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Can Investors Benefit From Using Morningstar's Stewardship Grades?

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Interest in governance led Morningstar to develop a summary measure for mutual fund governance. In contrast to previous work in this area, we focus on whether and how individual investors can use the Stewardship Grade Overall to improve mutual fund selection. We find that regardless of fee structure, top overall governance grade funds impose lower costs on investors regardless of fund investment style. We also find some evidence that choosing funds with the highest stewardship grade may earn positive risk adjusted returns. Stewardship Grade overall may therefore help less sophisticated investors identify better-performing mutual funds.

INTRODUCTION

Growing sentiment in the investment community that investors should consider fund governance in investment decision-making led Morningstar to develop a qualitative measure of governance for mutual funds. Morningstar called the measure the Mutual Fund Stewardship Grade. Fund Stewardship Grades follow a school grading scale, ranging from A for funds Morningstar deems well governed to F for funds they identify as poorly governed. Morningstar promotes Stewardship Grades as a ready indicator of the alignment of interests between fund sponsors and fund shareholders for individual mutual funds. Referring to Jack Bogle's well-known commentary, Morningstar claims that Stewardship Grades can help investors discern whether a fund company's posture toward investors tilts toward salesmanship or stewardship.

Morningstar first released the governance metric for a small number of funds in 2004. Thirteen years on, the number of funds Morningstar has assigned Stewardship Grades has expanded significantly, and the Stewardship Grade Overall remains one of the few readily available summary metrics investors may use to gauge fund governance. As is the case for its fund performance ratings, Morningstar does not instruct investors on how to use Stewardship Grades to select mutual funds. Beyond indicating that they intend the grades to assist investors in navigating fund selection, Morningstar is decidedly unspecific about how to use the metric to improve investment results. Further, while research on Morningstar's measure of fund governance has grown, the extant literature provides investors limited information on how investors may apply the grades in decision-making or the specific benefits of doing so. Our goal in this paper is to address these issues.

Considering the perspective of an individual retail investor, we ask how Morningstar's Stewardship Grade Overall may inform mutual fund selection. Like previous studies, we examine whether Morningstar's governance measure relates to returns to a broad sample of actively managed equity mutual

funds. However, as we argue below, the structure of mutual fund governance may be better suited structured to influence the costs investors face in owning mutual funds than in the returns they earn. We therefore also focus on Stewardship Grade's relationship to investor costs – the expense ratio, transactions costs, and the fee structures funds impose. These characteristics can substantially influence investment outcomes. Further, unlike previous research, we focus on Morningstar's summary measure of governance – the Stewardship Grade Overall. While individual components of the governance metric may be of significant interest to researchers, the question we address is whether Morningstar's summary measure of governance can help identify better performing or lower cost mutual funds. A simple summary measure of fund governance might be especially useful to retail investors or their advisers. [1]

We find strong evidence that mutual fund expense ratios differ across Stewardship Grades. Given the long periods over which investors tend to hold mutual funds according to the Investment Company Institute, choosing lower cost mutual funds can have a substantial impact on investor results from owning mutual funds. An implication of our results is that retail investors who are less inclined to investigate technical details of fund fees and expenses may use Stewardship Grades as a simple screen for low cost funds. Alternatively, retail investors who rely on financial advisers to make mutual fund recommendations may use Stewardship Grades as a means of verifying their advisers are recommending efficient options. Either way, investors can weed out high cost mutual funds by selecting among funds with high Stewardship Grades Overall. Consistent with previous studies, we find mixed evidence on the connection between governance and mutual fund returns. Depending on the measure of risk-adjusted return, we find either no evidence of difference in performance across Stewardship Grade, or we find the highest rated funds may outperform randomly formed portfolios with similar risk characteristics. We also find evidence investors bear different risks in funds with different Stewardship Grades. Finally, we find investors or advisers who form portfolios of funds based on Morningstar style characteristics can use Stewardship Grades to screen out high expense mutual funds.

In the sections that follow, we examine the recent fund governance literature as it relates mutual fund performance. We then describe our sample and data, our methods, our results, and we review the implications of our findings.

