
A Look at the Potential Impact of the New Morningstar Analyst Rating Methodology in EMEA and in Asia

Morningstar Research

11 October 2019

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Executive Summary

We recently announced our plans to update the methodology we follow in assigning Morningstar Analyst Ratings to mutual funds, exchange-traded funds, and other managed investments that we cover. In this piece, we examine the aggregate impact the methodology change would have if it were applied pro forma to funds that have been assigned an Analyst Rating and that are domiciled in European markets or in major cross-border Asian markets where European UCITS funds are available (principally Hong Kong, Singapore, and Taiwan). We separately published the pro forma impact to U.S.-domiciled funds on Aug. 30, 2019.

Study Approach

To analyze the potential impact of the ratings enhancement, we applied the updated methodology pro forma to funds and ETFs that have been assigned an Analyst Rating. We did so by taking the funds' current People, Process, and Parent Pillar ratings and running them through the updated methodology. For more information on the updated methodology, see this explainer here: <https://www.morningstar.com/articles/935412/looking-forward-to-changes-to-our-forward-looking-ratings>

After running the pillar ratings through the updated methodology, we compared those pro forma ratings against the existing Analyst Ratings and tallied up the results in the following impact analysis. It is worth noting that this pro forma analysis is subject to change, as analysts review their assumptions—including the pillar ratings they have assigned—in the normal course.

Key Takeaways

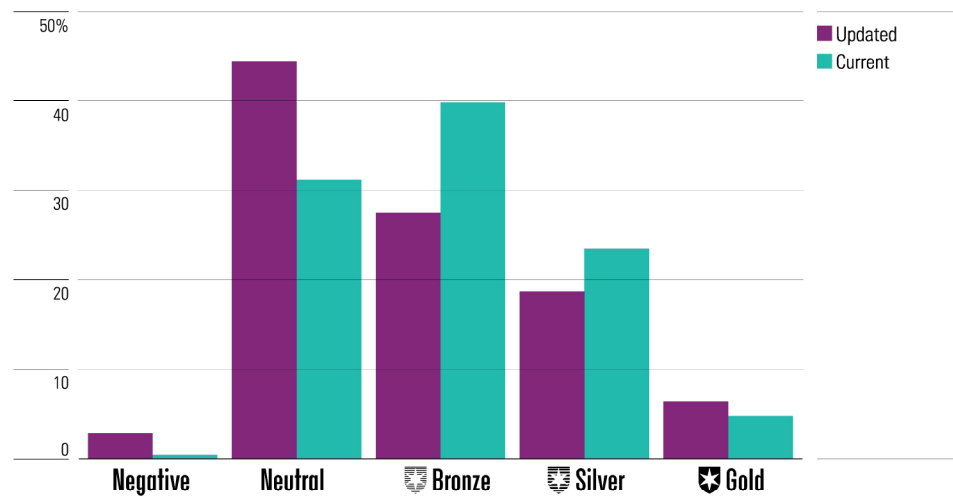
- ▶ Roughly one third of funds and ETFs would see a rating change; many rating changes stem from tailoring ratings to each fund share class by taking fee differences into account.
- ▶ Downgrades would outnumber upgrades by a roughly two-to-one margin.
- ▶ The percentage of active funds rated Gold, Silver, or Bronze would fall.
- ▶ The percentage of index funds earning Gold, Silver, or Bronze ratings would rise.
- ▶ Most ratings changes would be one rung and involve funds currently rated Bronze (52% of changes), Silver (30%), and Neutral (13%).
- ▶ In roughly 80% of cases, there would be at most two different ratings across a fund's multiple share classes.

- ▶ The proportion of Medalist ratings would stay roughly similar for share classes with only management fee (clean shares) but share classes with distribution and management fee would see large shifts toward Neutral and Negative.
- ▶ Only around 42% and 20% of share classes with an Above Average or High fee rank, respectively, would receive Morningstar Medalist ratings, compared with about two third for both currently.
- ▶ Once implemented, we do not expect the updated methodology to result in more-frequent ratings changes than now.

Impact Analysis: Big Picture

Pro forma, the distribution of Analyst Ratings would shift away from Gold, Silver, and Bronze ratings and towards Neutral and Negative ratings under the updated methodology. Around 1,400 more share classes would receive Neutral and Negative ratings compared with today. The proportion of medalists would fall to 53% from 68%. All told, roughly one third of funds and ETFs would see a rating change, with downgrades outnumbering upgrades by a margin of around two to one.

