

Fact Sheet: The Morningstar Stewardship Grade for Funds

Purpose

The Morningstar Stewardship GradeSM for mutual funds is designed to help investors further research, identify, and compare fund managers and fund companies that do a good job—or a poor job—of aligning their interests with those of fund shareholders.

The Stewardship Grade goes beyond the usual analysis of strategy, risk, and return. It helps investors to assess funds based on:

- The manner in which funds are run;
- The degree to which the management company's and fund board's interests are aligned with those of fund shareholders;
- The degree to which shareholders can expect their interests to be protected from potentially conflicting interests of the management company.

The Stewardship Grade tries to capture some of the intangibles associated with making an investment decision. While the grades are not intended to serve as buy/sell signals in isolation, when combined with other Morningstar analyst commentary—such as an assessment of a fund's strategy and management—they can help determine the difference between a great investment and one to avoid.

The new grades are based on information compiled from public filings, responses to a detailed survey Morningstar sent to each fund company, and the expertise of Morningstar's fund analysts.

Separate from the Star Rating

The methodology for the Stewardship Grade for funds is completely different from the Morningstar RatingTM for funds (the "star rating"), and the new Stewardship Grade has no impact on a fund's star rating. The Morningstar Rating is a quantitative assessment of a fund's past performance—both return and risk—as measured from 1 to 5 stars. The Stewardship Grade is determined using some quantitative measures, but it is primarily based on qualitative information gathered by Morningstar fund analysts.

Scope

Initially, Morningstar analysts are grading 500 of the largest funds. In the coming months, we will assign Stewardship Grades to all the funds we cover—approximately 2,000 funds.

Scoring

Scale

Each fund is assigned a letter grade from A (best) to F (worst). All funds are graded on an absolute basis. There is no "curve."

Components

Morningstar analysts' evaluation of the following five components determines the grade for each fund:

- Regulatory Issues
- Board Quality
- Manager Incentives
- Fees
- Corporate Culture

Each component is worth a maximum of 2 points, for a total, overall score of 10 possible points. Points for each component are awarded in increments as small as 0.5. With the exception of Regulatory Issues, the minimum score a fund can receive in each component is zero. For Regulatory Issues, the lowest possible score is -2.

Each component score corresponds to one of the following qualitative terms:

Excellent = 2 points
 Good = 1.5 points
 Fair = 1 point
 Poor = 0.5 points
 Very Poor = 0 points or fewer

The overall Stewardship Grade is based on the sum of the five component scores:

A: 9 - 10 points
 B: 7 - 8.5 points
 C: 5 - 6.5 points
 D: 3 - 4.5 points
 F: 2.5 points or fewer

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Stewardship Grade Components

Regulatory Issues (Score range: -2 to +2)

We examine any regulatory issues at the fund company in the past three years. Serious breaches of fiduciary duty can result in a score of -2; funds with no regulatory concerns receive 2 points. In the event of any breaches, we review the remedies in place and the scope of, and commitment to, reform.

Board Quality (Score range: 0 to +2)

We assess the quality of a fund's board, looking at the following factors; each is worth 0.5 points:

- Has the board taken action in cases where the fund clearly hasn't served investors well?
- Do the independent directors have meaningful investments in the fund? To earn the maximum score, at least 75 percent of a board's independent directors must have more money invested in the funds they oversee than they receive in aggregate annual compensation for serving on the board. However, the Securities and Exchange Commission requires directors to report investments in dollar ranges with the top range being "more than \$100,000." As a result, we will assume that directors with more than \$100,000 invested in the funds they oversee meet the above criterion.
- Is the board overseeing so many funds that it may compromise the ability to diligently protect the interests of shareholders at this specific fund?
- Does the fund meet the maximum SEC requirement for the proportion of independent directors, regardless of whether or not it is subject to the requirement? (Former fund company employees, family members, and current or former employees of fund service providers are not considered independent by Morningstar.)

Manager Incentives (Score range: 0 to +2)

We assess two distinct aspects; each is worth 1 point:

- Fund ownership: Does the manager have significant investment in the fund(s) he or she oversees, defined as one-third of his or her liquid net worth? If the funds run by the manager are inappropriate for such a large investment, does he or she have at least one-third of his or her liquid net worth in other funds at the same firm?

- Compensation structure: Do the compensation plans reward long-term performance or emphasize asset growth? Incentive programs that encourage a focus on short-term performance or asset growth are viewed less favorably.

Fees (Score range: 0 to +2)

Each question is worth 1 point:

- Is the fund's expense ratio below the average for its type of share class within its peer group defined as its Morningstar Category?
- Has the fund's expense ratio declined meaningfully as assets have grown?

Corporate Culture (Score range: 0 to +2)

This component looks at a wide range of factors to assess how seriously a firm takes its fiduciary duty to its fund shareholders. Morningstar analysts may consider the following:

- Has the firm launched "trendy" funds in an attempt to gather assets?
- Has the firm closed funds at an appropriate size, or has it allowed fund assets to grow too large?
- Does the firm implement redemption fees or otherwise discourage rapid trading of its funds?
- Has the firm done a good job of retaining key personnel?
- How strong are the firm's shareholder communications?
- Has the firm used soft dollars?

Where to Find the Stewardship Grade

- Morningstar.com. Each fund report displays the scores of each of the five components, as well as the final grade.
- *Morningstar*® *Mutual Funds*™.
- *Morningstar*® *FundInvestor*™. 