# Submission by Morningstar to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Collapse of Trio Capital and Any Other Related Matters

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# Executive Summary

Morningstar publishes quantitative Morningstar Ratings and qualitative Morningstar Recommendations for Australian managed funds.

Morningstar Ratings are a function of a fund's past performance, a high rating reflecting stronger performance. They are a quantitative, backward-looking measure calculated on the basis of Morningstar's risk-adjusted return quantitative methodology. This methodology is applied by Morningstar globally.

Morningstar Recommendations are based on forward-looking qualitative analyst research on fund managers and their funds. (Morningstar has announced that in the fourth quarter of 2011, Morningstar will adopt a global standardised analyst research model, incorporating a standard designation to be known as the 'Morningstar Analyst Rating'. This will replace the Morningstar Recommendation in Australia.)

Morningstar published quantitative star ratings for some of the funds managed by Trio Capital Ltd (then known as Astarra Capital Ltd) between 2005 and 2009. Those ratings were based on unit prices and distributions reported by Trio/Astarra to Morningstar. Morningstar did not publish qualitative analyst research on or Morningstar Recommendations for the Trio/Astarra funds.

Morningstar believes that the collapse of Trio illustrates the need for greater disclosure and transparency on the part of Australian fund managers and promoters of investment schemes. In particular, Morningstar believes that there ought to be regulation requiring the comprehensive, periodic disclosure of the stocks, bonds, and other securities that make up underlying portfolio holdings.

# Introduction

Morningstar is pleased to respond to the call for submissions to the Inquiry into the Collapse of Trio Capital and Any Other Related Matters (**Inquiry**).

As the Committee is aware, the Inquiry's terms of reference include “the appropriateness of information... provided to consumers”, and “the role of ratings agencies and research organisations in product promotion and confidence”.

In this submission, Morningstar provides an overview of the research it provides generally and, specifically, its quantitative rating of funds that were managed by Trio Capital Limited (**Trio**) (formerly known as Astarra Capital Limited). It also includes Morningstar's recommendation for regulatory reforms around managed fund disclosure obligations.

Morningstar would be pleased to provide any additional information or clarification on request.

# About Morningstar

Morningstar Australasia is an Australian subsidiary of Morningstar, Inc., a leading provider of independent investment research in North America, Europe, Australia, and Asia. Morningstar offers an extensive line of products and services for individuals, financial advisers, and institutions.

Morningstar provides data on approximately 400,000 investment offerings, including stocks, mutual funds, and similar vehicles, along with real-time global market data on more than five million equities, indexes, futures, options, commodities, and precious metals, in addition to foreign exchange and Treasury markets. Morningstar also offers investment management services and had nearly US$140 billion in assets under advisement and management at 31 March 2011. Morningstar has operations in 26 countries.

# Morningstar Ratings and Recommendations for Funds

**The Morningstar Rating**
Morningstar publishes ratings from one to five stars for unlisted managed funds, and has done so in Australia since 1998. These ratings are known as 'Morningstar Ratings'.

A fund's Morningstar Rating is a function of its past performance. It is a purely quantitative, backward-looking measure calculated on the basis of Morningstar's risk-adjusted return quantitative methodology. That methodology is applied by Morningstar globally. Under the model, funds that have produced higher returns over time while taking less risk will achieve a higher rating than funds that have produced lower returns over time while taking more risk.

Morningstar recalculates and republishes star ratings on a monthly basis for all Australian funds on Morningstar's database that have at least three years' performance history and are also part of a Morningstar category (a group of similar, alternative, funds) with a large enough peer group. The ratings are determined within fund categories, thereby enabling comparison between similar funds. The ratings are based on unit prices and distributions provided by the fund manager. Morningstar's fund research analysts do not have any input into the ratings.

In order to be added to the Morningstar database, a fund must have a product disclosure statement registered with the Australian Securities & Investments Commission. Morningstar's database contains audit checks, although Morningstar ultimately relies on fund managers and their agents providing accurate information.

The star rating was designed, in part, to reduce investor focus on short-term returns. The rating is calculated on long-term returns, is risk-adjusted, and is assessed relative to other funds in a similar category. For these reasons, we believe the rating is a better assessment of past performance than the one-year return, for example.