Exhibit 1 Distribution of Analyst Ratings: All Share Classes of All Covered Funds



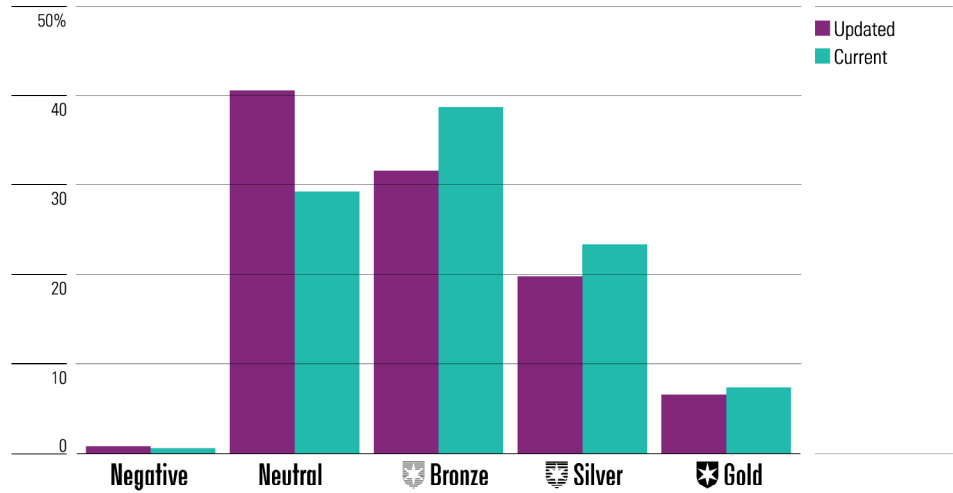
Source: Morningstar.

This shift would stem at least partly from assigning Analyst Ratings to individual share classes. To this point, we have assigned the same rating to each of a fund's share classes irrespective of fee differences. Going forward, we would vary the ratings we assign to share classes by taking these fee differences into account. All things being equal, more-expensive share classes of funds would receive lower ratings and vice versa for cheaper share classes.

The effect of assigning ratings to individual share classes in this fashion becomes apparent when we remove multiple fund share classes from the analysis. When we limit to one share class per fund (that is, the share class tagged "oldest share class"), the distribution would shift towards Neutral and

Negative but to a lesser degree, with around 42% of funds receiving such ratings (versus 47% of all share classes).

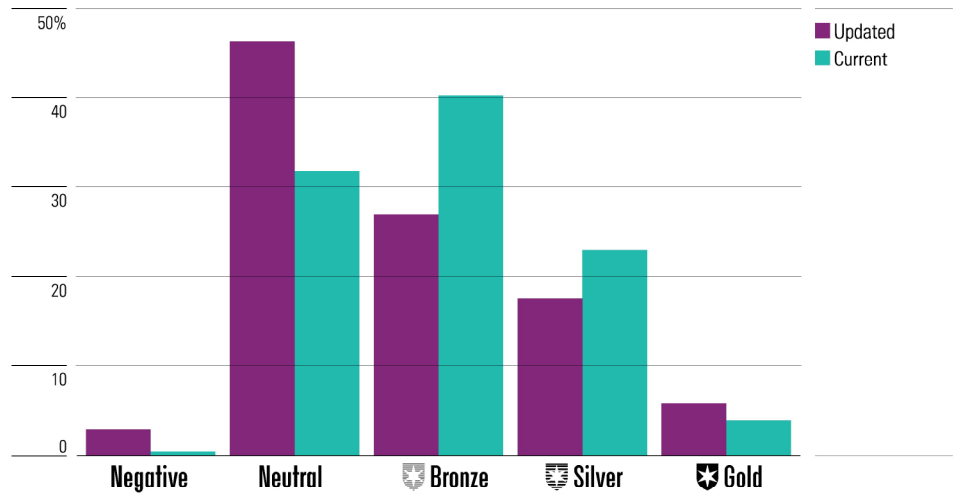
Exhibit 2 Distribution of Analyst Ratings: Oldest Share Class of Each Covered Fund



Source: Morningstar.

The distribution of Analyst Ratings assigned to active funds would shift in a way that mirrors the overall rated universe (more Negative and Neutral, fewer Medalists). This is explained by the fact that active funds dominate our coverage universe, accounting for 95% of the share classes that we have assigned Analyst Ratings to.

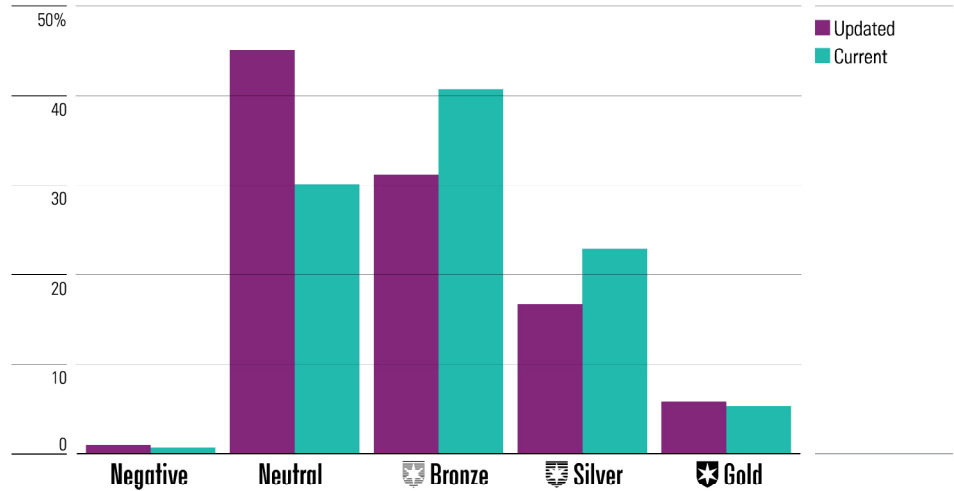
Exhibit 3 Distribution of Analyst Ratings: All Share Classes of All Covered Active Funds



Source: Morningstar.