RELATED FUND GOVERNANCE LITERATURE

The investment community has long recognized the potential for companies that sponsor and manage mutual funds to take advantage of fund shareholders by earning inferior returns or charging excessive fees. Competition among funds would seem to be the logical first line of defense against this agency problem. In a competitive market, investors that experience consistently low returns or high fees would shift dollars from weakly managed funds to strong performers. Choice and competition would insure survival of the fittest among funds and fund managers. However, Baker, Haslem, and Smith (2009) argue that the actively managed segment of the mutual fund industry differentiates its products extensively to limit price competition. Other factors such as the complexity of the investment process and tax consequences of trading funds may further impede investors from changing funds when performance is consistently weak or costs are particularly high. Many retail investors select funds with assistance from professional advisers who may limit the menu of funds from which investors choose. Similarly, retirement plan sponsors may restrict fund choices for plan participants. Finally, low tax basis investors may be reluctant to move to lower cost funds or funds that earn marginally higher returns when realized capital gains taxes would more than offset the benefits of switching.

If barriers to choice inhibit competition and allow poorly managed, poorly performing, or high-cost funds to survive, mutual fund governance takes on greater importance.[2] Broadly speaking, fund governance defines the relationship between investors and the fund management companies that provide for the bundle of services that make up a mutual fund. In the U.S., the Investment Company Act of 1940 provides the legal framework for establishment of mutual funds and sets out the structure of fund governance. The 1940 act places a number of potential checks on mutual fund companies to limit the potential agency problem between fund companies and fund shareholders. The 1940 act requires mutual

funds to have boards of directors, and it charges boards with representing fund shareholder interests in the management of funds. In principle, mutual fund boards should play a vital role in monitoring fund sponsors and investment managers, enforcing limits on their behavior through oversight, contracting, and hiring alternative service providers. Other mechanisms commonly associated with corporate governance such as the investment manager's contract, the portfolio manager's compensation, board and manager ownership stake in the fund, and distribution channels through which funds are sold also shape the relationship between fund management companies and fund shareholders. These mechanisms may also influence fund returns and expenses.

A key role of a mutual fund's board is to contract with the mutual fund management company and other third parties for the services required to operate the mutual fund. These service costs are a critical determinant of the fund expense ratios. The close relationship between mutual fund boards and mutual fund sponsors and management companies has led a number of authors to question whether board structure may affect fund fees and expenses. Tufano and Sevick (1997) study the relationship between board size, director independence, director compensation, and director workload on fund expenses and fees. They find that smaller, more independent boards are associated with lower investor costs. Rowe and Davidson (2005) and Gemmill and Thomas (2006) find similar results for board size and fees for a closed-end mutual funds. Meschke (2007) analyzes open-end fund board structure and expenses for a more recent sample period. His results are inconclusive with respect to the importance of the number and the proportion of independent directors on a mutual fund's board. However, Meshke finds that mutual funds with independent board chairs tend to have lower overall expenses. Khorana, Servaes, and Wedge (2006) investigate whether the investment manager's ownership stake in a fund he or she manages significantly explains fund expenses. They find an inverse relationship between investment manager ownership stake and fund expenses. They conclude that the investment manager's ownership stake provides an incentive alignment effect that improves fund management efficiency. Ferris and Yan (2007) find that board independence is insignificant in determining fund expenses. However, Ferris and Yan also find board size and director compensation relate statistically significantly to fund expenses. Erzurumlu and Kotomin (2016) study whether brokerage and soft dollar practices of mutual funds explain fund expenses. They find that funds that use soft dollars are more expensive to own but don't provide better return performance. They also examine the relationship between various board characteristics and commissions funds pay for securities trades. They conclude that board characteristics may influence soft-dollar related agency costs of mutual fund ownership.

A growing body of literature also examines the relationship between mutual fund governance variables and mutual fund returns. Tuffano and Sevick, and Ding and Wermers, for example, find that larger boards - but not the level of board independence - relate to better fund performance. Meschke, in contrast finds only weak support for a connection between fund governance variables and fund returns. Deli (2002) and Almazan et.al. (2004) examine contracting as a means of controlling mutual fund manager discretion to act against the interest of fund shareholders. They find limited evidence that contracting explains variation in mutual fund performance. Ding and Wermer's (2005) working paper examines whether investment manager entrenchment or changes in the investment portfolio manager relate to fund performance. Their study also considers the relationship between fund returns and various board characteristics.

