
Stewardship Grades and Parent Ratings: How Morningstar Evaluates Investment Firms

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Parent/Stewardship

The Evolution of Morningstar's Stewardship and Parent Research

**2003-
2004**

More than a dozen U.S. fund firms violate trading rules, allowing some clients to trade frequently.

**Stewardship
Grades**
CDF

In August 2004, Morningstar launches Fiduciary Grades for funds, later renamed Stewardship Grades.

**Fees +
Regulatory
History**
70%

In 2007, Morningstar creates new peer groups for fee comparisons and revises Regulatory History scoring.

**Target-Date
Retirement
Ratings**

Morningstar imbeds Stewardship Grade methodology into qualitative ratings for target-date retirement series in 2010.

**2011
Research
Paper**

Morningstar studies past Stewardship Grades and concludes they predict survivorship and good returns. Grades move to firm level.

**8
Firm-Level
Data**
76 99

In 2011, Morningstar aggregates fund data for U.S. firms to measure manager tenure, retention, ownership, fees, and investment performance.

**Morningstar
Analyst
Rating**

Stewardship Grade methodology drives Parent Pillar rating, one of five components of the global Morningstar Analyst Rating.

What Goes Into Morningstar's Stewardship Research

Corporate
Culture

Stewardship or Salesmanship?

What defines the firm's corporate culture?

Is the firm's primary interest asset gathering or care of capital?

Is the investment staff stable and talented?

Does the firm focus on known strengths or unproven trends?

Fund
Board
Quality

Are Directors Serving Fundholders?

Have directors negotiated low fund fees?

Are the funds well-managed?

Has the board closed capacity-constrained strategies?

Has the board signed off on sensible or trend-chasing new funds?

Manager
Incentives

Are Managers' Interests Aligned?

Do managers invest meaningfully alongside fundholders?

Are managers paid to deliver strong long-term returns?

Fees

Are the Strategies a Good Value?

Are the strategies priced competitively relative to similar peers?

Regulatory
History

Does the Firm Comply with Regulations?

Has the firm violated industry regulations?

If so, how has the firm made right with fundholders?

Corporate Culture Carries the Heaviest Weight



Maximum
Score: 5



Maximum
Score: 2



Maximum
Score: 3



Maximum
Score: 2



Maximum
Score: 0

Firm-Level Data Supports Morningstar's Stewardship Grades & Parent Ratings

Corporate Culture

Average Manager Tenure
(equal-weighted and asset-weighted)

Annual Manager Retention Rate

5-Year Manager Retention Rate

Morningstar Success Ratio

Morningstar Risk-Adjusted Success Ratio

Fund Board Quality

Morningstar Fee Level—
Distribution

Fund launches

Fund closures

Manager Incentives

Percentage of Firm Assets by
Manager Investment in
Fund Shares

Ranges from zero to more than \$1 million

Fees

Firm Average Morningstar Fee
Level—
Distribution

Regulatory History

Form ADV collection

Stewardship Grade and Parent Pillar Ratings Coverage

Stewardship Grades

U.S. and Canada

- × Largest 20 U.S. firms by AUM
- × Largest 15 Canadian firms by AUM
- × Lengthy reports in Direct/Office
- × Updated annually or as needed

Parent Pillar Ratings

All global research markets

- × Ratings on 400+ fund firms
- × Global and local committees review ratings
- × Text and data support ratings in Global Fund Reports
- × Updated annually or as needed

Other Firm-Level Research

Upcoming and on-going projects

- × Global Fund Reports
- × March 2014 research paper
- × Global Parent Survey

Global Fund Report

Morningstar Global Fund Report | Print Date: October 10, 2013 | FINRA Members. For internal use or client reporting purposes only.

