees (20% of overall grade)

- ▶ Is the fund a good value proposition?
 - ▶ Morningstar research shows that fees are the most important predictor of long-term fund performance
 - ▶ Cheapest funds get A's
 - ▶ If more expensive than 60% of peers, funds earn an F.

Fees: Help Predict Fundholder Success

Fee Expense Quintile by Supercategory and Share Class Type	3-year MRAR Beats Peer Group Average %	5-year MRAR Beats Peer Group Average %	10-year MRAR Beats Peer Group Average %
Cheapest Quintile	60	64	63
2	56	58	58
3	55	55	53
4	55	53	51
Most Expensive Quintile	48	44	41

Regulatory Issues (0 to -20% of overall grade)

- ▶ Has the fund company had run-ins with regulators, and if so, how serious were they?
 - ▶ Were shareholders harmed?
 - ▶ Have wrong-doers been fired?
 - ▶ Are procedures in place to make sure problems don't occur in the future?
- ▶ Take points away for infractions, can move back up to zero with good behavior over time.

Overall Stewardship Grade: Helps Predict Fundholder Success

2007 Overall Stewardship Grade	3-Year Morningstar Rating Success Ratio %	Average Total Return Category Rank 2008-2010	Average Investor Return Category Rank 2008-2010	Number of Funds
A	85	40.95	41.89	65
B	84	42.71	44.97	235
C	68	45.70	47.79	470
D	54	48.44	51.22	204
F	52	51.47	52.22	26

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