However, this shift would be slightly less pronounced if we limit the analysis to one share class per active fund. More specifically, 31% of the oldest share classes would see their rating changed (Exhibit 4) compared with 37% for all share classes (Exhibit 3).

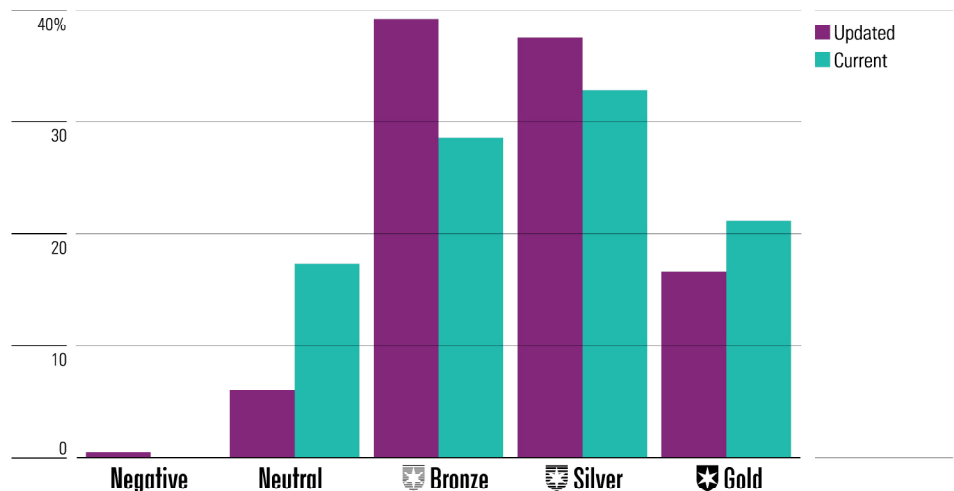
Exhibit 4 Distribution of Analyst Ratings: Oldest Share Class of Each Covered Active Fund



Source: Morningstar.

Unlike active funds, index funds would see more upgrades than downgrades under the updated methodology. The main reason for this is that the updated methodology further emphasizes low cost, which is a trait the index funds we cover often boast.

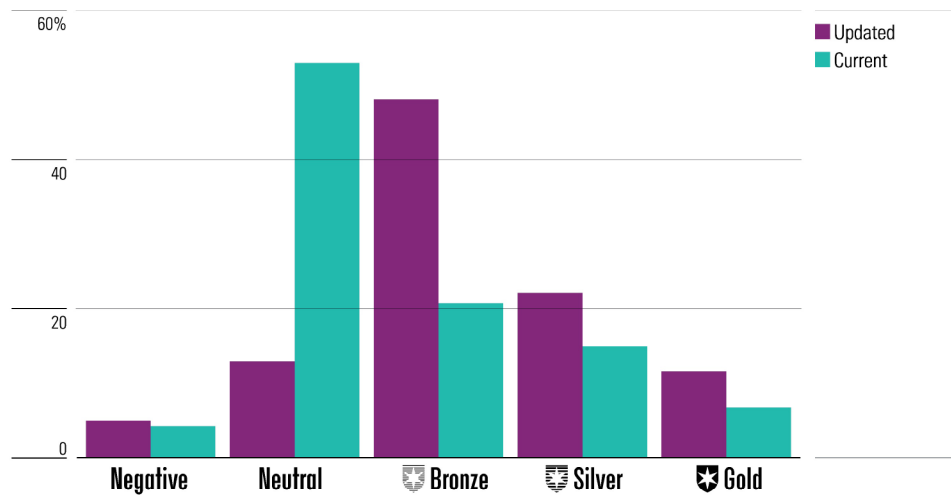
Exhibit 5 Distribution of Analyst Ratings: All Share Classes of All Covered Indexed Funds



Source: Morningstar.

It is worth keeping in mind that our coverage tends to emphasize the cheapest, more-established index funds, explaining why our ratings have skewed towards Gold, Silver, and Bronze. However, if we widen out to consider not just index funds that we cover but also those that we don't cover (these receive a forward-looking Morningstar Quantitative Rating), the relationship still holds, highlighting the advantage of low fees. Under the updated methodology, around 82% of all index fund share classes would receive a Gold, Silver, or Bronze Analyst Rating or Quantitative Rating, versus around 42% of such funds today, albeit the bulk of index-fund medalists would receive a Bronze rating, with just over 10% receiving a Gold rating.