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MFS Research A MFRFX

Morningstar Category
US DE Large Growth

Category Index
Russell 1000 Growth TR USD

Total Assets
3,855
M USD

Inception Date
10/13/71

Device
USA

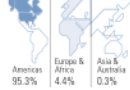
Currency
USD

Morningstar Analyst Rating
Bronze

Style Map



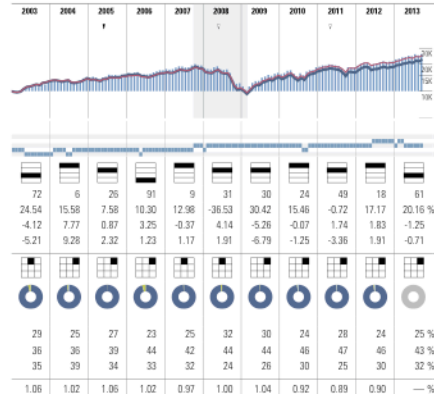
Regional Exposure



People

Joseph G. MacDougall 05/08

Total Named Managers 1



Performance 09/30/13

Growth of 10,000 Annualized USD %

Fund 25,790 9.21

Category 22,576 7.97

Index 24,900 8.89

1 Full Manager Change

2 Partial Manager Change

3 Bear Market

Morningstar Rating

Quantile Rank in Category

Percentile Rank in Category

Total Return USD

+/- Category

+/- Sector

+/- Industry

+/- Process

Equity Style Box

Asset Allocation

Stock Bond Cash Other

Super Sectors

Defensive

Sensitive

Cyclical

Price Expense Ratio

This analyst-driven fund is a compelling option.

Aug 12, 2013 | MFS Research shows off the firm's deep resources.

By keeping its sector-allocation aligned with those of the S&P 500 Index, this fund shines a light on one of MFS' strengths: the stock-picking abilities of its analysts. The firm divides its 24 U.S. stock analysts into eight sector-based teams, each led by an experienced sector leader. Named portfolio manager Joseph MacDougall adds an extra layer of oversight, keeping a tab on risk factors and managing cash flows to preserve the portfolio's sector-neutral guardrails.

The fund's relatively tight alignment with its buy/misselective stock-picking and position sizing will largely drive this fund's results. Indeed, the majority of the fund's roughly 130 holdings are also held by the index, albeit several index heavyweights such as Microsoft MSFT and General Electric GE are noticeably absent. The analysts tend to gravitate toward stocks with relatively strong growth characteristics, although they also keep an eye on a company's balance sheet; this leads to an overall portfolio with relatively

low debt/capital ratios and slightly lower trailing margins compared with its buy.

In April 2013 Morningstar transitioned the fund to the large-growth category from the large-blend group, a reflection of the portfolio's generally growth-leaning features during recent years.

Focusing on stock selection has worked well thus far. Since the fund adopted its benchmark-neutral strategy in August 2003 through July 2013, the fund's 8.6% annualized return has surpassed the 7.6% of its benchmark, as well as the 6.5% and 6.9% of the average large-growth and large-blend peer, respectively. The fund hasn't had to take on much more risk than the benchmark, as measured by its only slightly higher standard deviation, and its risk-adjusted results top those of the index and the typical large-growth and large-value funds. The fund isn't bulletproof, as evidenced by its stumble within the health-care sector that contributed to its 0.7% loss during 2011 (the benchmark was up 2.1% for the calendar year). Still, over the long haul, the experienced analyst team has shown it can deliver.

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MFS Research A
MFRFX

Process Approach

The analyst team uses a bottom-up approach to identify and select stocks. The fund's portfolio is characterized by a high concentration of large-cap growth stocks. The fund's portfolio is characterized by a high concentration of large-cap growth stocks. The fund's portfolio is characterized by a high concentration of large-cap growth stocks.

Asset Allocation

Equity Style Box

Asset Allocation

Stock Bond Cash Other

Super Sectors

Defensive

Sensitive

Cyclical

Price Expense Ratio

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Parent

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Asset Allocation

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Expense Ratio

The fund's expense ratio is 1.02%, which is in line with the category average of 1.05%. The fund's expense ratio is 1.02%, which is in line with the category average of 1.05%. The fund's expense ratio is 1.02%, which is in line with the category average of 1.05%.

Performance

The fund's performance is in line with the category average. The fund's performance is in line with the category average. The fund's performance is in line with the category average.

MFS Research A
MFRFX

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Morningstar's Impact

Fidelity

Firm encouraging managers to invest more in funds.

Fund boards keep list of managers with low investments.

Goldman Sachs

Senior management provides detailed manager ownership data for investments across all firm's funds.

JPMorgan

Changed manager compensation system to make it easier for managers to invest in their own funds.