Several studies consider the relationship between fund governance variables and outcomes related indirectly to fund performance. For example, Ding and Wermers (2005) examine the relationship between board characteristics and the likelihood of a change in fund investment manager following poor returns. Similarly, Fu and Wedge (2011) study departures of the investment managers of equity mutual funds. They find that director independence at funds with weak returns increases the chance that investment managers will depart. Ding and Wermers also examine whether governance variables predict the likelihood a fund is involved in legal or regulatory difficulties. Khorana, Tufano, and Wedge (2007) study the role of fund governance in explaining the outcomes of mutual fund mergers. Khorana, Wahal, and Zenner (2002) consider whether rights offerings by closed-end funds lead to wealth transfers from fund shareholders to fund sponsors.

On balance, the results from the growing body of literature on mutual fund governance suggest investors may gain from considering governance in making mutual fund decisions. The results from these studies broadly support the proposition that fund governance variables relate to outcomes that matter to investors – especially fund expenses. For retail investors, unfortunately, information on governance variables such as board independence, board compensation, the number of funds overseen by board members, or the trading commissions in a fund he or she manages is tucked away in unfamiliar reports like the Statement of Additional Information. In some cases, construction of the variables that may affect fund returns and expenses are complex, and the nature of the link between the governance variables and investor outcomes is similarly complex. It is reasonable to ask therefore whether investors – especially individual retail investors, or in many cases, their advisers – can reasonably process fund governance information effectively or efficiently enough to aid in selecting mutual funds. From this perspective, a summary measure of fund governance like the Morningstar Mutual Fund Stewardship Grade Overall could be useful to investors.

To date Morningstar's Stewardship Grades have enjoyed less popularity as a measure of fund governance in empirical studies of mutual fund performance than specific mechanisms of the fund governance structure such as the proportion of independent directors on the board.[3] Chou, Ng and Wang (2011) examine whether Morningstar Stewardship Grade explains governance characteristics of the companies fund managers select into a fund portfolio or fund manager proxy voting records. They conclude funds with better governance ratings invest in better-governed companies, but the reasoning behind the result is scant. Chen and Huang (2012) examine the relationship between Morningstar performance measures and Morningstar Stewardship Grades. They report mixed results, but conclude there is evidence that some categories of the Stewardship Grade Overall are related to performance. Gottesman and Morey (2012) consider the connection between fund performance and fund culture. They find that the grade Morningstar assigns to fund culture fails to explain fund returns. Gottesman and Morey also find funds with better Morningstar fund culture ratings tend to have lower fund expense ratios. However, surprisingly few studies focus on the relationship between the Stewardship Grade Overall and fund expenses.

Based on our review above, there appears to be merit in examining Morningstar Stewardship Grades from the perspective of retail investors who might use the information to select among mutual funds, or wish to evaluate their retirement plan fund offerings, or their financial adviser recommendations. Thus, this paper focuses specifically on whether and how investors might meaningfully employ Morningstar's Stewardship Grade Overall to better evaluate and choose among the wide assortment of mutual funds available, better gauge the offerings of their retirement plans, or better evaluate the judgment of their financial advisers. The results presented below help fill this void in the extant literature.

SAMPLE DATA

Morningstar covered just 400 mutual funds when it introduced Stewardship Grades in 2004. Since then it has since expanded coverage significantly. Today Morningstar publishes fund Stewardship Grades for nearly 10,000 U.S. based and international mutual funds. Morningstar arrives at its overall grade for individual fund governance by assessing five fund characteristics, including:

- Board Quality
- Manager Incentive
- Corporate Culture
- Expenses
- Regulatory Issues

Initially, Morningstar established a numerical score and grade for each characteristic for each fund.[4] They summed individual characteristic scores to determine the Stewardship Grade Overall. Morningstar

continues to evaluate the five fund governance characteristics listed above, however, the company modified the methodology for determining Stewardship Grade Overall. Morningstar no longer reports a grade for Regulatory Issues; now Morningstar lists Regulatory Issues as 'Negative' if the fund is involved in a regulatory dispute and 'Neutral' if it is not. The weight Morningstar assigns each component to determine the Stewardship Grade Overall has also changed somewhat. Initially the scores were approximately equally weighted. Today, Morningstar puts more weight on its grades for Corporate Culture and Manager Incentive. Morningstar reports all five individual governance characteristic grades for the funds it rates as well as its Stewardship Grades Overall online and in its publications.[5]

