Morningstar April 2021 Category Launches - Frequently Asked Questions

High Level Overview

Retail Categories:

- 11 new US Retail Categories will be added
- 2 existing US Retail Categories will be renamed and redefined
- 2 existing US Retail Categories will be redefined
- 8 US Retail Categories will be retired
- 5 US Retail Categories will update the assigned Primary/Category Group Index
- 5 US Retail Categories will update the assigned Secondary/Category Index
- 20 US Retail Categories will update the assigned Morningstar Index
- 4 US Retail Categories will remove the assigned Morningstar Index (without replacement)
- 9 US Retail Categories will be remapped to new US Category Groups / US Asset Classes
- 9 US Retail Categories will be remapped to new Global Broad Category Groups

Fee Level Groups:

- 12 new Fee Level Groups will be added
- 1 Fee Level Group will be renamed
- 2 Fee Level Groups will be retired

US Institutional Categories:

- 8 new US Institutional Categories will be added
- 5 US Institutional Categories will be retired
- 1 US Institutional Category will be renamed and redefined

US Category Groups / US Asset Classes:

- 2 new US Category Groups / US Asset Classes will be added

US 529 Categories:

- 2 new US 529 Categories will be added
- 4 US 529 Categories will update the assigned Morningstar Index

Global Categories:

- 1 new Global Category will be added
- 3 Global Categories will be remapped to new Global Broad Category Groups

US Retail Categories

Alternative Changes

What is an alternative investment strategy?

Alternative investment strategies attempt to expand, diversify, or eliminate the dominant risk factors contained in traditional market indexes, such as equity, credit, and rates. These strategies tend to focus on capital preservation, long-term portfolio diversification, or enhanced risk-adjusted returns in isolation or combination. Application may be across single or multiple asset-classes using a variety of investment techniques.

These strategies not only have the ability to short securities, but they also aim to provide access to differentiated and/or diversifying exposures with a high degree of flexibility and little correlation to traditional market indexes.

Why is Morningstar making changes to its alternative categories?

The alternative investment landscape is continuously evolving, and Morningstar is enhancing its category classification system to better equip investors to navigate the alternative investment universe. These latest changes achieve the following benefits:

- Help investors make more relevant comparisons between strategies that are driven by similar market dynamics and pursue similar objectives by splitting large, heterogeneous categories into smaller, more focused peer groups;
- Align alternative category classifications across regions to provide greater consistency for investors in selecting strategies;
- Differentiate between alternative strategies that aim to minimize exposure to traditional market risks and strategies that employ similar instruments and techniques – such as heavy use of derivatives, shorting, and options overlays – while maintaining exposure to traditional market risks.

What is changing?

- The Long-Short Equity category is moving to the Equity Global Broad Category Group and the new Nontraditional Equity U.S. Category Group.
- The Long-Short Credit category will be retired, and funds in this category will move to Nontraditional Bond.
- The Options-based category is splitting into two new categories: Derivative Income (in the Equity Global Broad Category Group and Nontraditional Equity U.S. Category Group) and Options Trading (staying in the Alternative Global Broad and U.S. Category Groups).
- The Volatility category will be retired, and funds in this category will move to Options Trading.
- Multialternative is splitting into two new categories: Multistrategy and Macro Trading.
- Market Neutral is splitting into two new categories: Equity Market Neutral and Event Driven.
- Relative Value Arbitrage is being introduced as a new category.
- The Managed Futures category will be renamed Systematic Trend, to align category names globally.
- The Single Currency category will move to the Taxable Bond U.S. Category Group. The Multicurrency category will be retired, with absolute return-oriented strategies moving to Macro Trading and benchmark-

oriented strategies moving to the Emerging-Markets Local-Currency Bond or World Bond categories, as appropriate.

- Trading categories will be removed from Alternatives to the new Miscellaneous U.S. category group.

When will alternative category changes take place?

The changes to alternative categories will take place on April 30, 2021.