Firm pays a portion of managers' bonus in fund shares rather than JPMorgan stock.

Lord Abbett

Eliminating 35 basis-point 12b-1 fees.

Studying Stewardship



2014 Morningstar U.S. Mutual Fund Industry Stewardship Survey

March 20, 2014

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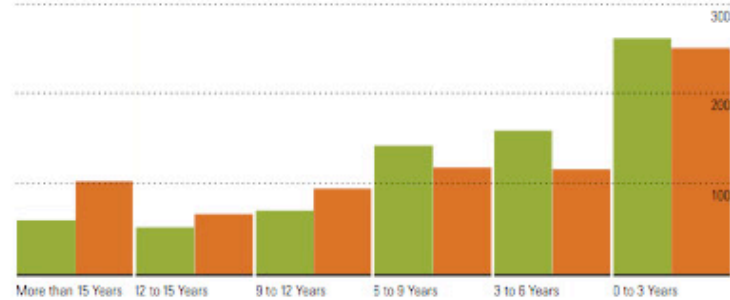
Executive Summary

Morningstar has long maintained that investors win when they invest in funds with strong stewardship. The research in 2011 to help evaluate asset managers' stewardship attributes, and it finds that firms with the highest levels of mutual fund ownership of mutual fund shares also have delivered better performance over the 10-year period of firms that offer funds with lower expense ratios.

Morningstar measures investor outcomes at the firm level to express as a percentage the number of fund share classes that have higher Morningstar Success Ratios, on average, than the funds' category rank and risk-adjusted category rank over the 10 years. This study finds that firms with stronger firm-level data have higher Morningstar Success Ratios, on average.