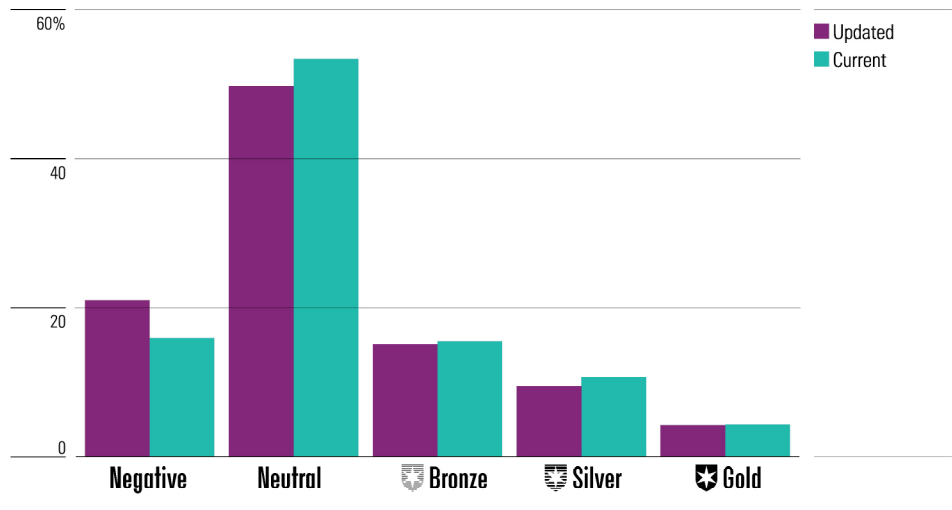
Exhibit 6 Distribution of Analyst Ratings and Quantitative Ratings: All Share Classes of All Indexed Funds



Source: Morningstar.

In similar fashion, we can also widen out the analysis to all share classes of all funds that have received an Analyst Rating (that is, covered by analysts) or a Quantitative Rating (that is, not covered by analysts) to see how the distribution of ratings would change under the updated methodology. In summary, the distribution would shift away from Gold, Silver, and Bronze ratings and towards Neutral and Negative ratings, with 29% of share classes earning a medalist rating under the updated methodology.

Exhibit 7 Distribution of Analyst Ratings and Quantitative Ratings: All Share Classes of All Funds



Source: Morningstar.

Impact Analysis: Detail

We can drill down further to examine the potential impact of applying the updated methodology to rated funds.

By Rating

Although many fund share classes would retain the same Analyst Rating under the updated methodology, a significant number would see a rating change. Roughly speaking, 40% to 60% of funds rated Gold, Silver, Bronze, and Negative would keep the same rating. By contrast, 80% of share classes rated Neutral would retain that rating. (See the diagonal in Exhibit 8).

Exhibit 8 Where Current Analyst Ratings End Up: % Breakdown of Pro Forma Ratings by Current Rating, All Share Classes of All Covered Funds

| Current | Updated | | | | | |
|----------|---------|--------|--------|---------|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | Gold | Silver | Bronze | Neutral | Negative | |
| Gold | 57.7 | 35.8 | 5.9 | 0.7 | 0.0 | <ul style="list-style-type: none"> ■ Upgrade ■ No Change ■ Downgrade |
| Silver | 11.4 | 40.7 | 32.2 | 15.3 | 0.5 | |
| Bronze | 2.4 | 17.9 | 39.7 | 38.8 | 1.2 | |
| Neutral | 0.0 | 0.9 | 12.1 | 80.3 | 6.8 | |
| Negative | 0.0 | 0.0 | 0.0 | 60.0 | 40.0 | |

Source: Morningstar, Inc.

Many of the ratings changes would stem from assigning the Analyst Rating to individual share classes. (Today we assign the same Analyst Rating to all fund share classes, irrespective of fee differences.) This is evident when we remove multiple share classes, narrowing the analysis to one share class per fund.

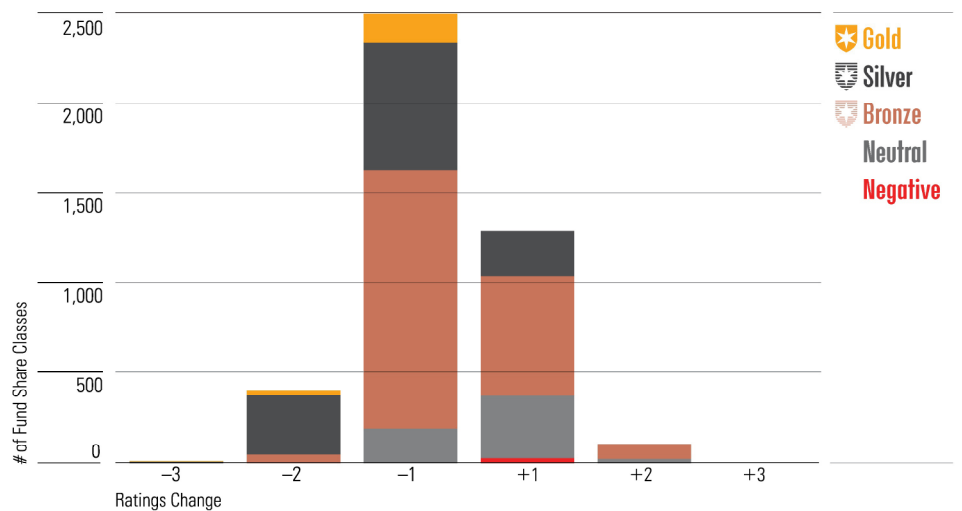
Exhibit 9 Where Current Analyst Ratings End Up: % Breakdown of Pro Forma Ratings by Current Rating, Oldest Share Class of Each Covered Fund

