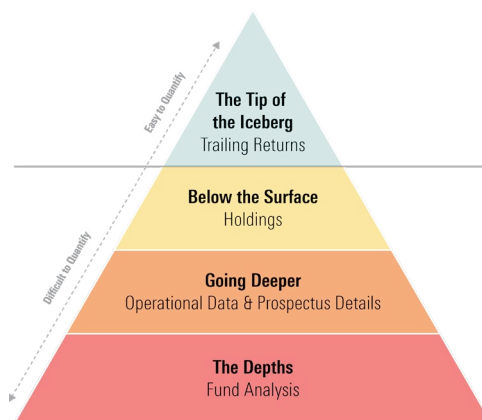


Looking Beyond Returns

KYP Done Right

It is often said that 90% of an iceberg's mass is below the surface of the water.



As part of the Canadian client focused reforms and according to [National Instrument 31-103 Section 13.2.1\(2\)](#):

“A registered individual must not purchase or sell securities for, or recommend securities to, a client unless the registered individual takes steps to understand the securities, including the securities’ structure, features, risks, initial and ongoing costs and the impact of those costs.”

Morningstar has [talked at length](#) about fees and the impact of fees over time, but what does it mean to understand structure, features, and risks?

The Tip of The Iceberg

Looking Backwards

When presented with a very broad set of choices, our inclination is to lean on quantifiable, objective and readily available data. In the investment fund world, fund returns, a largely commoditized data set, provide a great first look. Sliced in certain ways, historical returns are used to produce several risk metrics, the most basic being standard deviation, [an unfortunate proxy](#) for risk that has become standard for funds to disclose on a Canadian Fund Facts document, providing an incomplete picture when used in isolation. Though returns provide useful information on the prior success of a fund, they don’t paint the full picture.

Fact: Morningstar Canada independently collects returns and NAV data for 21,000 share classes of Canadian-domiciled mutual funds and 1400 Canadian-domiciled ETFs. A database built leveraging local expertise while harnessing the efficiency of our global data centers.

Fact: Morningstar’s data includes multiple measures of risk, most notably the [Portfolio Risk Score](#), a holdings-based methodology that measures a portfolio’s level of risk compared with [Morningstar’s Target Allocation Index](#) family which can be applied to client portfolios, model portfolios, proposed portfolios, or individual managed investments.

Below the Surface

What's Inside?

Though fund returns are a great start, they don't give you nearly enough information to properly assess whether the product belongs in a portfolio. For this, we turn to the next most readily available data: holdings. This data provides information to help advisors with asset allocation, and increasingly to ensure [non-financial preferences](#) are being met. Holdings are useful when comparing products with the assumption that investment funds with similar asset allocations and exposures should behave similarly, allowing investors to identify better managers within an asset class. Moreover, having detailed insights and independent analysis on the holdings themselves provides advice givers with the ammunition needed to power client conversations.

Fact: Canadian regulatory standards require that full holdings are disclosed only bi-annually, for funds that are governed by NI 81-102 (mutual funds and ETFs). Morningstar's database houses full holdings for 8000 unique Canadian-domiciled managed products, the majority of which are updated on a monthly basis.

Fact: Morningstar houses the largest independent equity research team in the world (120 analysts covering 1500 global equities). Our [equity valuation methodology](#) distills down to easy-to-read ratings and talking points on individual issuers, revolving around the concept of [economic moats](#), a concept that resonates with investors of all levels, most notably with the Oracle of Omaha, Warren Buffet.

Fact: Morningstar Sustainalytics' is a world leader in ESG research covering 17,500 issuers globally. As investors increasingly demand to align investments with personal values, having insights about what facets of the market and what companies exhibit financially material risk from environmental, social, or governance factors are of utmost importance.

Did you know: Morningstar's predecessor founded the [Canadian Investment Funds Standards Committee](#) 25 years ago, empowering Canadians with an industry-accepted framework to classify funds based on holdings information. The 2023 committee is chaired by Morningstar Canada's Director of Manager Research.

Going Deeper

What's Really Happening?

If the Canadian regulation requires that an advisor takes step to understand the features of an investment fund, then a detailed read of a fund's prospectus and associated documents is an absolute requirement. Unfortunately, these heavy documents are not written with a retail investor in mind, requiring some level of skill to comprehend. Regardless, they capture several dimensions that are equally if not more important than what returns and holdings information provide. Some important questions it can answer include:

- Is the fund actively managed, passively managed, or some combination?
- Does the fund hold other funds?
- Are derivatives like options and futures being used, and if so, how?
- What components are sub advised, and by whom?
- Does the fund invest broadly in a theme, like robotics or big data?
- Does the fund follow a sustainable investment approach?
- For balanced funds, what is an acceptable range of the mix between stocks and bonds?
- Who manages the fund and how long have they been doing it?