Stewardship Grade Overall and all other mutual fund data for this study are taken from the December 2007 Morningstar Principia Plus database. Following much of the previous research which focuses on equity mutual funds, our sample selection begins with all non-index mutual funds in the Principia database that have an equity style box and no fixed income style box. We then select actively managed open-end mutual funds for which Morningstar publishes Stewardship Grades. We then eliminate funds without positive net assets, and funds that have zero or missing net expense ratios. Although each fund that passes the screens above has a separate ticker, many of the funds are actually share classes of the same fund. For example, Table 1 shows Franklin Templeton offers five share classes – A, B, C, Retirement, and Institutional - of its Mutual Discovery fund. Each share class is invested in the same underlying fund portfolio according to the fund's investment objective, but the share classes have different minimum investments, front-end or back-end loads, and varying expense ratios.

TABLE 1

NET ASSETS INVESTED AND VARIOUS INVESTOR FEES AND EXPENSES BY SHARE CLASS OF FRANKLIN TEMPLETON'S MUTUAL DISCOVERY SERIES FUNDS

Net assets are in millions of dollars. The net expense ratio, loads and 12b-1 fee are expressed as percentages of net assets.

Fund Name	Share Class	Net Assets in $millions	Net Expense Ratio (%)	Front Load (%)	Back Load (%)	12b-1 Fee (%)
Mutual Discovery A	A	$8,928.50	1.36	5.75	0.00	0.31
Mutual Discovery B	B	$276.20	2.05	0.00	4.00	1.00
Mutual Discovery C	C	$3,074.50	2.05	0.00	1.00	1.00
Mutual Discovery R	Retirement	$276.10	1.55	0.00	0.00	0.50
Mutual Discovery Z	Institutional	$4,718.90	1.05	0.00	0.00	0.00
Total Portfolio Assets		$17,274.20				

Table 2 presents summary information on the number and size of all 2,597 equity mutual share classes of the funds that meet our sample criteria. We report this information sorted by Morningstar's investment categories in descending order by the aggregate net assets of the funds in each category. The number of share classes and the size of the actively managed mutual funds in our sample is highly concentrated. Almost 40% of the share classes and almost half of the net assets managed fall in the first three Morningstar investment style categories - large growth, large value, and large blend. Table 2 also reports the mean size of the share classes in each category and the largest and smallest share class in each category. The data indicate that the distributions of assets across the different investment styles are also highly skewed, with many small share classes and some very large classes. Table 2 also splits the sample according to whether the funds impose sales charges (either front-end or back-end loads or 12b-1 fees) or are purely no-load. Overall, share classes that charge sales fees outnumber share classes of funds that do not, but total assets in load and pure no-load funds are split about evenly.

We are particularly interested in the cost of investing in equity mutual funds. Previous studies commonly measure investor cost with the net expense ratio. The net expense ratio includes the management

Table 2

SUMMARY STATISTICS – NUMBER AND NET ASSETS OF ALL SHARE CLASSES IN THE SAMPLE

Share classes in the sample must have positive net assets, a Morningstar equity style box value, and a Morningstar Stewardship Grade overall. The data are sorted by investment objective category and aggregate net assets. Assets are in $ millions. 2,597 share classes meet our criteria in the Morningstar Principia database for December 31, 2007. We classify a share class as Load if it has a front load, a back-end load, or a 12b-1 fee. 661 of the 2,597 share classes are unique portfolio share classes.

