

# Fact Sheet: New Morningstar® Categories

## Investor Benefits

- ▶ Offers better peer group comparisons and ratings
- ▶ Provides clearer picture of fund risk
- ▶ Helps differentiate between funds that have similar names or prospectus objectives

## Background

The Morningstar Category fund classifications were introduced in the mid-1990s to help investors make meaningful comparisons between funds. Morningstar found that the broad investment objective listed in a fund's prospectus did not say a lot about how the fund actually invested. For example, many funds claimed to be seeking "growth," but some were investing in U.S. blue-chip companies while others were seeking growth by investing in small international companies.

The Morningstar Category classifications solved this problem by breaking funds into peer groups based on a quantitative analysis of each fund's holdings. The categories helped investors identify the top-performing funds, assess potential risk, and build well-diversified portfolios.

Morningstar is introducing a few changes to its category structure in order to help investors differentiate between new types of funds that are now available. Morningstar is broadening its set of 48 categories to include 11 new ones and will also be discontinuing one category. There will also be minor changes to the content and/or names of eight existing categories.

## Category Structure

The driving principles behind the classification system are as follows:

- ▶ Individual funds within a peer group invest in similar types of securities and therefore share the same risk factors (e.g. style risk, prepayment risk, geographic risk).
- ▶ Individual funds within a peer group can, in general, be expected to behave more similarly to one another than to funds outside the group.
- ▶ The aggregate performance of different peer groups differs materially over time.
- ▶ Categories have enough constituents to form the basis for reasonable peer group comparisons.
- ▶ The distinctions between peer groups are meaningful to investors and assist in their pursuit of investing goals.

Morningstar analysts studied the behavior and portfolio holdings of mutual funds to determine which funds were substantially different from their peers. In addition, the analyst team tracked a number of emerging

categories as they became firmly established in the fund marketplace. Morningstar also fine-tuned the characteristics that separate one group from another to ensure that the dividing lines were placed appropriately. This study formed the basis for these category additions and changes.

## What It Means for Investors

The new, enhanced classification system draws sharper distinctions between funds and helps highlight the risks associated with certain types of funds. For example, a balanced fund that owns lots of stocks has a different level of risk than a balanced fund that predominantly owns bonds. In response, the Domestic Hybrid category will be split in two to accommodate both allocation strategies, and investors will be able to find a fund that meets their specific needs and level of risk tolerance. The system will also help those investors who want to find very specialized funds (e.g. funds that invest in municipal debt from Massachusetts).

Investors often use the Morningstar Categories to determine how a fund performed compared to its peers. This analysis will be more meaningful with the new categories, because funds will be ranked against very similar peers. For example, high yield municipal bond funds take a different approach than investment-grade municipal bond funds and will now be ranked separately. One important peer comparison is the Morningstar Rating™ ("the star rating"). This was designed to highlight how one portfolio manager added value compared to his or her category peers; the new classification system will produce more similar peer groups as the basis for this rating.

## When and Where

These additions and changes to the Morningstar Category fund-classification system will be implemented in all of Morningstar's U.S. products starting in June 2003. Open-end funds will start using these categories beginning with the performance period ending May 31, 2003. Variable annuities and separate accounts will start to use these categories during the performance period ending June 30, 2003. Historical Morningstar Ratings will not change. ■■