These important dimensions provide insights into the management of the fund that is simply not visible by looking at holdings and returns. Only when an investor understands the stated objective of the investment, and what strategies the fund manager plans to use to achieve them, can they understand and measure whether an investment is meeting those objectives.

Fact: Canadian regulations do not require a specific person to be named as the portfolio manager within the fund prospectus. Morningstar collects this information independently and the information drives our forward-looking analyst ratings.

Fact: Morningstar considers information from the prospectus and associated filings as operational datapoints. Globally, we process on average of 5.6 million of these datapoints monthly using an arsenal of AI/ML models to extract information on a timely and efficient basis.

Fact: Morningstar led the launch of the CIFSC Responsible Investment Identification framework in Canada, aligning it closely with local regulatory guidance and our own [Sustainable Investing Framework](#).

The Depths

The Hard Stuff and
Morningstar's Foundation

Morningstar's mission to empower investor success is relentlessly driven by our global research teams, who for the last 35 years (and for the foreseeable future) operate independently from issuers, distribution networks, and asset managers – a particular rarity in the vertically integrated Canadian market. Within the investment fund space, our researchers believe that there are three components that drive an investment fund's future success:

Parent: We believe the parent organization is of utmost importance in evaluating funds. Although other factors may have more immediate impact, they would not be sustainable without backing from the fund firm. Further, the fund firm and its management set the tone for key elements of our evaluation. We prefer firms that have a culture of stewardship and put investors first to those that are too heavily weighted to salesmanship. The former tends to operate within their circle of competence, do a good job of aligning manager interests with those of funds owners, charge reasonable fees, and treat fund owners' capital as if it were their own. The latter might be characterized by their view of fund investors as sales opportunities— they tend to offer faddish products in an attempt to gather assets and have higher charges and incentive programs that do a poor job of aligning managers' interests with those of fund investors. Although relatively few firms fall obviously at one extreme or another, determining where a fund company falls on the spectrum is a key part of our research approach.

People: The overall quality of a strategy's investment team is a significant key to its ability to deliver superior performance relative to its benchmark and/or peers. Evaluating a strategy's investment team requires that our analysts assess their experience, ability, stability, and alignment of interests.

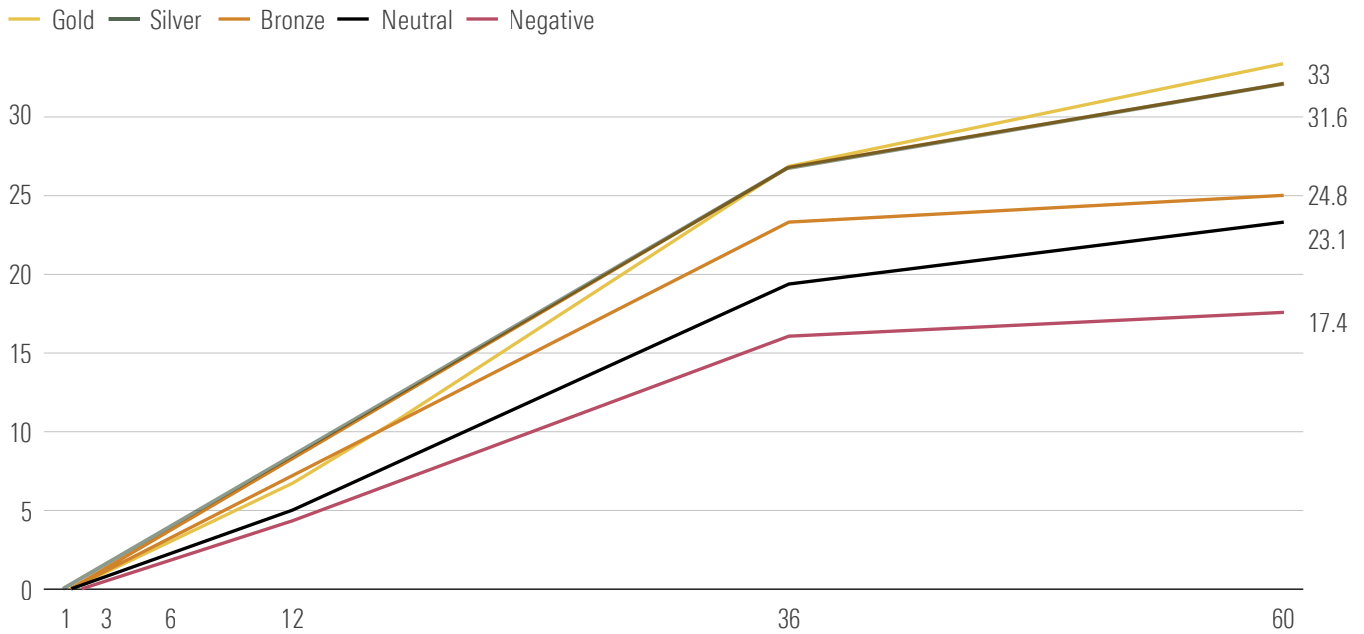
Process: Our analysts are agnostic to a manager's overall style, meaning that for equity managers, we do not prefer value to growth or momentum, or vice versa. For fixed-income managers both high-quality and credit-sensitive styles are viable. For multi-asset class funds, a wide range of approaches to asset allocation can succeed. We look for funds with a performance objective and investment process, for both security selection and portfolio construction, that is sensible, clearly defined, and repeatable. It must also be implemented effectively. In addition, the portfolio should be constructed in a manner that is consistent with the investment process and prospectus objective. Our analysts look to define the key edge of a manager's process, and the suitability of the fund for different types of investors given the risks we would expect to see in its portfolio.