Morningstar does not charge or accept payment from fund managers to calculate and publish star ratings on particular funds. Fund managers are entitled to use the rating in their promotions as part of licensing agreements with Morningstar for the handling of fund data. Morningstar Ratings are published widely in locations including Morningstar's Australian retail website www.morningstar.com.au, software platforms for financial advisers and institutional investors, tables in newspapers and magazines, third-party websites, and fund manager advertisements.

When fund managers choose to license the right to republish the star ratings for their funds, our licensing agreements require them to quote the Morningstar Rating definition below in its entirety and without edits:

> "The Morningstar Rating is an assessment of a fund's past performance – based on both return and risk – which shows how similar investments compare with their competitors. A high rating alone is insufficient basis for an investment decision."

Our licensing agreements also make it clear that:

**"Language should not be used that depicts the Morningstar Rating as an endorsement of a referenced fund**
The Morningstar Rating is based on an objective, mathematical calculation, and is not to be construed as an endorsement of any fund.

*Incorrect Usages*
Fund XYZ was awarded Morningstar's highest rating!
Fund XYZ earned 5 stars!"

The following documents discuss the Morningstar Rating methodology in more detail.
http://corporate.morningstar.com/au/documents/MethodologyDocuments/MethodologyPapers/Rating_Methodology.pdf

http://corporate.morningstar.com/au/documents/MethodologyDocuments/FactSheets/MRARIllustrated_Factsheet.pdf

http://www.morningstar.com.au/Funds/MorningstarRatings

**The Morningstar Recommendation/Analyst Fund Research**
Separately to the Morningstar Rating, Morningstar also publishes forward-looking qualitative analyst research on Australian fund managers and their funds. These assessments are called the 'Morningstar Recommendation', and are on a five-point scale from 'Highly Recommended' to 'Avoid'. The Morningstar Recommendation signals the extent to which Morningstar recommends the fund for financial advisers and investors to consider using in investment portfolios.

The purpose of the Morningstar Recommendation (Morningstar's qualitative analyst fund research) is to determine which fund managers and funds deserve the attention of advisers and investors, and which do not. Morningstar assesses fund managers on the basis of how we believe they will perform in the future over an economic cycle, against both peers and accepted benchmarks. The analyst research model rewards managers that are open and transparent, have a well-run investment process, and importantly, are good fiduciaries of investors' monies.

The qualitative research assesses a fund manager's capacity in an asset class in five key areas: the investment people; the investment philosophy and process; the composition of the investment portfolio, and how it reflects the process; the fund manager's parent; and the performance track record. The portfolio and performance are considered as key outcomes of the investment process.

Morningstar is transitioning all global fund analyst research to a global standard model in the fourth quarter of 2011. This will result in the publication of a designation to be called the 'Morningstar Analyst Rating' which in Australia will replace the Morningstar Recommendation. The following document discusses the global analyst research methodology in more detail.
http://global.morningstar.com/AnalystRatingForFunds

Morningstar does not charge or accept direct payment from fund managers to undertake analyst qualitative research. Morningstar selects funds to assess on the basis of several key criteria, including analyst assessment of investment merit, demand from our financial adviser clients and investors, and asset size. If a fund manager wishes to license the use of this intellectual property, then they are charged a licensing fee by Morningstar. There is a strict separation between Morningstar's sales staff (who license the ratings and research) and the analyst staff (who produce the research).

# Morningstar Ratings for Trio/Astarra Funds

Morningstar published quantitative Morningstar Ratings (star ratings) for a number of Trio/Astarra funds between 2005 (or the subsequent point at which the individual Trio/Astarra fund achieved a three-year performance record) and the market announcement of the detection of the alleged fraud in 2009.

In determining the ratings for funds managed by Trio/Astarra, Morningstar applied its standard methodology, discussed above. In applying that methodology, Morningstar relied upon unit prices and distributions reported by Trio/Astarra to Morningstar. Based on that information, the Morningstar Ratings for the funds varied over time, consistent with our methodology.

