

# Fact Sheet: The New Morningstar Rating™ for Separate Accounts

## Investor Benefits

- ▶ Gives investors the ability to quickly and easily identify separate accounts that are worthy of further research—those with superior risk-adjusted returns.
- ▶ Allows investors to compare separate accounts by Morningstar Category to aid in portfolio construction.
- ▶ Provides investors with a familiar tool that is also used for mutual funds, stocks, and variable annuities.

The Morningstar Rating™ for separate accounts is a quantitative assessment of past performance—both return and risk—as measured from 1 to 5 stars. The Morningstar Rating, often referred to as the “star rating,” is a familiar tool that helps investors evaluate the risk-adjusted returns of separate account composites. It also helps identify management teams that are adding value over time, compared with others in their Morningstar Category™. As always, the Morningstar Rating is intended for use as a first step in the investment evaluation process.

## Similarities

The Morningstar Rating for separate accounts is based on the same methodology that Morningstar uses to rate other investments, such as open-end mutual funds, closed-end funds, and variable annuity subaccounts. Morningstar made significant enhancements to its methodology for the Morningstar Rating for mutual funds in June 2002. For more information about the calculation, please see the paper titled *The New Morningstar Rating Methodology*.

- ▶ Star ratings are assigned to separate accounts in a bell curve distribution.
- ▶ The Morningstar Rating uses an enhanced risk-adjusted return measure based on “expected utility theory,” which accounts for all variations in a separate account’s monthly performance, with more emphasis on downward variation.
- ▶ The rating is an objective grade of demonstrated performance. It is not designed to try to anticipate future performance.

- ▶ Separate accounts are ranked against others in the same Morningstar Category. Categories are assigned based on extensive holdings-based portfolio analysis.
- ▶ Separate accounts are rated for up to three time periods (three, five, and 10 years). These ratings are weighted and combined to produce the overall Morningstar Rating.
- ▶ Morningstar will not calculate ratings for categories or time periods that contain fewer than five separate accounts.

Because separate accounts do not have sales loads or multiple share classes, those corresponding adjustments for the mutual fund rating are not applicable to the separate account rating.

## Differences

There are some differences between the separate account rating methodology and the rating methodologies for other investments because of the unique way that separate account managers calculate and report investment performance.

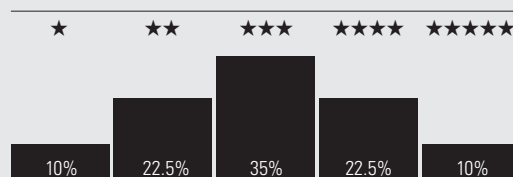
- ▶ All separate account performance data is reported to Morningstar as a “composite” of similarly managed portfolios.
- ▶ Morningstar rates separate accounts based on total returns that have not been adjusted for investment management fees.
- ▶ Morningstar does not tax-adjust the returns of separate accounts that invest in municipal bonds.

## Composites

Investors in the same separate account may have slightly different portfolio holdings because each investor has customized account needs, tax considerations, and security preferences. Therefore, separate account managers calculate and report composite returns for each investment style they offer. The method for calculating composites can vary. To ensure that the ratings are fairly assigned, Morningstar will calculate ratings for only those firms that report composites according to the guidelines of the Association for Investment Management and Research (AIMR). Approximately 90% of the separate accounts in Morningstar’s database come from firms that are AIMR-compliant.

## The Morningstar Rating

The Morningstar Rating methodology ranks separate accounts by their Morningstar risk-adjusted return scores, and stars are assigned using the following scale:



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## *No Adjustment for Fees*

Unlike a mutual fund where all investors in a fund pay the same fee, the fees for separate accounts can vary widely and are negotiated between the asset manager, the separate account program sponsor or advisor, and the investor. Morningstar has chosen to present performance before fees have been taken out—this is compliant with the AIMR-approved gross of fees standard. Net of fees calculations often deduct the highest theoretical fees that an investor may pay and often do not represent the average investor's experience.

## *No Tax Adjustment for Municipal Bonds*

Municipal-bond dividends are exempt from federal tax, but capital gains are not. To highlight the tax-exempt features that are so important to municipal-bond investors, Morningstar rates municipal-bond mutual funds based on tax-adjusted total returns. Because separate account managers report total returns to Morningstar instead of reporting raw data (share prices, dividends, and capital gains), Morningstar cannot adjust separate account returns for the tax benefits of municipal-bond dividends. Therefore, municipal-bond separate accounts will be rated based on gross total returns.

## **No Rating**

Separate accounts that do not have ratings can be divided into two groups: those that do not qualify to be rated and those that did not participate.

## *Does Not Qualify*

A separate account will not get a Morningstar Rating if:

- ▶ It is less than three years old
- ▶ The firm is not AIMR-compliant
- ▶ The category contains fewer than five separate accounts that are eligible for a rating

## *"Did Not Participate"*

Unlike mutual funds, which are required to report performance on a consistent basis, separate accounts are not regulated and have some discretion regarding when and how to report their data to Morningstar. In order to ensure that the basis for the ratings is consistent,

Morningstar will rate only those separate accounts that submit sufficient and timely performance and portfolio data. Morningstar will assign a "DNP" or "Did Not Participate" label to:

- ▶ Separate accounts that report performance data after Morningstar's production deadline (the 18th business day of the month following the end of a quarter).
- ▶ Separate accounts that have not submitted a representative portfolio of holdings. Morningstar uses this representative portfolio as the basis for the Morningstar Category assignment.
- ▶ Separate accounts that have not submitted at least three years of consecutive monthly returns. The separate account industry is moving to a monthly reporting standard. In recognition of this trend, Morningstar has chosen to use monthly returns as the basis for its ratings. Quarterly total returns too often conceal the month-to-month variation that affects the risk level and therefore will not be used for rating purposes.

The "Did Not Participate" label will help investors differentiate between those separate accounts that are not eligible for a Morningstar Rating and those that are not submitting enough data.

## **When and Where**

The new Morningstar Rating for separate accounts is based on quarter-end performance data. It will be recalculated quarterly, because many managers do not provide monthly returns until the end of each quarter.

The new rating is currently available in Morningstar® DataLab®, a research software product for investment professionals. Morningstar® Principia® Separate Accounts, an investment research and management software program for advisors, and Morningstar Advisor Workstation<sup>SM</sup>, an online investment planning system, will incorporate the new rating by the end of the year.