

Fact Sheet: The Morningstar Flexibility MeasureSM for Separate Accounts

Investor Benefits

- ▶ Illustrates the number of custom features that are available for a separate account.
- ▶ Helps financial professionals identify separate accounts that offer unique services and benefits that are not available from mutual funds.
- ▶ Summarizes separate account services with one easy-to-understand measure.

Background

The Morningstar Flexibility MeasureSM for separate accounts (“Flex Measure”) ranks separate accounts based on the number of custom benefits and services that are offered to investors. Retail and institutional investors are drawn to separate accounts because they offer services that mutual funds cannot provide. For example, some separate accounts allow investors to modify sector weightings in their accounts or control the timing of security sales. These features and others help investors customize their portfolios and monitor the taxes associated with their investments.

Asset managers can give separate account investors some discretion over their portfolios, because each investor directly owns the securities in his or her account. In contrast, mutual fund investors own shares in the fund—not the underlying holdings—and cannot make custom requests to the portfolio manager.

The Flex Measure classifies separate accounts as Highly Flexible, Moderately Flexible, or Less Flexible. The ranking is based on ongoing surveys of asset managers with an adjustment for average account size.

What This Means For Investors

The Morningstar Flex Measure for separate accounts helps financial advisors select the right separate account for their clients based on the customized services offered by each asset manager. Some separate accounts give clients direct access to the portfolio manager, while others provide exceptional reporting, such as daily access to portfolio and performance data. Financial advisors can use the Flex Measure to identify separate accounts with the services and resources to meet clients’ needs. The Flex Measure complements other metrics, such as the Morningstar RatingTM or portfolio holdings statistics.

The Flex Measure also highlights separate accounts that offer considerably more shareholder services than a comparable mutual fund. Operational characteristics are often more important in the investment selection process for separate accounts than for mutual funds. Most mutual funds offer a similar but limited menu of services, such as automatic investment plans or quarterly account reports.

Separate accounts, in contrast, can offer valuable, personalized services for investors who need highly customized portfolio planning. The Flex Measure can be a starting point for advisors to identify separate accounts that are worthy of further research.

Separate Account Features

Morningstar surveys asset managers for information on 18 specific types of special services. Managers identify whether each service is made available to clients proactively, by request, or not at all for each of the separate accounts offered by that manager. Morningstar assigns more points to separate accounts that proactively offer services to investors. Services are divided into two categories—custom features and tax-efficiency features.

Custom features give investors more control over security selection and more information about their account. Some separate accounts give investors the ability to:

- ▶ Exclude certain securities from the portfolio
- ▶ Modify sector weightings
- ▶ Consult with the portfolio manager
- ▶ Consult with the portfolio administrator
- ▶ Access daily portfolio holdings
- ▶ Access daily performance
- ▶ Access daily risk/Modern Portfolio Theory (MPT) statistics

Tax-efficiency features reflect the asset manager’s control and monitoring of taxable events on behalf of the investor. Some managers are able to:

- ▶ Analyze trades by holding period
- ▶ Provide access to tax reports
- ▶ Complete investors’ applicable year-end tax forms
- ▶ Use specialized tax optimization software
- ▶ Employ tax-aware trading strategies
- ▶ Harvest tax losses
- ▶ Use long-term capital gains in position changes
- ▶ Offer multiple reinvestment options for dividend cash flows
- ▶ Offer investors the option to sell high cost positions first
- ▶ Monitor short-term gains before trading
- ▶ Analyze potential candidates for capital losses

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Assigning the Flex Measure

The Flex Measure identifies those separate accounts that provide a relatively higher number of services to their clients. It can be costly for separate account managers to offer additional services; consequently, larger accounts generally receive more services. In order to create a level playing field for this measure, Morningstar evaluates the services offered by each separate account in relation to the average account size.

First, Morningstar determines the number of points assigned to each separate account for all 18 benefits. Services offered proactively receive two points and services offered by request receive one point. The ratio of points scored to total points possible (36) is then multiplied by an adjustment factor for account size. The formula is:

$$\text{Score} = \frac{\text{Points scored}}{36} \times \frac{1}{\ln \left(\frac{\text{total assets in the separate account}}{\text{number of accounts}} \right)}$$

Separate accounts are then ranked by their final score, divided into thirds, and assigned a measure of Highly Flexible, Moderately Flexible, or Less Flexible. Separate accounts that do not supply all of the required data will receive an "NA" or "Not Applicable." Separate accounts that score zero are not included in the ranking. This measure will be recalculated quarterly.

When and Where

The new Morningstar Flex Measure for separate accounts is now 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 WorkstationSM, an online investment planning system, will incorporate the new measure by the end of the year.