Exhibit 1 Firm Count by Firm Average Longest Manager Tenure

Equal-Weighted Asset-Weighted

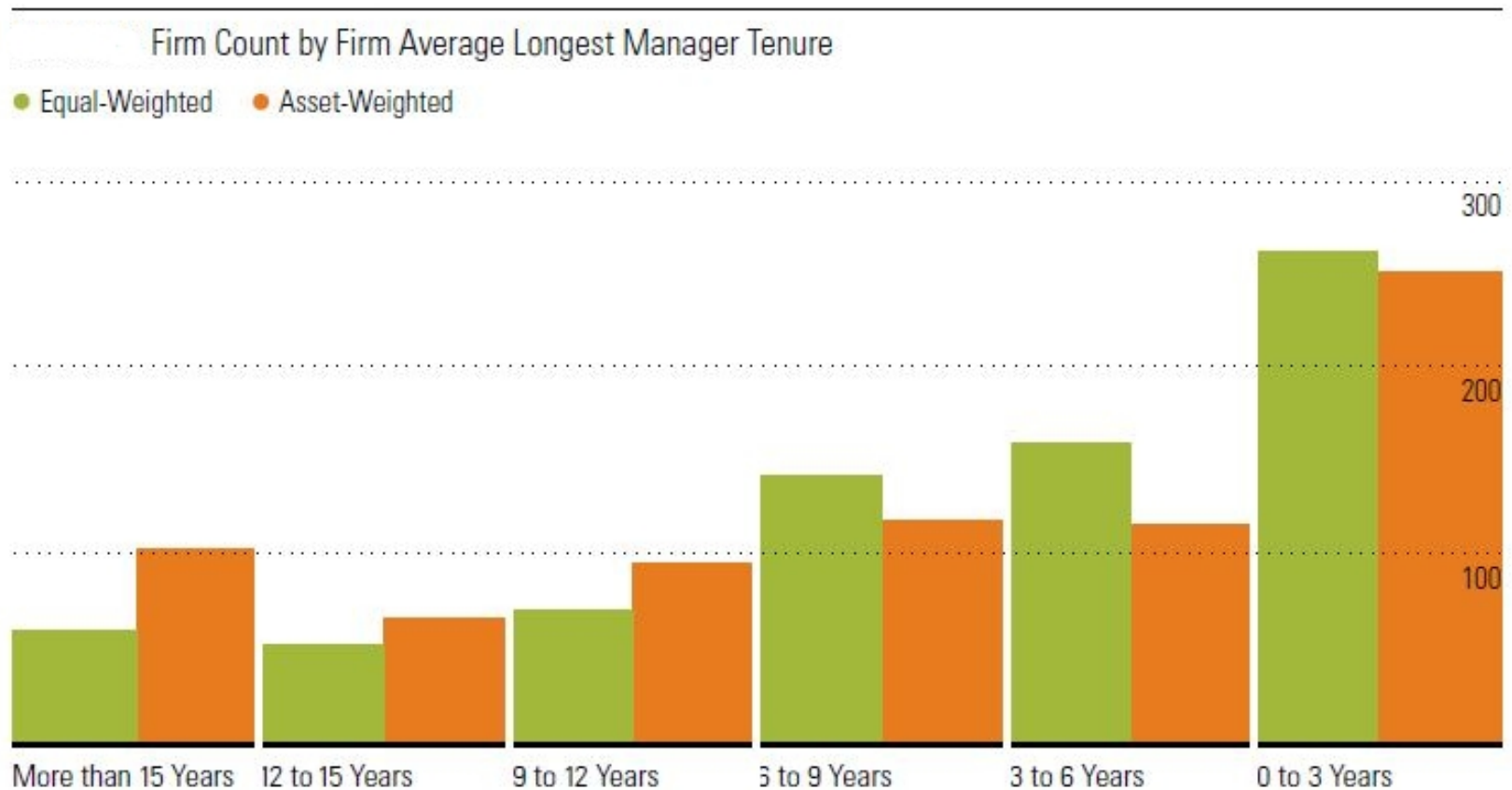


Source: Morningstar, Inc. as of 12/31/2013

Executive Summary: What's What

- × Studied relationships between firm-level data and performance for U.S. firms
 - × Industry
 - × Parent Pillar Ratings
 - × Stewardship Grades
