The Morningstar Medalist Rating

How it works and how it has performed.

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Overview

The Morningstar Medalist Rating is evolving, and from September, it will be powered by both analysts and a machine-learning algorithm. This article takes a look at how we scale our analyst effort and how well analysts and the algorithm have performed when it comes to ratings efficacy.

The Morningstar Medalist Rating is our ratings system that is depicted by our Gold, Silver, and Bronze medals. It is powered by our Pillar ratings – People, Process, and Parent. In Australia, those Pillar ratings have traditionally been powered only by our analysts. But as we stare down the barrel of potentially more than 1 million products globally by 2026, we recognise that even our large global team of more than 130 analysts cannot keep pace with this growth. Over the next few months, the Medalist Rating in Australia will evolve to be powered by both analysts and an algorithm to scale our coverage universe.

The History of the Algorithm

Morningstar's machine-learning algorithm is not new. It was developed in Chicago back in 2012 and was launched in major markets in 2017, including the United States and Europe. In Australia, it was working in the background but was suppressed from investor view. We wanted to see how it delivered before making it available to investors here.

Pillar Power—How We Scale Analyst Effort

From September, the Morningstar Medalist Rating's key inputs—the pillars—will be powered in two ways: analyst and/or algorithm. That is, analysts may assign People, Process, and Parent Pillar ratings of High, Low, or something in between to a fund. And where our analysts have not assigned a Pillar rating, the algorithm steps in.

There will also be instances when a fund will receive one or two pillars assigned by an analyst and the remaining pillars are from the algorithm—that is, a mix of both analyst and algorithm. How does this work? When you think about how a lot of funds operate—that is, one Parent firm offers many funds; one investment team runs multiple funds; and some investment processes can be applied across more than one fund—it makes sense that analysts' individual pillar ratings from one fund could be scaled at least partially across these "related" funds. This is part of the magic of the Medalist Rating—it takes the individual pillar ratings an analyst has awarded for a fund and applies that component where it makes sense. It scales our analysts' views.

The most obvious example is our Parent Pillar ratings. When a Morningstar analyst rates a parent, we port over that decision to all strategies offered by that parent. Similar rules and logic exist to extend analyst decisions across the People and Process Pillars. So, a fund "inherits" an analyst pillar rating

where we believe that analyst's pillar rating on one fund is relevant to another fund. As you can see, the pillars are the building blocks of a rating and the key to scaling our analyst effort.

Where our analysts haven't rated a pillar, the algorithm steps in. The algorithm was designed to replicate analyst processes as faithfully as possibly by using fund data such as performance, manager information, and fees.

This means ratings output may be powered in three ways going forward: analyst only; algorithm only, or a combination of analyst and algorithm.

Track Record—Analysts and the Algorithm

Earlier this year, Morningstar's global chief ratings officer took a look at the performance of our ratings assigned to funds available for sale in markets outside the United States, such as Europe, Asia, and Australia. In general, the study found that both the analyst and the algorithm were effective at sorting better funds from worse funds based on their future performance. Higher-rated funds were more likely to survive and outperform than lower-rated funds, though this was more pronounced when measured against the category average than against the costless benchmark index.

The performance results shown below are based on an "event study" in which we took monthly snapshots of the ratings since their inception, tracked performance of the rated funds over a subsequent event horizon, and then averaged the event-horizon returns. For simplicity, the study looked at funds that are covered only by analysts ("Analyst Rating Results") and funds covered by the algorithm or a combination of the analyst and the algorithm ("Algorithmic Rating Results").

Exhibit 1 Analyst Rating Results

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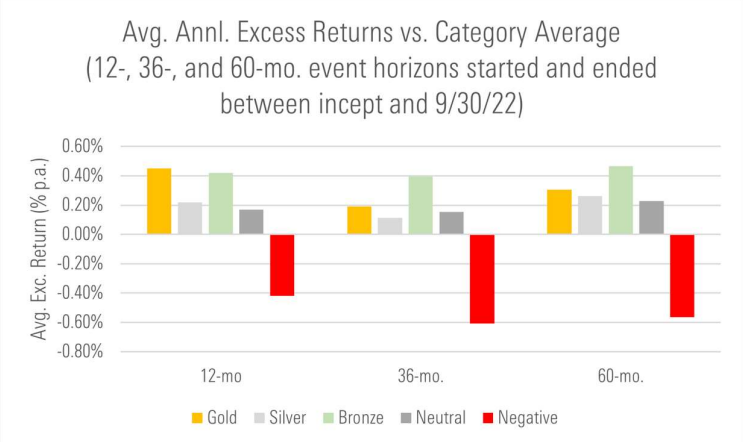

Source: Morningstar Direct. Data as of 30 September 2022.

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As shown above, analysts have done a good job of sorting funds based on future performance—that is, Gold-rated funds produced higher average excess returns (above the category average) than Negative-rated funds.

Exhibit 2 Algorithmic Rating Results

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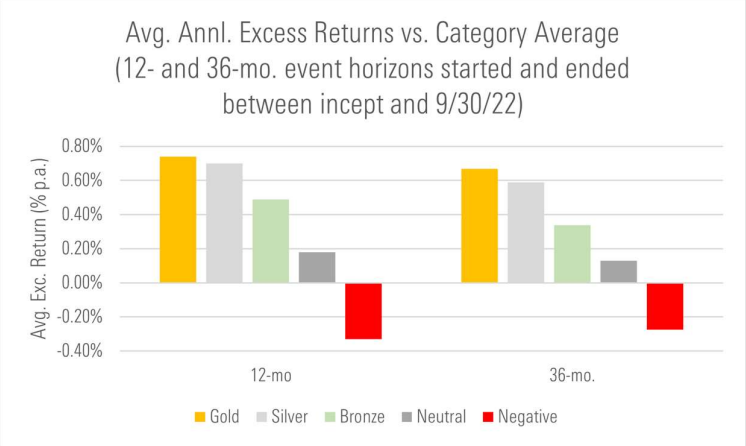

Source: Morningstar Direct. Data as of 30 September 2022.

Although the algorithmic rating approach is still relatively nascent outside the US, it also has done a good job of sorting funds based on their future performance, as measured by their average event-horizon excess returns versus the category average.

The results from both the analysts and the algorithm are pretty good—we are differentiating Medal ratings from Neutrals from Negatives and delivering value against the category average. There is still room for improvement when it comes to delivering results against indexes (versus category averages). And Morningstar is always looking to improve its ratings processes.

What's Ahead?

The Morningstar Medalist Rating is evolving. We look forward to covering a wider range of funds by scaling our analyst effort and leveraging the algorithm. And the performance of our analysts and algorithm to date shows a good ability to differentiate winners from losers. Finally, we look forward to monitoring both our analysts' efforts and the algorithm as we build a longer track record for the Morningstar Medalist Rating in Australia and continuing to improve our processes.

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