



# The New Morningstar Rating™ Methodology

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# Introduction

## **The Purpose of the Morningstar Rating for Funds**

This document describes the rationale for, and the recently revised formulas and procedures used in, calculating the new Morningstar Rating™ for funds (commonly called the “star rating”). It is anticipated that the revised formulas and procedures will be implemented effective June 30, 2002.

The Morningstar Rating was introduced in 1985. It has most often been used to help investors and advisors choose one or a few funds from among the many available within broadly defined asset classes. Over time though, increasing emphasis has been placed on the importance of funds as portfolio components rather than “stand-alone” investments. In this context, it is important that funds within a particular rating group be valid substitutes for one another in the construction of a diversified portfolio. For this reason, Morningstar will now assign ratings based on comparisons of all funds within a specific Morningstar Category™, rather than all funds in a broad asset class.

The star rating is based on risk-adjusted performance. However, different aspects of portfolio theory suggest various interpretations of the phrase “risk-adjusted.” As the term is most commonly used, to “risk adjust” the returns of two funds means to equalize their risk levels through leverage or de-leverage before comparing them. Hence, a fund’s score is not sensitive to its proportion of risk-free assets or its amount of leverage. The Sharpe ratio is consistent with this interpretation of “risk-adjusted.”

If two funds have equal positive average excess returns, the one that has experienced lower return volatility receives a higher Sharpe ratio score. However, if the average excess returns are equal and negative, the fund with higher volatility receives the higher score. While this result is consistent with portfolio theory, many retail investors find it counterintuitive. Unless advised appropriately, they may be reluctant to accept a fund rating based on the Sharpe ratio, or similar measures, in periods when the majority of the funds have negative excess returns.

The other commonly accepted meaning of “risk-adjusted” is based on assumed investor preferences. Under this approach, higher return is “good” and higher risk is “bad” under all circumstances, without regard to how these two outcomes are combined. Hence, when grading funds, return should be rewarded and risk penalized in all cases. The new Morningstar Risk-Adjusted Return measure described in this document has this property.

This document describes the application of Morningstar Risk-Adjusted Return in determining star ratings for U.S.-based mutual funds. However, most of the methods and processes described here are applicable to other types of funds.