- × Found that firms with stronger firm-level data have been more successful, especially over long time periods on a risk-adjusted basis
 - × Especially true for rated firms and largest firms

New Funds Skew Tenure



Source: Morningstar, Inc. as of 12/31/2013

But Investment Firms Look Fairly Stable

Maximum Firm Count by Morningstar Five-Year Manager-Retention Rate



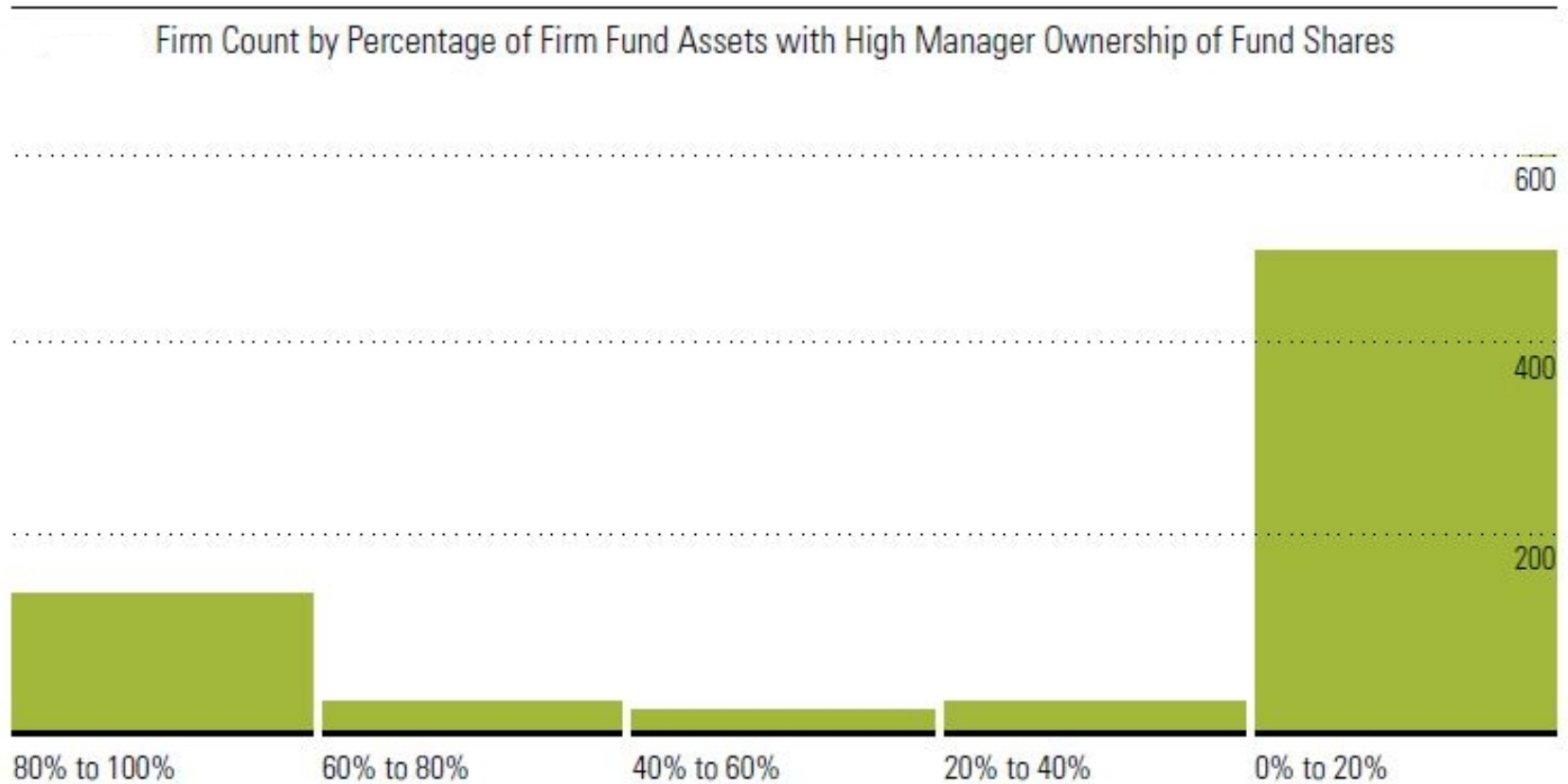
Source: Morningstar, Inc. as of 12/31/2013