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<p><b>New Allocation Categories</b></p>	<p>The Domestic Hybrid category will be replaced by two new categories.</p> <p><b>Conservative Allocation</b> funds invest in both stocks and bonds and maintain a relatively smaller position in stocks. These funds typically have 20%-50% of assets in equities and 50%-80% of assets in fixed income and cash.</p>	<p><b>Moderate Allocation</b> funds invest in both stocks and bonds and maintain a relatively higher position in stocks. These funds typically have 50%-70% of assets in equities and the remainder in fixed income and cash.</p>										
<p><b>New Specialized Categories</b></p>	<p><b>Bear Market</b> funds use short positions and derivatives in order to profit from stocks that drop in price. Because these funds have extensive holdings in shorts or puts, their returns generally move in the opposite direction of the benchmark index.</p> <p><b>Bank Loan</b> funds primarily invest in floating-rate bank loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London interbank offered rate, or LIBOR.</p>	<p><b>High Yield Muni</b> funds invest at least 50% of assets in high-income municipal securities that are not rated or that are rated by a major agency at the level of BBB (considered speculative for municipals) or below.</p> <p>These funds invest at least 80% of assets in municipal debt from that specific state and include long, intermediate, and short duration bond funds: <b>Muni Florida, Muni Pennsylvania, Muni Massachusetts, Muni New Jersey, Muni Ohio, Muni Minnesota</b></p>										
<p><b>Changes to Municipal Categories</b></p>	<p>State-specific municipal bond funds are most appropriate for investors who reside in that state and can take advantage of the state tax benefits. It is most useful to investors if these funds are grouped by state rather than by duration (short, intermediate, long). Therefore, all single-state municipal bond funds will be removed from the Muni Short category, which currently contains both national-focused and state-focused funds. These single-state, short-duration funds will either be assigned to a general single-state category or to a state-specific category.</p>	<p>Four of these categories will be renamed in order to reflect their new contents.</p> <table border="0" data-bbox="1019 894 1565 1031"> <tr> <td>Old Name:</td> <td>New Name:</td> </tr> <tr> <td>Muni Short</td> <td><b>Muni National Short</b></td> </tr> <tr> <td>Muni Single State Intermediate</td> <td><b>Muni Single State Int/Sh</b></td> </tr> <tr> <td>Muni California Intermediate</td> <td><b>Muni California Int/Sh</b></td> </tr> <tr> <td>Muni New York Intermediate</td> <td><b>Muni New York Int/Sh</b></td> </tr> </table>	Old Name:	New Name:	Muni Short	<b>Muni National Short</b>	Muni Single State Intermediate	<b>Muni Single State Int/Sh</b>	Muni California Intermediate	<b>Muni California Int/Sh</b>	Muni New York Intermediate	<b>Muni New York Int/Sh</b>
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<p><b>Other Changes</b></p>	<p><b>World Stock</b> and Foreign Stock funds both invest in international stocks; the key difference is that World Stock funds also have significant positions in the United States. Morningstar will now require World Stock funds to have at least 20% of assets in U.S. stocks; the previous level was 10%.</p> <p>International Hybrid and International Bond will be renamed <b>World Allocation</b> and <b>World Bond</b>, respectively, in order to be consistent with other category names.</p>	<p><b>Multisector Bond</b> funds invest in government, corporate, high yield, and international bonds. This investment approach exposes the fund to a certain level of credit risk, which Morningstar had always considered but had not quantified in the category definition. Now, all funds with 35% to 65% of assets in low rated (BB or below) fixed-income securities will be assigned to this category.</p>										
<p><b>Morningstar Categories</b></p>	<p><b>Domestic Equity</b></p> <ul style="list-style-type: none"> <li>Large Value</li> <li>Large Blend</li> <li>Large Growth</li> <li>Mid-Cap Value</li> <li>Mid-Cap Blend</li> <li>Mid-Cap Growth</li> <li>Small Value</li> <li>Small Blend</li> <li>Small Growth</li> <li>Specialty-Natural Res</li> <li>Specialty-Technology</li> <li>Specialty-Utilities</li> <li>Specialty-Health</li> <li>Specialty-Financial</li> <li>Specialty-Real Estate</li> <li>Specialty-Communications</li> <li>Convertibles</li> <li>*Bear Market</li> <li>*Conservative Allocation</li> <li>*Moderate Allocation</li> </ul>	<p><b>International Equity</b></p> <ul style="list-style-type: none"> <li>Specialty-Precious Metals</li> <li>Foreign Stock</li> <li>*World Stock</li> <li>Europe Stock</li> <li>Diversified Pacific/Asia</li> <li>Pacific/Asia ex-Japan Stk</li> <li>Japan Stock</li> <li>Latin America Stock</li> <li>Diversified Emerging Mkts</li> <li>*World Allocation</li> </ul>	<p><b>Taxable Bond</b></p> <ul style="list-style-type: none"> <li>Long Government</li> <li>Intermediate Government</li> <li>Short Government</li> <li>Long-Term Bond</li> <li>Intermediate-Term Bond</li> <li>Short-Term Bond</li> <li>Ultrashort Bond</li> <li>*Bank Loan</li> <li>High Yield Bond</li> <li>*Multisector Bond</li> <li>*World Bond</li> <li>Emerging Markets Bond</li> </ul>	<p><b>Municipal Bond</b></p> <ul style="list-style-type: none"> <li>Muni National Long</li> <li>Muni National Intern</li> <li>*Muni National Short</li> <li>*High Yield Muni</li> <li>Muni Single State Long</li> <li>*Muni Single State Int/Sh</li> <li>Muni California Long</li> <li>*Muni California Int/Sh</li> <li>*Muni Florida</li> <li>*Muni Massachusetts</li> <li>*Muni Minnesota</li> <li>*Muni New Jersey</li> <li>Muni New York Long</li> <li>*Muni New York Int/Sh</li> <li>*Muni Ohio</li> <li>*Muni Pennsylvania</li> </ul> <p>*indicates addition or change</p>								