| Current | Updated | | | | | |
|----------|---------|--------|--------|---------|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | Gold | Silver | Bronze | Neutral | Negative | |
| Gold | 52.7 | 39.8 | 7.5 | 0.0 | 0.0 | <div style="display: flex; flex-direction: column; align-items: center;"> <div style="width: 10px; height: 10px; background-color: #28a745; margin-bottom: 2px;"></div> Upgrade <div style="width: 10px; height: 10px; background-color: #6c757d; margin-bottom: 2px;"></div> No Change <div style="width: 10px; height: 10px; background-color: #dc3545; margin-bottom: 2px;"></div> Downgrade </div> |
| Silver | 9.3 | 45.0 | 36.4 | 9.3 | 0.0 | |
| Bronze | 1.5 | 16.3 | 47.1 | 35.2 | 0.0 | |
| Neutral | 0.0 | 0.0 | 14.9 | 82.4 | 2.8 | |
| Negative | 0.0 | 0.0 | 0.0 | 80.0 | 20.0 | |

Source: Morningstar, Inc.

Most of the ratings changes would involve funds currently rated Bronze (52% of changes), Silver (30%), and Gold (4%).

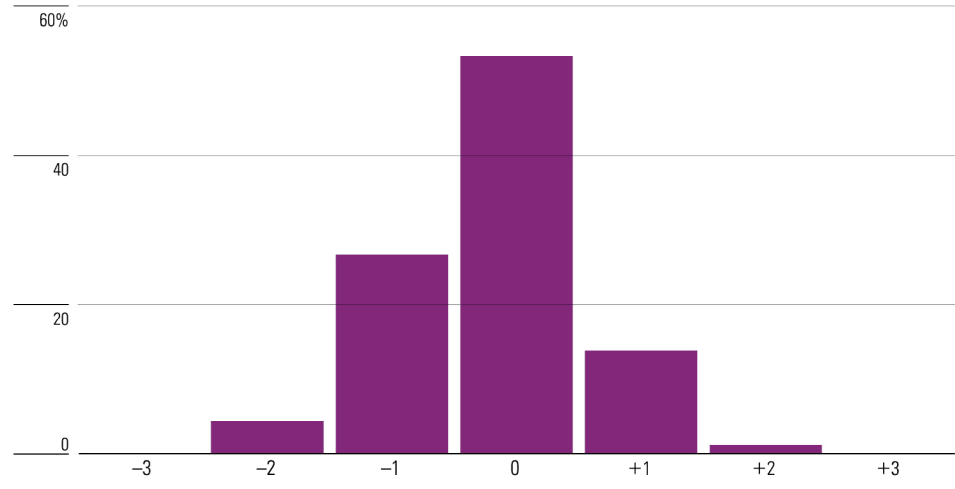
Exhibit 10 Distribution of Analyst Rating Changes by Current Rating: All Share Classes of All Covered Funds (Pro Forma)



Source: Morningstar.

Almost 90% of share classes experiencing a ratings change would see a one-rung move (30% up, 58% down), with changes to Neutral from Bronze, to Bronze from Silver, and to Silver from Bronze most commonplace.

Exhibit 11 Distribution of Analyst Rating Changes: All Share Classes of All Covered Funds



Source: Morningstar.

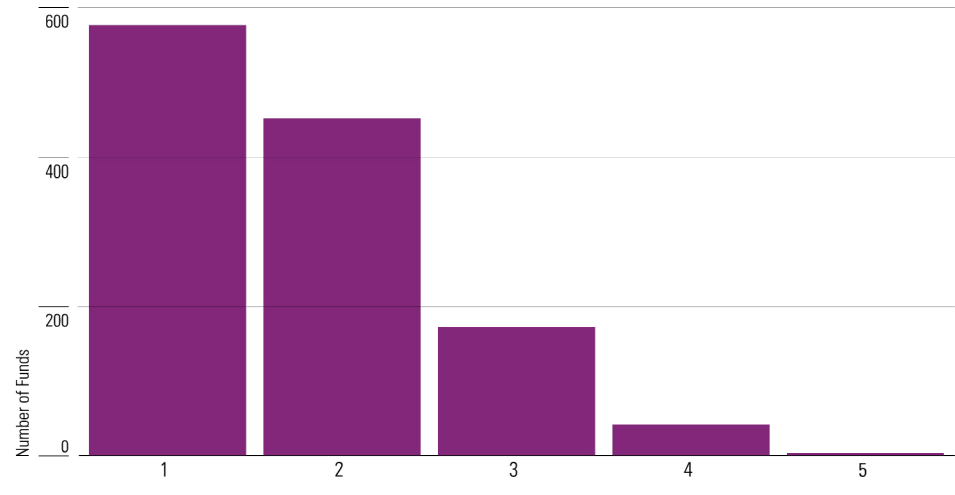
While the impact analysis did not assess frequency of ratings change under the updated methodology, we would not expect it to rise substantially. This is because ratings would change only when an analyst conducts a formal review, which typically happens on an annual basis. The updated methodology would not cause Analyst Ratings to change between formal analyst reviews.

