Changes to Morningstar Global Equity Classification – Q&A

What is changing?

Morningstar is reworking its entire global equity classification system, beginning at the industry level and extending up to the sector and super-sector level. It is a joint effort between Morningstar's Equity Research and Equity Data teams.

How is it changing?

Broadly speaking, there will be a reduction in the number of Industries and Industry Groups, and a redefinition of the Sectors and Super-Sectors. The new classification system will eliminate 79 current industries and will introduce 14 new industries, resulting in 148 industries. At the industry group level, there will be 69 groups rather than the current 91. There will be 11 Sectors under the new system, and they are being redefined based on their economic sensitivity. The number of Super-Sectors will remain at three, but will also be reworked based on sensitivity to economic cycles.

Current Classification System			
Super Sector	Sector	Industry Group	Industry
3	12	91	213

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New Classification System			
Super Sector	Sector	Industry Group	Industry
3	11	69	148

Below are a few highlights of the Sector level changes:

- Consumer-related sectors will be divided into Consumer Cyclical and Consumer Defensive, rather than Consumer Goods and Consumer Services sectors
- The Hardware and Software sectors will be consolidated into a new Technology Sector
- Mining, paper, and chemical companies will be split from Industrial Materials into Basic Materials
- Real Estate will be broken into its own sector rather than bundled into Financial Services
- The old Telecom sector will be renamed the Communication Services sector
- The Media sector will be eliminated and companies from that sector will be moved either to the new Consumer Cyclical or Communication Services sectors

Below are lists of the current sectors and the corresponding new sectors:

Current	New
Software	
Hardware	Technology
Telecommunications	Communication Services
Media	
Consumer Services	Consumer Cyclical
Consumer Goods	Consumer Defensive
Business Services	
Industrial Materials	Industrials
	Basic Materials

Financial Services	Financial Services
	Real Estate
Healthcare	Healthcare
Energy	Energy
Utilities	Utilities

Our new Super-Sectors reflect the degree of macro-economic sensitivity, or market leverage, inherent in each of the underlying Sectors. Our new super-sector structure divides equities into three major groups based on their responsiveness to business cycle peaks and troughs: 'Cyclical' or high-market-correlation stocks; 'Sensitive', or moderately correlated stocks; and 'Defensive', or anti-cyclical stocks.

Below is the new sector to super-sector roll-up:

Cyclical	Basic Materials
	Consumer Cyclical
	Financial Services
	Real Estate
Sensitive	Communication Services
	Energy
	Industrials
	Technology
Defensive	Healthcare
	Consumer Defensive
	Utilities

Why are we changing? Why now? Didn't you just make a classification change in the summer of 2009?

Our current sector classification system was created nearly 10 years ago, and since that time, the markets and our clients' needs have evolved. Our Equity Research team wanted a system that would better support their work as equity investors, so they reviewed our current system and recommended a new system based on historical correlation analysis of underlying industries, among other things.

The changes we made over the summer related primarily to our industry classifications, and were the result of an acquisition integration. The changes we are proposing now will affect all four levels of our classification scheme—the industries, the industry groups, the sectors, and the super-sectors—and represent a wholesale improvement to our system.

Why is this change a good thing?

We believe the foundation of the new equity classification system—economic sensitivity of a company's revenues—is a better way to break down the investment universe. The new classification system is more intuitive and adds a more global perspective to our research. It also has some important elements in common with the widely used S&P GICS, which simplifies comparison. Overall our revised system is more logical, allows for intelligent diversification, and makes it easier to understand the decisions made by portfolio managers. It presents a robust classification tool in line with both macro-economic factors as well as global market developments.

How does the Morningstar Global Equity Classification System compare to S&P GICS?

Structurally, there is much in common between the two systems. Both map stocks into industries based primarily on revenue, and group industries according to similar market characteristics, using four levels of categorization. Under the GICS structure, there are 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries. The sectors under the new Morningstar Global Equity Classification System are similar to GICS, but we include an additional sector for Real Estate. The Morningstar system will use three super sectors based on economic sensitivity, followed by 11 sectors, 69 industry groups, and 148 industries.

Our emphasis on sector sensitivity to economic conditions defines the framework for our new classification system, and differentiates us from GICS. We have several other key differentiators. Unlike GICS, we break out Real Estate separately from Financial Services, since real estate companies and REITs behave differently from general finance companies. Also for Financial Services, while GICS places all international banks into one Commercial Banks industry, we break down bank classifications according to world region, since we believe this is a better indicator of performance. We additionally include a unique Financial Exchanges industry, in order to capture the recent trend of financial exchanges becoming publicly traded companies. In a further departure from GICS, we base our categorization of utilities on whether an industry is regulated or not regulated, as this distinction is most relevant economically.

How will the new industry and sector assignments be maintained?

All 30,000+ equity securities in the Morningstar investment universe will be included under the new classification structure. Within this universe, each equity security will be mapped into one of the 148 new Morningstar global industries, based on which industry most accurately reflects the underlying business of the company. Industry mappings are based on publicly available information about each company and use annual and interim reports, including Form 10-Ks and 10-Qs, as a primary source. Current reports (8-Ks) are also monitored for corporate re-organizations which would trigger an industry re-assignment. The roll-up into industry group, sector, and super-sector follows automatically from the industry assignment. A dedicated team of company data analysts is responsible for reviewing industry assignments at least quarterly. Our Equity Research team will also monitor these assignments and will confirm the accuracy of the classifications.

When will the change take place, and who should I contact with questions?

The new structure will be rolled out gradually in Morningstar products beginning October 15, 2010. New industries will be effective in all products starting October 15, while new sectors will be adopted in phases according to each product's schedule. The complete new structure will be rolled-out in all products by March 18, 2011. In the coming months, we will deliver test data to clients. If you have additional questions, please contact your Data Group Client Manager, or Richard Birge, the project manager coordinating implementation of the changes. He may be reached at (312) 244-7052 or via e-mail at richard.birge@morningstar.com.