Retain Investment Talent

Morningstar Success Ratios by Morningstar
Five-Year Manager Retention Rate as of 12/31/13

Morningstar Firm-Level Five Year Manager Retention Rate	3-Year Average M* Success Ratio %	5-Year Average M* Success Ratio %	10-Year Average M* Success Ratio %	3-Year Average M* Risk-Adjusted Success Ratio %	5-Year Average M* Risk-Adjusted Success Ratio %	10-Year Average M* Risk-Adjusted Success Ratio %
100%	40	40	38	40	38	39
95%to 99%	48	42	40	50	43	43
90%to 94%	40	36	32	38	36	33
85%to 89%	38	34	30	41	31	27
84%and Below	34	29	28	32	26	31

Manager Investment Is Disappointing



Source: Morningstar, Inc. as of 12/31/2013

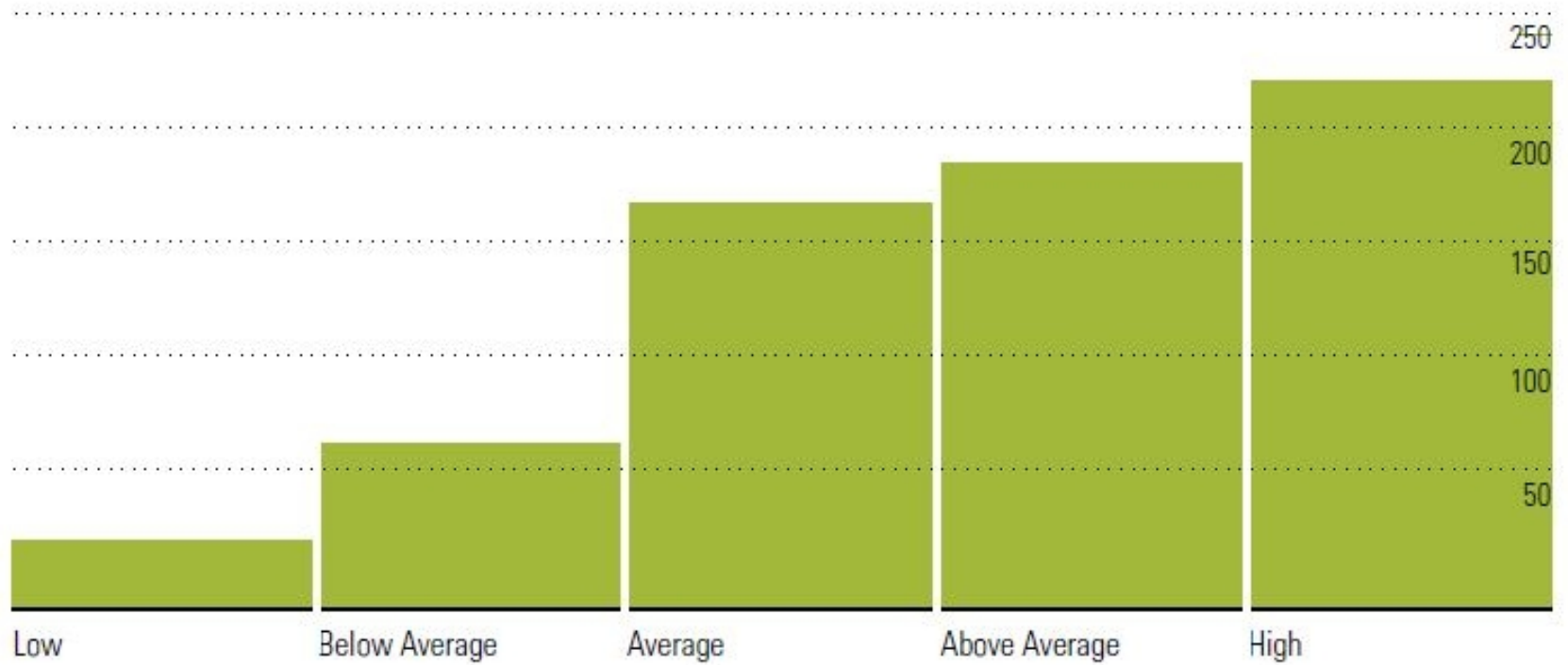
Invest Alongside Fundholders

Morningstar Success Ratios by Firm Percentage of Fund Assets with High Manager Ownership of Fund Shares as of 12/31/13

Percentage of Firm Fund Assets with More than \$1 Million in Manager Ownership	3-Year Average M* Success Ratio %	5-Year Average M* Success Ratio %	10-Year Average M* Success Ratio %	3-Year Average M* Risk-Adjusted Success Ratio %	5-Year Average M* Risk-Adjusted Success Ratio %	10-Year Average M* Risk-Adjusted Success Ratio %
100%to 80%	49	46	46	52	45	50
79%to 60%	42	43	35	45	45	34
59%to 40%	39	39	37	39	38	37
39%to 20%	40	33	32	42	34	30
19%to 0%	37	34	30	36	33	31

Funds Are Not Priced to Scale

Firm Count by Average Morningstar Fee Level—Distribution



Source: Morningstar, Inc. as of 12/31/2013

Give Funds a Head Start

Morningstar Success Ratios by Morningstar Average Fee Level Group as of 12/31/13

Firm Morningstar Average Fee Level— Distribution Percentile Rank	3-Year Average M* Success Ratio %	5-Year Average M* Success Ratio %	10-Year Average M* Success Ratio %	3-Year Average M* Risk- Adjusted Success Ratio %	5-Year Average M* Risk- Adjusted Success Ratio %	10-Year Average M* Risk- Adjusted Success Ratio %
Low	56	54	54	54	52	53
Below Average	48	45	40	51	43	45
Average	42	37	38	43	38	39
Above Average	45	40	36	44	35	36
High	27	29	19	28	30	20