Why isn't a strategy with short exposure categorized as an alternative?

Many managers in traditional asset classes, particularly in fixed income and asset allocation categories, routinely utilize short exposures, typically via ETFs or derivative instruments, for risk management purposes or as an additional source of excess return. While such measures may modify a portfolio's risk levels, these strategies still primarily provide investors exposure to traditional asset classes. As such, shorting, and derivative use more broadly, should not be viewed as a defining attribute of alternative strategies.

Why is Long-Short Equity moving to the Equity Global Broad Category Group?

Long-Short Equity has long been considered an alternative strategy by many. However, as we think about a strategy's ability to diversify or eliminate traditional market risks, long-short equity strategies often fall short because their returns tend to be highly correlated with equity market indexes. The strategies' short exposure may help temper losses in downturns while still allowing them to participate in some equity market upside, but these strategies can be thought of as *modifying* a portfolio's equity market exposure rather than diversifying it.

By placing the Long-Short Equity category into the Equity Global Broad Category Group, we are signaling to investors that these strategies should be considered as a part of a diversified portfolio's equity allocation. A long-short equity strategy's ability to deliver alpha versus a relevant equity benchmark is a useful way to assess manager success in this area.

Why are certain strategies that trade options moving out of the Options-based category into Derivative Income?

The Options-based category has historically been one of the most heterogenous of the alternative categories. Some strategies are highly correlated to equity markets while others are based on options market volatility structures. Derivative income strategies largely rely on option contracts to generate incremental income on top of traditional equity market return drivers. The common theme here is that strategies that rely on traditional market beta are moving out of alternative categories.

All strategies with a beta value less than 0.6 over a three-year period would typically fall in the revised options trading category, and any options-heavy strategy with a typical beta value between 0.6 to 0.9 would fall into the long-biased derivative income category

Why are Long-Short Credit funds moving back to the Nontraditional Bond category?

The Long-Short Credit category has dwindled in size since its launch in 2016, and we're returning the remaining strategies to their prior home in the Nontraditional Bond category. While long-short credit strategies focus more narrowly on corporate credit markets, they have other key traits in common with nontraditional bond funds. Strategies in both groups often have absolute return objectives and employ shorting, and while some nontraditional bond funds use active interest-rate positioning as a return driver, in practice, both groups of funds have tended to minimize interest-rate risk and emphasize credit exposures. As with long-short equity, these strategies tend to modify their credit exposure rather than diversify it, which makes them a good fit for the Nontraditional Bond category in Fixed Income rather than the Alternative Global Broad Category Group.

Where is the line drawn between the Tactical Allocation and Multistrategy categories?

For a multi-asset strategy to qualify in an alternative category, greater than 30% of a strategy's gross exposure must be allocated to alternative substrategies. Alternative substrategies should provide an 'alternative' exposure to the dominant risk factors found in traditional indices, and as standalone strategies, would generally fall into one of the other Morningstar alternative categories: Equity Market Neutral, Event Driven, Macro Trading, Options Trading, Relative Value Arbitrage, and Systematic Trend. Using derivatives or other hedging techniques to modify traditional exposures does not qualify as an alternative strategy. In most of these circumstances, the strategy in question should reside in the Tactical Allocation category. These investments are typically long-biased in nature, but managers do have some latitude to use alternative strategies on the margin.

What is the difference between a Multistrategy fund and a Global Macro strategy?

Multistrategy funds are either single manager or fund of funds strategies that allocate capital to several alternative strategies. These strategies tend to have a fixed low-to-modest sensitivity to traditional markets thanks to either the market neutral implementation of underlying strategies or cross-correlation benefits between strategies. Macro trading strategies trade a broad range of securities based on a combination of macroeconomic indicators and fundamental data for security selection. Although uncorrelated over a full market cycle, macro strategies tend to be directional over short periods of time, resulting in episodic correlation and the potential for significant drawdowns. Multistrategy funds may include macro trading strategies as one of several alternative strategies in their portfolio allocation.