By Fund

Formerly, we assigned the same rating to all fund share classes irrespective of fee differences. Going forward, we'll tailor ratings to each share class by taking those fee differences into account. This means that Analyst Ratings might vary across the share classes of a single fund.

We recently were assigning Analyst Ratings to 1,251 funds with multiple share classes. Under the updated methodology, we expect that 578 of those funds, or 46%, would receive the same Analyst Rating across the share classes. (In these situations, the fee differences between share classes are not so large as to pull costlier share classes into lower rating rungs.) 453 funds would receive two different Analyst Ratings across their share classes, and the remaining 220 funds would receive three or more different ratings.

Exhibit 12 Distribution of Covered Funds by Number of Different Analyst Ratings Assigned to Multiple Share Classes (Pro Forma)



Source: Morningstar.

This means it would be more the exception than the rule to see three or more Analyst Ratings across a fund's various share classes. In roughly 80% of cases, there would be at most two different ratings across a fund's multiple share classes.

By Share Class Type

Here we analyze the potential impact of applying the updated methodology by share class type. We specifically look the impact on share classes that include management and distribution fee and on clean share classes with only management fee. Clean share classes are typically much less expensive. Although some classes of covered funds are not identified as either clean or as including distribution fees, a large enough proportion is identified as one or the other to enable the below analysis.

Share classes with management and distribution fee: 3,523

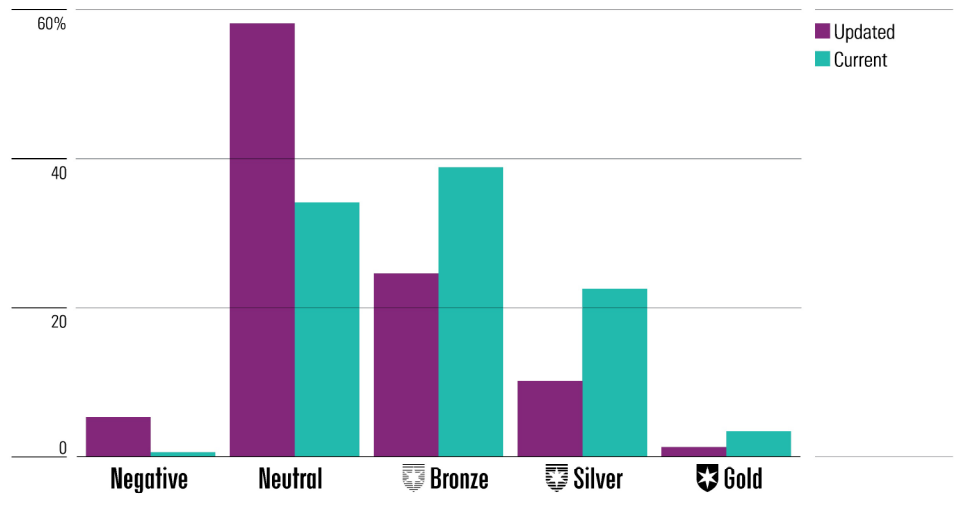
Share classes with only management fee ("clean" share classes): 3,252

Following is an analysis of the way the Analyst Ratings distribution would change under the updated methodology.

Share classes with management and distribution fees

The ratings assigned to these share classes would shift toward Neutral and Negative. Currently, around 65% of such share classes earn Gold, Silver, and Bronze ratings. Under the updated methodology, 36% would receive such ratings.

Exhibit 13 Distribution of Analyst Ratings: Management + Distribution Fee Share Classes of All Covered Funds

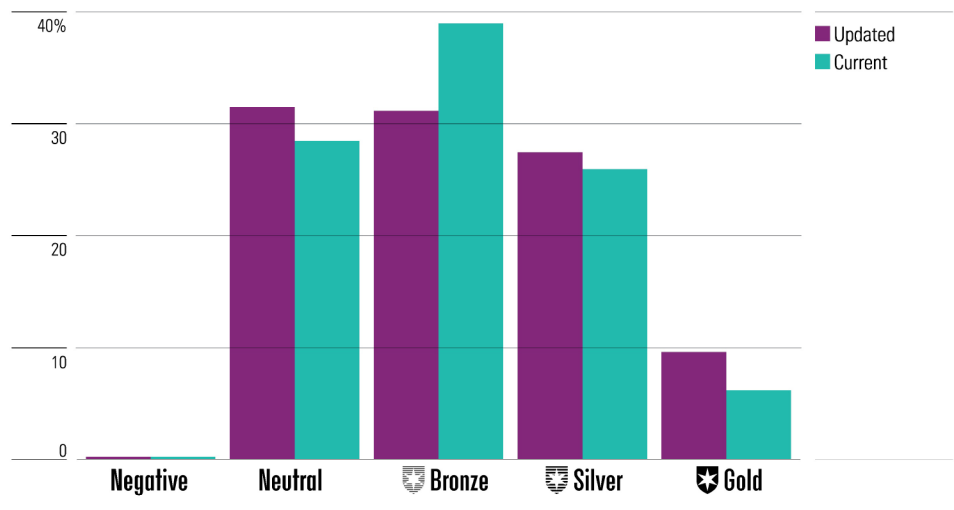


Source: Morningstar.

