Fact Sheet: The Morningstar Rating

Key Benefits

- The Morningstar Rating is highly-proficient at assessing a fund manager's ability to provide added value for investors.
- Separation of quantitative research (Morningstar Rating) from qualitative research (Morningstar Recommendation) reduces complexity and introduces greater transparency to fund assessment.
- The Morningstar Recommendation provides a clear, actionable distillation of fund analysts' views about an investment strategy.

Background

Morningstar introduced star ratings for managed funds in Australia in April 1998, the first company to do so. Using an easily-identifiable scale from one to five stars, Morningstar Ratings have helped investors and their advisers make more fully-informed decisions about fund managers and their funds, and build and manage better investment portfolios.

Morningstar Ratings for Australian funds are based on a risk-adjusted return quantitative measure, in line with Morningstar's global ratings methodology. Morningstar's qualitative research is separate from the star ratings, and incorporated exclusively in the Morningstar Recommendation. Morningstar Ratings are calculated within fundamentally-based fund categories, enabling more robust peer comparisons.

What It Means for You

The key benefit is that this model is highly-proficient at assessing a fund manager's ability to provide added value for investors. The Morningstar Rating is a pure measure of a fund's delivery of risk-adjusted returns to investors over the last three to five years.

While Morningstar Ratings are solely quantitative measures, our commitment to forward-looking qualitative research remains, as we believe this is critical to helping investors and advisers make informed decisions about fund managers' capabilities.

The separation of qualitative research - in the form of the Morningstar Recommendation - from quantitative research - the Morningstar Rating - reduces complexity, and introduces greater transparency into the intellectual property Morningstar provides for assessing past performance and future prospects. This also increases the universe of funds with Morningstar Ratings, giving greater numbers of investors convenient snapshots of their funds' track records.

Qualitative Research

The Morningstar Recommendation - from 'Highly Recommended' to 'Avoid' - provides a clear and actionable distillation of our fund analysts' views about an investment strategy.

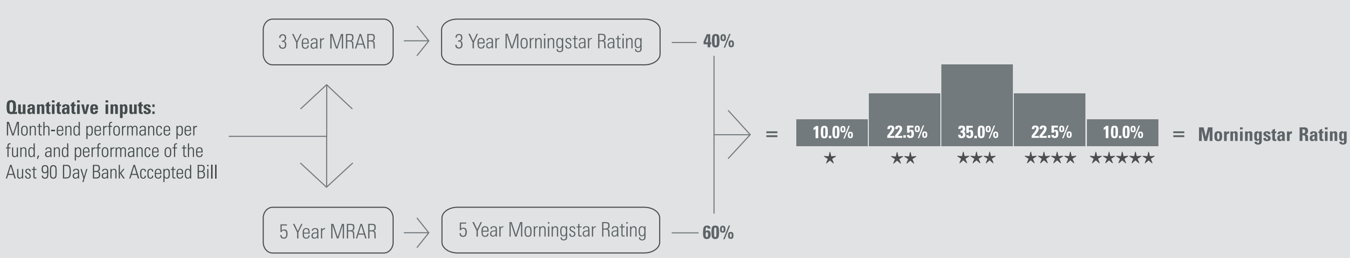
The accompanying report and commentaries focus on key issues and risks, while extensive, regularly-updated holdings, valuation multiples, and performance data offer meaningful insights into current and future performance drivers and outcomes. Readers will understand how a fund manager's philosophy and process translate into security selection, and whether or not the fund manager is staying true to label.

Quantitative Research

Morningstar Ratings are based on a fund's Morningstar Risk-Adjusted Return ('MRAR') measure, the foundation of our quantitative research since 2002, and used by Morningstar globally.

MRAR is motivated by 'expected utility' theory, whereby an investor ranks alternative portfolios using the mathematical expectation of a function (called

How Does the Morningstar Rating Work?



Key Benefits

- The 60:40 five-/three-year Morningstar Risk-Adjusted Return measure rewards consistent good performance over an extended timeframe, and is less subject to short-term performance variations.
- Fundamental, holdings-based Morningstar Categories enable more robust peer comparisons, and help investors and advisers select and combine funds in ways more likely to translate into true portfolio diversification.

the 'utility' function) of the end value of each portfolio. With this basis in expected utility theory, investors are firstly, more concerned about a possible poor outcome than an unexpectedly good outcome; and secondly, willing to give up some portion of their expected return in exchange for greater certainty of return.

Morningstar Rating

So how does it work? Morningstar calculates each fund's three- and five-year MRAR measures, compared with the risk-free rate as measured by the Australian 90-Day Bank Bill Accepted Rate, provided there are enough monthly returns for these periods (36 and 60 month-ends, respectively).

A fund's overall Morningstar Rating is a 60:40 combination of five- and three-year Morningstar Ratings, drawn from the MRAR measures for these periods. This mix rewards consistent good performance over an extended timeframe, and is less subject to short-term variations in fund performance.

Morningstar Categories

A fund's Morningstar Rating is also relative to the MRAR measures of other funds in the same peer group. This makes it even more important that peer groups are constructed appropriately.

Morningstar Categories are therefore built to create well-defined groups, in which constituent funds can be considered direct alternatives. These Morningstar Categories are based on our global Style Box model, which classifies funds according to the market-cap and investment style of the securities in which funds invest.

Grouping similar-style funds together in discrete Morningstar Categories ensures investment styles are treated equally, and helps investors and advisers select and combine funds in ways more likely to translate into true portfolio diversification.