

Net Expense Ratio Changes FAQ

Why has Morningstar introduced a change to the Net Expense Ratios?

Morningstar made this methodology change so that our published net expense ratio data point would comply with existing regulatory guidance.

When is this change taking place?

The revised data will be loaded into the data base on **July 31, 2018**, to be in line with month-end production.

Why do Net Expense Ratios prior to the change not match the fund company disclosure documents?

The clear majority of Net Expense Ratios Morningstar publishes do match disclosure documents. However, when fund companies engage in shorting, Morningstar backs out the interest and dividend expenses on borrowed securities to calculate the Net Expense Ratio we database and publish.

Why does Morningstar not back out dividend and interest expenses on short sales in the Net Expense Ratio?

Philosophically, Morningstar views the short interest and dividend expenses as trading costs that are intrinsic to the fund's strategy. Morningstar elected to exclude interest and dividend expense from the Net Expense Ratio to provide the end investor with an apples-to-apples comparison of expense ratios. For example, funds that employ shorting strategies or reverse-repo transactions are required to report interest expense in the Annual Report whereas funds that employ futures, swaps, TBAs, and forwards are not required to report the cost associated with those instruments as interest expense.

Does this only impact Prospectus Net Expense Ratios?

No, Morningstar will use this opportunity to enhance the Annual Report Net Expense Ratio to follow existing regulatory guidance.

Does this only affect the Net Expense Ratios? What about the Gross Expense Ratio?

There is no change to the Gross Expense Ratios Morningstar publishes, because gross expense ratio currently matches disclosure documents.

How is Net Expense Ratio defined after the change?

Prospectus: Total Annual Fund Operating Expenses after Waiver and/or Expense Reimbursements

Annual Report: Found in the "Financial Highlights" section of the Annual Report. Usually this will be called "Ratios of expenses to average net assets AFTER expense reimbursement and/or fee waiver, recoupment, including interest and dividend expense for securities sold short"

Will there be a Morningstar Direct product release for this change?

No, the underlying data in the currently published fields will update without any need for product adjustments.

What are the universes that are impacted by this change?

Open End Funds, Exchange Traded Funds, Exchange Traded Mutual Funds, Money Market Funds, 529 Portfolios, Closed End Funds and Unit Investment Trusts.

Will any report disclosures be updated by this change?

Yes, the Mutual Fund Investment Detail Report, Mutual Fund Comprehensive, ETF Investment Detail Report, Fund vs. Fund, Portfolio Comparison Report and CIT Investment Detail Report will have the Net Expense Ratio disclosure language updated on July 31, 2018.

What are the funds that are impacted by this change?

The majority of funds impacted by the change are those that engage in short selling. Currently, we estimate that the number of funds that have interest or dividend expenses in their disclosure documents to be about 550. 30% of the funds impacted are in the Long-Short Equity, Multi-alternative and Market Neutral categories.

Are there any downstream impacts to the restatement of the Net Expense Ratios?

Yes, Gross Returns and Fee Levels and Rankings.

How does this impact Fee Levels and Ranks?

Fee Levels and Ranks uses the Prospectus Net Expense Ratio and will be impacted by the increases in the net expense ratio.

How does this impact Gross Returns?

Morningstar's Gross Returns calculation uses the Annual Report Net Expense ratio for the associated month of return. Because we will be updating the past 3 years of Annual Report Net Expense ratios, the calculation will be receiving the new higher expense ratio input. Because of this, the gross returns for impacted funds will be increased because more expense will be added back to the total return.

Then some funds will now have improved Gross Returns from those that do not have interest and distribution trading expenses?

Yes, that is true, but for the highest impacted categories, many funds will experience this adjustment, so a rising tide lifts *most* boats. However, to quote Josh Charlson's article "Tallying Up the Cost of Short Interest Expenses," 'Annual report and prospectus net expense ratios are perfectly adequate starting point [to evaluating an investment], but any time a manager uses complex strategies like shorting, it behooves an investor to dig deeper.'

How many years of Expense Ratios will be restated?

Prospectus: The most recent Prospectus Net Expense Ratio is the only Prospectus Net Expense Ratio that Morningstar publishes. I.e., the most recent Prospectus Net Expense Ratio will be restated.

Annual Report: The Annual Report Net Expense Ratio is stored as a time series. In line with normal restatement methodology, we will be restating 3 years of Annual Report Net Expense Ratios.

I understand that Morningstar is required to make this change, but will this alter the way Manager Research evaluates the cost of a fund?

No, Morningstar's research will remain its own intellectual property.

Why is there such a large increase in some Expense Ratios?

Effectively, Morningstar had previously been publishing a synthetic expense ratio, which removes the costs associated with interest and distributions on short sales. Now, Morningstar will be matching the Net Expense Ratio on the disclosure documents verbatim.

What if a fund's disclosure document has footnotes under the fee table describing a "cap" or another fee adjustment to the table?

Morningstar will not include any fee adjustments outside of the fee table.

Will Morningstar make available the data aligned with your current methodology?

Yes, due to this update Morningstar made the decision to create 2 net new Morningstar data points, which will be known as Annual Report Adjusted Operating Expense Ratio and Prospectus Adjusted Operating Expense Ratio. These data points were created as Morningstar wants to provide investors an apples-to-apples comparison of expense ratios using our current methodology which excludes interest and dividend expense on short sales from the calculation. Morningstar believes these data points will satisfy both the investor transparency for comparing investments and the cost evaluation process researchers use.

When should these data points be used instead of the Prospectus Net Expense Ratio and Annual Report Net Expense Ratio?

Please use your discrepancy on when the data will be best suited for your insight and/or research. Depending on the leveraging techniques employed by the fund, the fund may or may not be required to report interest expense. For example, funds that employ shorting strategies or reverse-repo transactions are required to report interest expense in the Annual Report whereas funds that employ futures, swaps, TBAs, and forwards are not required to report the cost associated with those instruments as interest expense. In addition, interest costs in general can vary widely depending on the economic environment, the tools involved, and the magnitude in which they're being used. Therefore, the new data points will provide you to see data that excludes interest and dividend expense on short sales.

Where will these data points be available?

These new data points will be available in Office and Direct Web Based.