What are Relative Value Arbitrage strategies?

Trading across a broad range of asset classes, relative value arbitrage managers use fundamental and/or quantitative methods to identify discrepancies in value between related securities. Like event-driven strategies, some positions may be based on corporate transactions, but the profits of the trade are based on the convergence of values between the securities rather than the outcome of the corporate transaction. Some of these strategies can use significant leverage. Examples include convertible arbitrage, volatility arbitrage, fixed-income relative value or capital structure arbitrage and typically have low equity market sensitivity.

Why are single currency funds moving to the Fixed Income Global Broad Category Group, and some multicurrency funds moving to fixed-income categories?

Single currency funds essentially provide exposure to unhedged ultrashort bond instruments issued in a local currency. Because currency exposure is typically the dominant risk factor in unhedged global bond strategies, diversified emerging- and developed-markets currency strategies are a better fit for the Emerging-Markets Local-Currency Bond and World Bond categories, respectively, than an alternatives category. As with global bond strategies, sovereign debt levels and trade deficits, inflation rates, interest rates, and geopolitical events commonly drive outcomes for currency strategies.

Why is the Market Neutral category being split?

Even though the new Equity Market Neutral and Event Driven categories contain strategies that are typically designed to be market neutral, there are major differences in return drivers for the constituents of these categories. In attempting to reduce systematic risk, equity market neutral strategies emphasize issue selection, with profits dependent on their ability to make advantageous long and short decisions. Event driven strategies, meanwhile, typically will hold positions that involve a hard catalyst such as a merger, which means idiosyncratic corporate actions have a greater impact on returns, as does the overall market climate for corporate actions.

Where did the trading strategies go, and why is the Bear Market category being retired?

Trading categories (leveraged commodities, inverse commodities, leveraged debt, inverse debt, leveraged equity, inverse equity, miscellaneous) will be moved to a separate Miscellaneous U.S. Category Group. These categories are typically comprised of ETFs that either provide leveraged exposure to traditional market indexes or inverse market exposure. They are not appropriate for consideration in a diversified alternatives portfolio.

In addition, we're retiring the Bear Market category. Most funds in that category are ETFs that will move to the Trading—Inverse Equity Category. The remaining handful of open-end funds, which don't share the ETFs' advantages as trading vehicles, will also move to Trading—Inverse Equity since they similarly offer short equity exposure.

International Equity

Why is World Large Stock being retired and replaced with World Large-Stock Growth, Blend and Value?

Morningstar continually evaluates our categories to ensure they house similar strategies and are therefore effective in fund comparison across all spectrums of portfolio analysis. Upon review, the World Large Stock category had become too large and warranted differentiation across our style spectrum to ensure global portfolios were compared to their closest peers.

Allocation

Why is Target-Date 2065+ being launched?

This is a routine category launch for our Target-Date series. We typically launch new Target-Date categories when there are 30 unique funds that fall within a retirement date range.

Commodities

Why has Morningstar chosen Bloomberg Commodity TR USD to be the new category index for its commodity categories?

The current category index, the Morningstar Long-Only Commodity Index, is being retired, and the Bloomberg Commodity Index is the most commonly employed diversified commodities market index used by funds in the Commodities Broad Basket Morningstar Category.

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Institutional Categories

Institutional categories are a more granular grouping of our alternative categories, further delineating notable aspects of a strategy that may have an impact on risk and return expectation and expenses.

What is Diversified Tactical Asset Allocation?

A subset of Macro Trading, these strategies typically utilize levered exposure to multiple themes and asset classes such that they are diversified to a point of offering absolute returns. These strategies tend to have persistently lower sensitivity to traditional markets and are intended to have very limited drawdowns. Diversified tactical asset allocation strategies rely on many sources of expected return but often will have relative value exposure to traditional asset classes.

What are Alternative Risk Premia strategies?