Share classes with only management fee (clean classes)

The distribution of ratings assigned to clean share classes would shift slightly towards Silver and Gold ratings from Bronze because the updated methodology places a premium on cost. But the overall proportion of medalists would stay roughly similar. Currently, 71% of these shares receive a Gold, Silver, and Bronze compared with 68% under the updated methodology.

Exhibit 14 Distribution of Analyst Ratings: Clean (Management Fee Only Share Classes of All Covered Funds



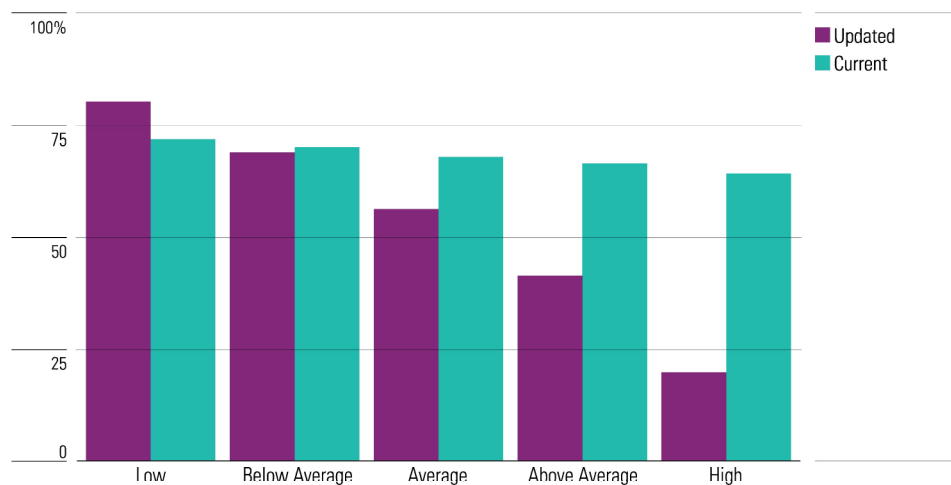
Source: Morningstar.

By Fee Level

We can also examine the impact of applying the updated methodology through the fee level. The Fee Level datapoint indicates how the cost of a fund share class ranks within the context of its broad peer group—that is, including all share classes of all funds with fee data in its Morningstar Category. It takes the form of Low (cheapest 20% of share classes), Below Average (next 20%), Average (middle 20%), Above Average (next 20%), and High (priciest 20%).

While Fee Level rank isn't a direct input into the updated methodology, the impact analysis makes it clear that the more expensive a fund, the less often it would receive a Gold, Silver, or Bronze rating. Only around 42% and 20% of share classes with an Above Average or High fee rank, respectively, would receive medalist ratings, compared with about two third today for both.

Exhibit 15 Percentage of Share Classes That Would Receive Gold, Silver, or Bronze Ratings, by Broad Fee Level



Source: Morningstar.

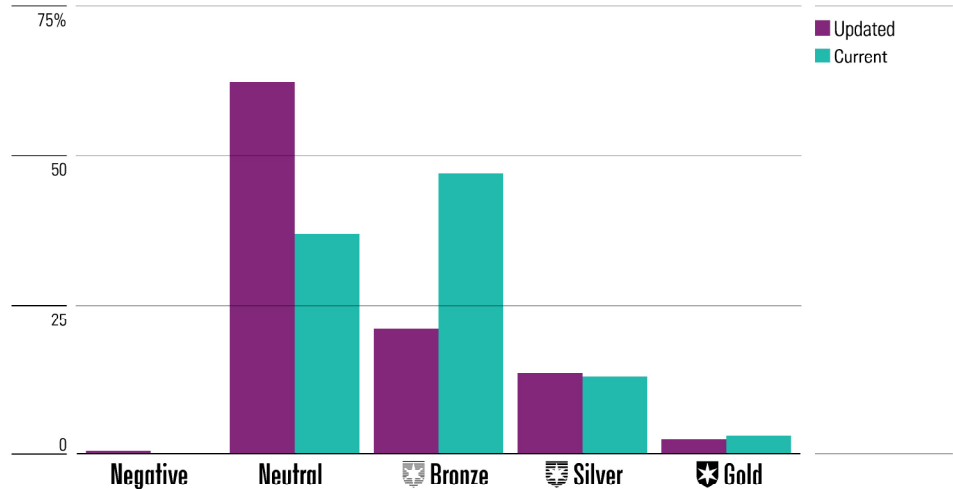
By Asset Class

Another way to look at the impact is by asset class. The distribution of Analyst Ratings for each broad asset class—allocation, equity, and fixed income—would shift in a way that mirrors the universe taken as a whole. As with the rest of the universe, we would see more Negatives and Neutrals and fewer medalists for each asset class. However, the shift away from Gold, Silver, and Bronze ratings and towards Neutral and Negative is more significant for allocation and fixed-income funds than for equity funds. This reflects the updated methodology's greater emphasis on fees combined with the fact that net-of-fee alpha is harder to generate for fixed-income and allocation funds. The more expensive share classes of fixed-income and allocation funds therefore sustain more downgrades than those of equity funds.