Morningstar Category (Investment Objective)	Total Number of Share Classes	All Share Class Net Assets*	Smallest Share Class Net Assets†	Largest Share Class Net Assets	All Class Mean Net Assets
Large Growth	383	742,125.3	0.1	92,196.6	1,937.7
Large Value	319	613,590.7	0.1	74,763.3	1,923.5
Large Blend	297	368,804.3	0.1	38,662.5	1,241.8
World Stock	179	330,937.0	0.1	82,897.5	1,848.8
Foreign Large Blend	117	266,575.8	0.5	65,036.5	2,278.4
Mid-Cap Growth	200	152,798.8	0.1	16,905.4	764.0
Specialty	229	133,468.3	0.1	14,965.4	582.8
Foreign Large Value	53	120,687.5	2.4	53,426.1	2,277.1
Moderate Allocation	62	114,132.0	0.4	27,227.2	1,840.8
Foreign Large Growth	47	93,229.8	0.3	56,765.0	1,983.6
Mid-Cap Blend	88	83,505.0	0.7	35,230.7	948.9
Mid-Cap Value	68	66,729.6	0.2	20,398.6	981.3
Small Blend	98	64,587.3	0.1	6,319.4	659.1
Diversified Emerging Markets	49	62,011.4	2.2	13,373.1	1,265.5
Small Growth	151	49,960.2	0.1	8,228.0	330.9
Foreign Small/Mid Growth	55	28,351.0	0.9	4,965.7	515.5
Small Value	51	22,949.7	0.1	4,225.6	450.0
World Allocation	4	21,898.6	381.9	13,041.4	5,474.7
High Yield Bond	11	16,778.8	100.2	9,718.3	1,525.3
Europe Stock	32	15,097.0	0.1	5,282.4	471.8
Foreign Small/Mid Value	18	13,641.1	2.6	5,479.7	757.8
Pacific/Asia ex-Japan Stock	3	12,682.5	1,758.4	5,555.4	4,227.5
Latin America Stock	10	11,562.6	12.9	5,831.5	1,156.3
Conservative Allocation	19	8,922.7	1.3	4,715.9	469.6
Target-Date	6	7,548.4	27.4	4,859.6	1,258.1
Convertibles	12	5,239.3	3.6	2,977.4	436.6
Long-Short	10	3,438.3	6.5	1,098.0	343.8
Diversified Pacific/Asia	13	2,917.4	0.4	1,148.7	224.4
Japan Stock	7	2,778.4	4.4	1,654.4	396.9
Emerging Markets Bond	6	2,414.7	22.3	2,106.0	402.5
Totals	2,597	3,439,363.5			

Table 2

SUMMARY STATISTICS – NUMBER AND NET ASSETS OF ALL SHARE CLASSES IN THE SAMPLE
(Continued)

Morningstar Category (Investment Objective)	Number of Load Classes	Load Class Net Assets	Mean Load Class Net Assets	Number of Pure No-Load Classes	Pure No-Load Class Net Assets	Mean Net Assets No-Load Classes
Large Growth	269	340,381.5	1,265.4	114	401,743.8	3,524.1
Large Value	232	337,785.7	1,456.0	87	275,805.0	3,170.2
Large Blend	199	199,372.6	1,001.9	98	169,431.7	1,728.9
World Stock	136	286,740.9	2,108.4	43	44,196.1	1,027.8
Foreign Large Blend	85	144,808.5	1,703.6	32	121,767.3	3,805.2
Mid-Cap Growth	137	62,115.9	453.4	63	90,682.9	1,439.4
Specialty	144	33,696.5	234.0	85	99,771.8	1,173.8
Foreign Large Value	36	26,211.3	728.1	17	94,476.2	5,557.4
Moderate Allocation	38	7,946.4	209.1	24	106,185.6	4,424.4
Foreign Large Growth	32	9,880.9	308.8	15	83,348.9	5,556.6
Mid-Cap Blend	55	21,238.5	386.2	33	62,266.5	1,886.9
Mid-Cap Value	44	25,783.0	586.0	24	40,946.6	1,706.1
Small Blend	61	22,201.3	364.0	37	42,386.0	1,145.6
Diverse Emerging Mkts	33	36,271.2	1,099.1	16	25,740.2	1,608.8
Small Growth	109	16,777.2	153.9	42	33,183.0	790.1
Foreign Small/Mid Growth	36	9,537.5	264.9	19	18,813.5	990.2
Small Value	33	7,898.5	239.3	18	15,051.2	836.2
World Allocation	2	18,430.7	9,215.4	2	3,467.9	1,734.0
High Yield Bond	8	5,439.7	680.0	3	11,339.1	3,779.7
Europe Stock	23	5,396.0	234.6	9	9,701.0	1,077.9
Foreign Small/Mid Value	13	9,170.3	705.4	5	4,470.8	894.2
Pacific/Asia ex-Japan Stk	.	.	.	3	12,682.5	4,227.5
Latin America Stock	6	786.5	131.1	4	10,776.1	2,694.0
Conservative Allocation	13	749.1	57.6	6	8,173.6	1,362.3
Target-Date	3	160.5	53.5	3	7,387.9	2,462.6
Convertibles	10	1,828.9	182.9	2	3,410.4	1,705.2
Long-Short	7	1,848.3	264.0	3	1,590.0	530.0
Diversified Pacific/Asia	9	812.1	90.2	4	2,105.3	526.3
Japan Stock	3	48.3	16.1	4	2,730.1	682.5
Emerging Markets Bond	4	263.7	65.9	2	2,151.0	1,075.5
Totals	1,780	1,633,581.5		817	1,805,782.0	

