Appearance by Morningstar Australasia Chief Executive Anthony Serhan at Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Collapse of Trio Capital and Any Other Related Matters

23 September 2011

MORNINGSTAR™

Prepared by: Morningstar Australasia Pty Ltd
Level 36, Australia Square
264 George Street
Sydney NSW 2000
www.morningstar.com.au

+61 2 9276 4456 Phone
+61 2 9276 4545 Fax

Introductory Statement

I'd like to thank the Committee for the opportunity to participate in the public hearing into the collapse of Trio Capital and related matters. In my opening comments I'd like to reiterate some of the key themes in our submission.

I should clarify at the outset that I am speaking in my capacity as chief executive of the Australian and New Zealand businesses of Morningstar. I can therefore address specific issues about our business, and about the business of undertaking investment research more generally, but cannot answer specific questions about other research firms and what they did or did not publish with respect to Trio/Astarra and its funds.

Perhaps if I could begin with a very brief overview of the Morningstar business, again drawing on some of the material in our submission. Morningstar is an independent investment research firm, listed on the NASDAQ stock exchange in the United States, whose founder owns nearly half of the company. We've been operating in Australia and New Zealand under the Morningstar banner since 1999.

In terms of the Trio/Astarra funds, we published star ratings for a number of Trio/Astarra funds between 2005 and 2009. These star ratings are a quantitative, backward-looking metric designed to measure relative risk-adjusted performance. These ratings were based on unit prices and distributions data we received from Trio/Astarra. Our fund research analysts did not undertake research on Trio/Astarra or its funds, and we did not put them forward for use by financial planners in model portfolios.

Finally, again as we outlined in our submission, we believe that the Trio/Astarra case illustrates the need for greater transparency and disclosure on the part of Australian fund managers. We believe that by showing on a regular basis exactly what their funds are investing in, this will increase the likelihood of detection of deviation from stated investment mandates. It will also help investors, advisers, and other parties gain a greater understanding of an investment's characteristics and specific risks, and hopefully also reduce the potential for another Trio/Astarra situation to occur.

Statement of Matters

INFORMATION

What information does Morningstar use to develop its ratings and recommendations?

The basis of the Morningstar Rating (the quantitative assessment) is information received from fund managers, specifically fund unit prices, distributions, and other information we collect from funds' product disclosure statements. The basis of the Morningstar Recommendation (analyst research assessment) includes the fund's product disclosure statement, a standardised information presentation prepared by fund managers for use by researchers, database analysis by the research analyst, interviews with the personnel running the fund, peer review both locally and globally, and production and publication of a detailed research report justifying and expanding on the analyst recommendation.

How does Morningstar check the veracity of that information?

For the underlying data upon which the quantitative star rating is calculated, we have a series of audit checks on our database. For instance, when a unit price for a fund moves above or below a certain amount from the previous price, that piece of data is quarantined until a data analyst has checked with the fund manager or their agent whether or not the information is correct. There are also other database audits for specific data, such as fund sizes and asset allocations. Ultimately, however, in terms of the data upon which the star ratings are based, we rely on fund managers or their agents to provide accurate information.

The veracity of the information provided by fund managers in the analyst research process is tested by analyst observation, assessment, and judgement. For instance, if a fund manager states that its portfolio contains only 100 stocks, and we see from portfolio holdings-based analysis that over time the portfolio has had 200 stocks, then our analysts would challenge the fund manager on the point.

Does Morningstar examine or verify a fund's underlying assets?

Morningstar does not examine or verify a fund's underlying assets, except to the extent that the fund manager is prepared to disclose detailed information relating to portfolio holdings. We have consistently advocated standardised, periodic disclosure of portfolio holdings on the grounds that this would enable identification of a fund's underlying assets, and help investors and other parties understand more about the fund's essential characteristics and risks.

Does Morningstar publish all the research it does including negative findings?

Morningstar publishes all Morningstar Ratings and Recommendations it undertakes, including negative findings, to our adviser clients directly, in our software, on our website for retail investors, and to the media.