A subset of the Multistrategy category, alternative risk premia strategies offer exposure to a diversified portfolio of assets, often in a format designed to be market neutral. Rather than bet on specific asset classes, sectors, or individual securities, these strategies aim to capture the premiums of well-known factors that drive returns across asset classes, such as value and momentum, usually with a modicum of leverage and lower costs.

What are Multimanager strategies?

A subset of the Multistrategy category, multimanager funds, or funds of funds, invest with multiple managers. The advisor has discretion to pick which underlying managers and strategies to utilize within the fund structure. By investing in multiple managers, significant left tail risk is usually minimized, but there are usually higher costs associated with a multimanager program from the added layer of subadvisor fees.

Timeline & General FAQ

Notification Timelines

- 12/31/20 - T-120: category names and ids of what is being launched and/or retired
- 1/29/21 - T-90: +all category indexes and fee-level group assignments
- 2/26/21 - T-60: +draft definitions (internal only)
- 3/31/21 - T-30: +final draft definitions (category change notifications sent individually to fund companies around this date)
- 4/30/2021: All changes databased. It can take up to three business days for all new category changes to flow through to products.

- **When will clients know which category their fund will fall into?** After we propose a change to a fund's category, we notify fund representatives for each investment. Category changes are sent to the fund's advisor in early April with two weeks to challenge our opinion and provide contravening information in a category appeal. Once an appeal is received, the change is escalated and reviewed again by a second group of analysts. This is only applicable for the specific impacted fund companies. For clients who aren't associated with a fund company, such as a wealth manager, we do not provide the list of securities changing categories before Apr. 30 (this is mostly due to of the aforementioned appeal process, where if a fund company is appealing the proposed category change, the final decision on the fund’s placement may be different than the original notification).

- **When will the full peer groups be available? Clients have indicated they want to see in advance where they fall in rank, is this possible?** Unfortunately not, it’s the same response as above where because of the appeal process we do not provide the category changes, including peer groups, until the Apr. 30 release date.

- **Do the category changes affect analyst ratings?** Potentially. The Morningstar Category is used in different parts of the Morningstar methodology for determining a fund’s Analyst Rating or Quantitative Rating. Further details on how Morningstar Categories are used in the Analyst Ratings methodology can be found in the Morningstar Analyst Rating 2.0 methodology paper. If there are category shifts it could impact how funds are reviewed in their peer group or ranking. These Analyst Rating changes won’t happen on Apr. 30, but when the funds are being reviewed by the analysts or when the new monthly calculations are run for the Quantitative Rating.

- **Are there any definitions that might help clients get an idea of what the new categories entail?** The draft definitions will be provided internally 60 days in advance of the change (early Mar.) and the final definitions will be provided 30 days in advance of the change (early Apr.) which will be added to the current category change announcements and can be shared with clients.

- **Can a fund manager make a formal request to be assigned to a specific category for the ones that are splitting into 2 categories?**
  As discussed, assignments for new categories will be sent out in early April to fund managers, and they will have until 4/15 to appeal. If your funds were not selected to change categories, you can still appeal their assignment to be assigned to any category, including newly launched categories. To appeal a Morningstar Category assignment, a fund company representative must submit a Category Appeal using the Category Appeal Center. Fund companies are encouraged to supply additional portfolio metrics and analysis they believe substantiate their proposed category assignment. The category team will then consider the appeal, taking in full consideration of the fund company's analysis, and either approve or reject the appeal complete with Morningstar's tailored response to the fund company's analysis. Appeals must be based on concrete, data-driven reasons that our evaluation and subsequent decision are misguided. Appeals based on methodology differences will not be upheld.

- **Confirmation that the Long-Short Equity category move to the Equity Global Broad Category Group and the new Nontraditional Equity U.S. Category Group will have no impact on Star Ratings.**
  Yes, the Star Rating peer groups are determined within a Morningstar category not within a US Asset Class.