fee the sponsor charges to cover operating expenses of the fund as well as the 12b-1 fee if applicable. In addition, though the trend has been moving away from funds with loads, many investors pay sales charges when they enter a fund or when they redeem funds – or both. Trading costs are nother potentially important operating cost for mutual funds. Most investors would have a difficult time determining mutual fund trading costs. Mutual funds deduct brokerage commissions from net assets. Though clearly pertinent to mutual fund investors, trading costs are not included in net operating expenses. We approximate trading costs by the turnover rate, which measures roughly the number of times in a year the fund sells and repurchases its entire security portfolio. Higher turnover impacts investors negatively in

two ways – first by increasing transactions costs and second by increasing realized capital gains for taxable investors.

Table 3 provides additional summary information on the sample broken out according to the fees the different share classes charge. The table reports aggregate net assets, the mean share class size, various expense ratios, the turnover rate, and the Overall Stewardship Grade converted to a four-point numerical scale similar to a GPA. Panels A and B break down the sample according to whether share classes charge 12b-1 fees. Each panel further breaks down the share classes according to whether they charge front or back loads. 852 share classes (about one third of the total) do not charge front or back loads; most of these share classes are pure no-load. Among the 1,745 share classes that charge 12b-1 fees most also charge a front load or a back load, but very few charge both. Interestingly, as previous researchers report, share classes with no 12b-1 fee have lower net expense ratios on average. However, the mean Load Adjusted Expense ratio (the sum of the net expense ratio and the loads) is highest for share classes with no 12b-1 fee but which charge front loads. Excluding expense categories with 3 share classes or less, average Stewardship Grades Overall are highest for funds that have no loads.

To avoid redundancy and potentially understating standard errors in the statistical tests we report below, we follow previous researchers' approach and include only one share class of each mutual fund in our results. We include the share class Morningstar designates as the unique portfolio share class for each fund. Morningstar's designated unique portfolio share class is nearly always the largest share class among the funds offered for the given portfolio or fund.[6] 661 of the 2,597 share classes in our sample are unique portfolio funds. These share classes make up $2.60 trillion of the $3.44 trillion in assets invested across all 2,597 share classes in our sample. 308 of the share classes charge sales fees and hold $1.092 trillion in net assets while 353 of the share classes are pure no-load funds and hold $1.508 trillion in net assets.

Table 3

SUMMARY STATISTICS ALL SHARE CLASSES WITH POSITIVE NET ASSETS BY SALES CHARGE TYPE:NET ASSETS, FEES, TURNOVER, NET EXPENSES, AND STEWARDSHIP GRADE

Aggregate and mean assets are in millions of U.S. dollars. Expense ratios, 12b-1 fees, and loads expressed in percent. Net Expense Ratio includes 12b-1 fees. Unweighted means include all category share classes. The Load-adjusted Expense Ratio is the sum of the Net Expense Ratio and the Front and Back Load. Loads and the Net Expense Ratio may differ across investors. For funds with multiple share classes, the turnover ratio is the same for all share classes. We assign each fund's Stewardship Grade Overall an integer point value as follows: A=4, B=3, C=2, D=1, F=0 and compute the Mean Stewardship Grade in the same way as a GPA.

	Panel A No 12b-1 Fees			
	No Front Load		**Front Load**	
	No Back Load	**Back Load**	**No Back Load**	**Back Load**
N – Number of Share Classes	817	1	31	3
Aggregate Net Assets	$1,805,782.0	$396.7	$11,462.5	$832.8
Mean Share Class Net Assets	$2,210.3	$396.7	$369.8	$277.6
Mean Net Expense Ratio (%)	0.91	0.92	1.26	0.97
Mean 12b-1 (%)				
Mean Front Load (%)	-	-	5.94	3.83
Mean Back Load (%)	-	0.75	-	1.67
Load-adjusted Expense Ratio (%)	*0.91*	*1.67*	*7.20*	*6.47*
Mean Turnover (%)	68.93	91	73	29.33
Mean Stewardship Grade (4.0 Scale)	2.07	1	1.71	3