The following table shows the ratings for the retail and wholesale Astarra Strategic Funds from 30 November 2008 (the point at which the funds first achieved a rating) to 31 August 2009 (the month before the alleged fraud was made public). (The funds did not receive star ratings at the 31 March and 31 July 2009 month-ends, because Trio/Astarra did not supply information to Morningstar by our deadline for calculation and publication of ratings.)

**Morningstar Ratings – Retail and Wholesale Astarra Strategic Funds**

| Fund Name | Month-End | Morningstar Rating |
|---|---|---|
| Astarra Strategic Fund Retail | 31-Aug-09 | ★★★ |
| Astarra Strategic Fund Retail | 30-Jun-09 | ★★★ |
| Astarra Strategic Fund Retail | 31-May-09 | ★★★ |
| Astarra Strategic Fund Retail | 30-Apr-09 | ★★★★ |
| Astarra Strategic Fund Retail | 28-Feb-09 | ★★★★ |
| Astarra Strategic Fund Retail | 31-Jan-09 | ★★★★ |
| Astarra Strategic Fund Retail | 31-Dec-08 | ★★★ |
| Astarra Strategic Fund Retail | 30-Nov-08 | ★★★★ |
| | | |
| Astarra Strategic Fund Wholesale | 31-Aug-09 | ★★★ |
| Astarra Strategic Fund Wholesale | 30-Jun-09 | ★★★ |
| Astarra Strategic Fund Wholesale | 31-May-09 | ★★★ |
| Astarra Strategic Fund Wholesale | 30-Apr-09 | ★★★★ |
| Astarra Strategic Fund Wholesale | 28-Feb-09 | ★★★★ |
| Astarra Strategic Fund Wholesale | 31-Jan-09 | ★★★★ |
| Astarra Strategic Fund Wholesale | 31-Dec-08 | ★★★★ |
| Astarra Strategic Fund Wholesale | 30-Nov-08 | ★★★★ |

Morningstar entered into a licensing agreement with Astarra Capital in June 2008, by which Morningstar granted to Astarra Capital a non-transferrable, non-exclusive license to publish Morningstar Ratings on three of Astarra Capital's funds, on the terms set out in the licensing agreement. Those terms required Astarra, when publishing Morningstar Ratings, to publish the Morningstar Rating definition set out above. (Morningstar did not publish a forward-looking Morningstar Recommendation for any of the Trio/Astarra funds.)

# Regulatory Reform Issues

**Need For Greater Disclosure and Transparency**

We believe that the Astarra/Trio case illustrates the need for greater disclosure and transparency on the part of Australian fund managers and promoters of investment schemes, in particular the comprehensive, periodic disclosure of the stocks, bonds, and other securities that make up the underlying portfolio holdings.

Currently, Australia does not require fund managers to disclose their portfolio holdings regularly and comprehensively. Australian investment scheme providers, fund managers, and superannuation funds currently utilise a mish-mash of voluntary approaches to disclosing information about the assets they own. Some disclose information on a monthly basis, some quarterly, and some not at all. Some only disclose their top 10 holdings, and some nothing at all.

Australia lags global best practice in this area. US mutual funds, for instance, are required to disclose portfolio holdings by filing quarterly reports with the US Securities & Exchange Commission. In two Morningstar studies of global managed fund investor experiences published over the past three years, Australia and New Zealand were the only countries among the 16 assessed that do not require funds to make regular, full disclosure of their portfolio holdings (http://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf). Disclosure by funds in Australia is also poor when compared with the extensive mandatory disclosure requirements imposed upon listed securities.

An obligation on funds to regularly and comprehensively disclose portfolio holdings would assist researchers, investors, financial advisers, and other market participants to detect deviation from stated investment mandates. Enhanced disclosure would also enable parties to gain a greater understanding of the characteristics and specific risks associated with the assets in which monies are being invested. The level of illiquid assets in a portfolio would also be more readily observed. Such disclosure would also provide greater opportunity for detection of undesirable investment manager behaviours such as excessive turnover.

Mandatory disclosure of portfolio holdings would ensure that investors, researchers and other market participants have available uniform and consistent information about funds' portfolio holdings. It would thereby increase equity between investors and increase consumer confidence in the investments industry. Most importantly, it would create an information platform that would drive better assessment of investments and their associated risks.