Low Correlation Among Datapoints

Correlations of Firm-Level Data	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	
1 Firm Average Longest Manager Tenure Equal-Weighted	1.00															
2 Firm Average Longest Manager Tenure Asset-Weighted	0.95	1.00														
3 Firm Manager-Retention Rate 1 Year	0.17	0.15	1.00													
4 Firm Manager-Retention Rate 5 Year	0.31	0.28	0.52	1.00												
5 Firm Fund Assets with High Manager Ownership of Fund Shares	0.28	0.33	0.09	0.26	1.00											
6 Firm Fund Assets in Index or Enhanced Index Funds	-0.01	-0.02	-0.01	-0.10	-0.11	1.00										
7 Firm Average Fee Level Percentile Rank	-0.02	-0.09	0.13	0.10	-0.08	-0.10	1.00									
8 Firm Total Fund Assets	0.03	0.10	-0.04	-0.06	0.07	0.15	-0.22	1.00								
9 Firm Number of Fund Offerings	0.02	0.12	-0.14	-0.26	0.01	0.21	-0.28	0.64	1.00							
10 Firm Average Morningstar Rating 5 Year	-0.05	0.01	0.05	0.05	0.17	-0.03	-0.19	0.09	0.10	1.00						
11 Firm Morningstar Success Ratio 5 Year	-0.02	0.03	0.15	0.10	0.15	-0.03	-0.16	0.08	0.05	0.76	1.00					
12 Firm Morningstar Risk-Adjusted Success Ratio 5 Year	0.01	0.06	0.13	0.12	0.16	-0.02	-0.16	0.08	0.04	0.80	0.87	1.00				
13 Firm Growth Rate 5 Year	-0.07	-0.08	0.04	0.01	-0.03	-0.02	0.04	-0.02	-0.04	0.11	0.13	0.13	1.00			
14 Firm Fund Launches Cumulative 5 Year	0.16	0.25	-0.13	-0.25	0.06	0.10	-0.27	0.53	0.89	0.06	-0.01	-0.01	-0.05	1.00		
15 Firm Fund Liquidations and Mergers Cumulative 5 Year	-0.05	0.03	-0.17	-0.30	0.04	0.06	-0.25	0.17	0.58	0.04	0.00	-0.01	-0.05	0.75	1.00	

Correlation (positive or negative)

- None 0.0 to 0.1
- Weak 0.1 to 0.3
- Medium 0.3 to 0.5
- Strong 0.5 to 1.0

Source: Morningstar, Inc. as of 12/31/2013

Positively Rated Parents Have the Right Idea

Morningstar Firm-Level Data Averages for Rated Parents as of 12/31/13

Morningstar Parent Pillar Rating	Firm Average Tenure, Equal-Weighted Years	Firm Average Tenure, Asset-Weighted Years	Firm Average 5-Year Manager Retention Rate %	Firm Average Assets with More than \$1 Million in Manager Ownership %	Firm Average Morningstar Fee Level-Distribution %
Positive	10.2	13.8	95.28	71.71	51
Neutral	7.1	9.6	91.17	29.48	53
Negative	6.5	8.3	87.39	14.65	72

Positively Rated Parents Have Performed Better

Morningstar Success Ratio Averages for Rated Parents as of 12/31/13

Morningstar Parent Pillar Rating	3-Year Average Morningstar Success Ratio %	5-Year Average Morningstar Success Ratio %	10-Year Average Morningstar Success Ratio %	3-Year Average M* Risk-Adjusted Success Ratio %	5-Year Average M* Risk-Adjusted Success Ratio %	10-Year Average M* Risk-Adjusted Success Ratio %
Positive	60	56	59	61	58	59
Neutral	45	34	37	43	36	36
Negative	33	30	27	32	31	27

A Sampling of The Largest Firms

Success Ratios

Firm	Stewardship Grade	Average Risk-Adjusted Success Ratio %		
		3-YR	5-YR	10-YR
T. Rowe Price	A	79	76	80
Vanguard	A	78	72	77
Fidelity Investments	B	42	44	30
PIMCO	C	47	59	61
BlackRock	C	30	27	23
JP Morgan	C	43	44	32

Stewardship Matters

Losers

Winners

Stewardship Matters

Losers

Higher costs

Winners

Lower costs

Stewardship Matters

Losers

Higher costs

Poor controls

Winners

Lower costs

Strong compliance

Stewardship Matters

Losers

Higher costs

Poor controls

Hot concepts

Winners

Lower costs

Strong compliance

Investment merit

Stewardship Matters

Losers

Higher costs

Poor controls

Hot concepts

Short-term sales focus

Winners

Lower costs

Strong compliance

Investment merit

Long-term investor focus

Stewardship Matters

Losers

Higher costs

Poor controls

Hot concepts

Short-term sales focus

“Funds are sold”

Winners

Lower costs

Strong compliance

Investment merit

Long-term investor focus

“Funds are bought”