How does Morningstar decide which research it publishes?

Morningstar Ratings (the quantitative assessments) are published for all Australian unlisted managed funds with at least three years' performance history in a peer group category with sufficient funds for normal distribution. We recalculate and republish the star ratings monthly.

Morningstar selects funds to undertake analyst research on the basis of key criteria including analyst assessment of investment merit, demand from financial adviser clients, and asset size. Once a fund has been selected for inclusion in our coverage list we will publish a Morningstar Recommendation regardless of the outcome. Equally, a fund continues to be covered until Morningstar, and not the fund manager, elects to cease coverage. Morningstar does not charge or accept payment from fund managers for the production of Morningstar Recommendations or ratings.

DISCLOSURE

Morningstar, in its submission, argues for greater disclosure and transparency on the part of Australian fund managers and promoters of investment schemes. If fund managers are currently not required to provide full disclosure of portfolio holdings, how confident should investors be that ratings and recommendations provided by Morningstar are robust?

The Morningstar Rating is a quantitative measure, designed to assess relative risk-adjusted performance, and based on established behavioural finance theory. As such, the robustness of the Morningstar Rating does not depend on the disclosure of portfolio holdings. Portfolio holdings do assist with allocating a fund to an appropriate Morningstar Category, but in the absence of holdings, other factors such as reported asset allocation and offer documents can assist with this process.

Morningstar does not undertake and publish analyst research on funds without full disclosure by the fund manager of detailed portfolio holdings. Nevertheless, as we have advocated, we believe that comprehensive, periodic disclosure of portfolio holdings for all funds offered in Australia (including those upon which Morningstar does not undertake analyst research) would assist investors, financial advisers, superannuation fund trustees, and other market participants to achieve a more complete understanding of funds' characteristics, the nature of the assets in which funds invest, and funds' specific risks.

ASIC in its submission argues for stronger disclosure requirements for research houses and rating agencies to make the methodology used by these entities transparent, and enable users of research to assess the performance of the research house and the quality of that research. What is Morningstar's opinion of this recommendation?

Morningstar agrees that it is important for research houses to be transparent about their research processes and disclose how the research and outputs are produced, and supports ASIC's recommendation for enhanced disclosure requirements. In Morningstar's case, we already place strong emphasis on transparency and disclosure of the methodologies behind the production of our research and ratings. In the case of the quantitative star rating, we publish detailed methodology papers, flyers, and website articles explaining the basis of the rating, the nuances of the model, and what it measures – and what it does not. Additionally, we endeavour to ensure that wherever the star rating is published, it is accompanied by a standard description explaining that the rating is a measure of risk-adjusted performance which is not intended as a recommendation to invest. Similarly, for our analyst research and recommendations, we publish methodology documents and flyers explaining in detail how we produce our research and recommendations. We also publish regular updates on the performance of our analyst recommendations.

Would either of these changes to disclosure requirements have prevented the Trio/Astarra collapse?

Increased transparency surrounding the methodologies used by research houses may well help users of that research gain a better understanding of how the research is produced and what it is intended to convey, but is unlikely to have prevented the Trio/Astarra collapse. To the extent that investors relied on Morningstar ratings and research, lack of disclosure could not have been the problem. As we say above, in Morningstar's case, we already place strong emphasis on transparency and disclosure of the methodologies behind the production of our research and ratings.

The Trio/Astarra collapse was an extreme circumstance, an unprecedented case of systematic fraud. Research houses are not auditors or forensic accountants, or regulatory bodies possessing statutory investigative powers. It is possible that the requirement to disclose portfolio holdings on a regular basis would have led to a more complete understanding of funds' characteristics, the nature of the assets in which funds invest, and funds' specific risks. In addition, such disclosures may have provided a disincentive to the perpetrators of this fraud from entering this market.

COMMERCIAL RELATIONSHIPS

In broad terms, what is Morningstar's business model?