Allocation

For allocation funds, 37% of share classes earn a medalist rating under the updated methodology compared with 63% currently. The shift is mainly to Neutral ratings from Bronze.

Exhibit 16 Distribution of Analyst Ratings: All Share Classes of All Covered Funds - Allocation

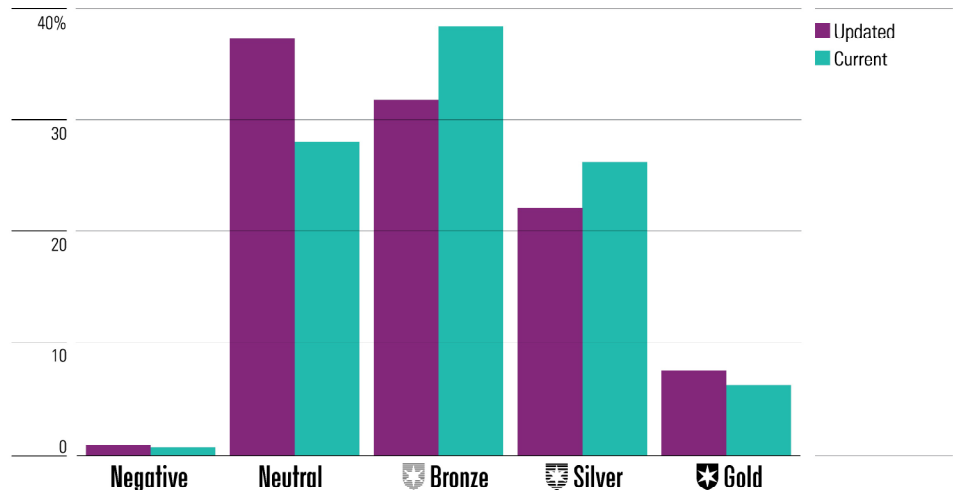


Source: Morningstar.

Equity

For equity funds, 62% of share classes earn a medalist rating under the updated methodology compared with 71% currently. The shift is mainly to Neutral ratings from Bronze and Silver.

Exhibit 17 Distribution of Analyst Ratings: All Share Classes of All Covered Funds - Equity

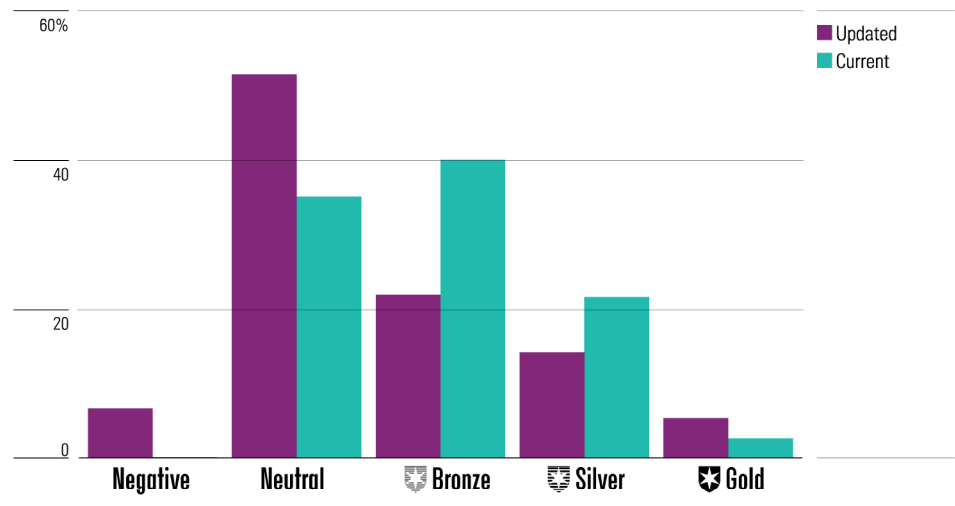


Source: Morningstar.

Fixed Income

For fixed-income funds, 42% of share classes earn a medalist rating under the updated methodology compared with 65% currently. The shift is mainly to Neutral and Negative ratings from Bronze and Silver.

Exhibit 18 Distribution of Analyst Ratings: All Share Classes of All Covered Funds - Fixed Income



Source: Morningstar.

Conclusion

This analysis is pro forma, as it takes the People, Process, and Parent Pillar ratings analysts have assigned to UCITS funds and runs them through the updated methodology. It goes without saying that it is subject to change, as analysts will be reassessing those pillar ratings in the normal course of re-evaluating funds.

In the event analysts elect to lower their pillar ratings (subject to a ratings committee's oversight and consent), then the distribution of Analyst Ratings could shift even more decidedly to Neutral and Negative. On the other hand, if analysts upgrade their assessments, then the distribution could shift in the other direction.

This process will unfold gradually, with a subset of the Analyst Ratings universe slated to be rerated under the updated methodology on Oct. 31, 2019, and the remainder over the 11 to 12 months that follow. ■■

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