Performance and Price both play an important role and are used as core inputs to our ratings methodology in addition to the above pillars. Together, these pillars lay the foundation of our forward-looking medalist ratings, providing a true 360-degree view of an investment fund, far beyond returns, holdings, or what is disclosed in regulatory filings.

Do They Work?

The below study outlines the ex-post (after the fact) performance of funds sorted by their point-in-time medalist ratings. We believe that the ratings system has performed as one would expect. On aggregate, funds that have been granted medalist ratings (gold, silver, bronze) outperform those that have received neutral or negative ratings in the subsequent periods after the ratings date, tilting the odds of success in the investor's favor.

The Effectiveness of Morningstar Medalist Ratings in Canada



| Months from Rating | 1 | 3 | 6 | 12 | 36 | 60 |
|--------------------|-------|------|------|------|-------|-------|
| Gold | 0.0% | 1.3% | 3.3% | 6.7% | 26.6% | 33.0% |
| Silver | 0.0% | 1.4% | 3.5% | 7.6% | 26.6% | 31.6% |
| Bronze | -0.1% | 1.3% | 3.4% | 7.5% | 23.2% | 24.8% |
| Neutral | -0.1% | 1.1% | 2.6% | 5.3% | 19.5% | 23.1% |
| Negative | -0.1% | 0.8% | 2.2% | 4.4% | 16.0% | 17.4% |

Source: Morningstar Research Inc. | Data includes Ratings from August 2018—September 2023, n = 14898

Future performance aside, the pillars of our manager research (and accompanying commentary) provide ample information for an advice giver to truly understand an investment fund in detail.

Fact: The Morningstar medalist rating encompass a portfolio manager's full history, including other funds they've managed in the past

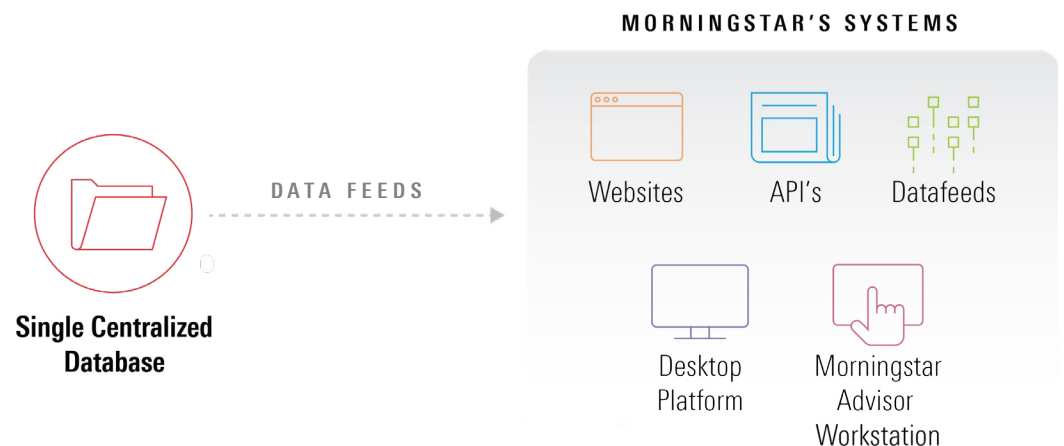
Fact: Our global research footprint provide great efficiencies and insights from other markets, enabling timely insights about well-established managers that are new to the Canadian market

Did you Know: [According to Canadian regulators](#), firms that only recommend proprietary products (in-house funds) must regularly show that those products are competitive with non-proprietary products on the market to avoid a conflict of interest.

So What?

Ensuring you have a well-rounded knowledge of a fund's characteristics is certainly more involved than comparing historical performance and fees. We strongly believe that having a reasonably deep insights provide great opportunity to connect with clients and prospects, further cementing the [value of advice](#).

Connected at the Centre: Morningstar's systems, whether it be our public web sites for retail investors, our API's powering advisor portals, our datafeeds, our flagship desktop platform, or the widely used Morningstar Advisor Workstation source their data from a single centralized database, ensuring a single source of truth within a firm and across the Canadian industry.



**Does your KYP process cover the whole iceberg?
If not, contact us.**