Morningstar operates a 'subscriber-pays' business model in the areas of fund and stock research, whereby Morningstar produces independent research and then financial advisers and investors pay subscriptions for access to our research through our software products and websites. Morningstar does not charge or accept payment from fund managers for the production of Morningstar Recommendations or ratings.

If, after Morningstar produces and publishes the research, a fund manager wishes to license the use of Morningstar's intellectual property, the fund manager is charged a licensing fee. Our analyst staff and sales staff are separate and independent of one another, and we have a strict code of ethics in place.

How independent is Morningstar from the funds it rates?

Morningstar is completely independent from the funds it rates. There is no equity or ownership relationship between Morningstar and the funds it rates, and Morningstar does not charge or accept payment for the production of research or ratings. Morningstar sells its products and services, which include datafeeds, software, magazine subscriptions, and website advertising, to fund managers, financial advisers, brokers, and other financial services businesses.

Does Morningstar receive commissions?

No, Morningstar does not receive commissions from fund managers or investment product providers. Fund managers are among the customers to which Morningstar sells its products and services, which include datafeeds, software, magazine subscriptions, and website advertising. Morningstar analyst staff are remunerated on the basis of a combination of base salary, performance bonus on completion of agreed objectives, and in some cases company equity. Morningstar sales staff may earn sales commissions on the basis of meeting agreed revenue targets. Morningstar also has documented policies relating to the acceptance of gifts and gratuities from fund managers.

RESPONSIBILITY

What is the best way for investors to use the information provided by research houses?

We believe that investors should use the information provided by research houses as part of their investment decision-making. However, this information is no substitute for financial advice. Morningstar requires its licensees to publish its ratings along with a reminder that a high rating alone is an insufficient basis to make an investment decision. Information provided by research houses should be used in conjunction with identification by the investor and/or their financial adviser of the investor's specific situation, needs, age, investment time horizon, risk profile, investment preferences, existing investments, level of financial literacy, and related factors unique to each investor. Additionally, investors and/or their advisers should not consider an individual fund in isolation, but the overall investment portfolio, and what role, if any, that fund should play within the portfolio. Because of this, research houses are not in a position to assess the suitability of an investment product for each individual investor. Investors and/or advisers should also not rely on the headline rating alone in decision-making. Our analyst recommendations, for instance, are accompanied by a detailed report explaining a fund's strengths and weaknesses, including highlighting the principal risks, and we believe that investors and advisers need to read these reports carefully to understand the basis of the analyst recommendation published.

Research houses are one of a range of gatekeepers providing information to the market. To what extent can a research house be held responsible for the ratings and recommendations it provides?

Morningstar's mission is to create products to help investors achieve their goals. This includes the provision of accurate and timely data, the use of due diligence and best endeavours by our research analysts to produce insightful analysis, and maintenance of accuracy and currency in the information and research we publish. Morningstar conducts this research on a best endeavours basis, and clients not happy with the outcomes will terminate their contract with Morningstar. As our business model is built around client subscriptions, we have a strong incentive to produce the best research possible.

However, research houses do not deal with individual investors, and cannot control the way in which investors use the research provided. Research houses should (and Morningstar does) do whatever they can to ensure that investors have access to information about what the research and/or rating is designed to measure – and equally importantly, what it is not intended to measure. That said, research houses do not control decision-making by individual investors and/or their advisers in the use of this information. An individual investor's decisions as to whether or not to invest in a product will also be influenced by their own individual situation, needs, age, investment time horizon, risk profile, investment preferences, existing investments, level of financial literacy, and related factors.

Can investors have confidence in the information provided by research houses?

We believe that investors can on the whole have confidence in the information provided by research houses. This is because research houses' reputations and commercial viability depend on their use of due diligence and best endeavours to produce quality outcomes. However, we also believe that it is encumbent on investors and other users of research to inform themselves fully as to the basis and nature of the research published, the currency of the research, and most importantly, what the research and/or rating are designed to measure – and equally importantly, what they are not intended to measure.