	Panel B 12b-1 Fees			
	No Front Load		**Front Load**	
	No Back Load	**Back Load**	**No Back Load**	**Back Load**
N – Number of Share Classes	427	842	474	2
Aggregate Net Assets	$237,194.9	$250,071.3	$1,133,432.4	$190.9
Mean Share Class Net Assets	$555.5	$297.0	$2,391.2	$95.5
Mean Net Expense Ratio (%)	1.39	1.96	1.27	1.37
Mean 12b-1 (%)	0.45	0.95	0.31	0.38
Mean Front Load (%)	-	-	5.25	2.25
Mean Back Load (%)	-	2.78	-	0.63
Load-adjusted Expense Ratio (%)	*1.39*	*4.74*	*6.20*	*4.25*
Mean Turnover (%)	60.40	65.95	70.46	92.5
Mean Stewardship Grade (4.0 Scale)	2.23	1.82	1.81	1.5

RESULTS

To examine how investors might use Stewardship Grade Overall to make better mutual fund selections, we begin by sorting our sample share classes by Stewardship Grade and compare expense ratios, turnover, and risk-adjusted return performance as measured by Morningstar's reported Sharpe Ratio. Table 4 presents the results. Panel A shows the sample statistics for the Net Expense Ratio by Stewardship Grade. Both mean and median net expense ratios climb noticeably as Stewardship Grade declines. The differences between average net expenses from A-graded funds to F-graded funds is 62.7 basis points for the sample funds. Panel B presents the sample statistics for Turnover by Stewardship Grade. Once again, portfolio turnover rises markedly as Stewardship Grade falls. Average portfolio turnover, which indicates trading intensity and increases investor transactions cost – and potentially taxes - is nearly twice as high for F-graded funds as it is for funds with A-grades. Unless funds with poor Stewardship Grades negotiate remarkably favorable brokerage commissions, trading costs are likely to be higher for lower Stewardship Grade funds. Panel C shows average Sharpe ratios across the sample by Stewardship Grade. In the bivariate analysis, the excess returns measured by Sharpe ratio appear to show less variation across Stewardship Grades than expenses and turnover. The Sharpe ratio results are consistent with previous studies that suggest a tenuous relationship between fund governance and fund returns.

TABLE 4

EXPENSE AND TURNOVER RATIO SUMMARY STATISTICS FOR UNIQUE PORTFOLIO SHARE CLASSES BY STEWARDSHIP GRADE

Panel A - Net Expense Ratio (%) by Stewardship Grade. All funds - N = 661

Stewardship Grade	N	Mean	Median	Standard Deviation	Highest Value	Lowest Value
A	41	0.889	0.860	0.277	1.880	0.460
B	135	0.936	0.940	0.388	2.010	0.210
C	323	1.070	1.010	0.278	2.200	0.080
D	146	1.321	1.250	0.357	2.680	0.550
F	16	1.501	1.535	0.318	1.950	0.900

Panel B – Turnover (%) by Stewardship Grade. All funds - N = 660

Stewardship Grade	N	Mean	Median	Standard Deviation	Highest Value	Lowest Value
A	41	37.4	32.0	29.7	131.0	4.0
B	135	49.1	40.0	41.3	225.0	0.0
C	322	73.0	61.5	48.5	236.0	0.0
D	146	77.7	57.0	57.4	329.0	5.0
F	16	68.2	64.0	33.2	120.0	17.0

Panel C - Morningstar Sharpe Ratios (%) by Stewardship Grade. All funds N = 650

Stewardship Grade	N	Mean	Median	Standard Deviation	Highest Value	Lowest Value
A	41	0.612	0.590	0.368	1.440	0.070
B	133	0.724	0.670	0.453	1.760	-0.260
C	317	0.672	0.650	0.430	1.980	-1.170
D	143	0.659	0.640	0.467	1.590	-0.480
F	16	0.705	0.595	0.435	1.580	0.080

Table 5 presents results of ANOVA analysis of the differences fund performance characteristics by Stewardship Grade Overall. The top portion of the table presents the F-test of the null hypothesis that there is no difference in net expense ratio for funds with different Stewardship Grades Overall. We reject the null hypothesis at the 1% level for the full sample. We also break the full sample into funds that charge sales fees – either in the form of front-end or back-end loads or have 12b-1 fees – and true no load funds. The F-tests reject the null hypothesis of equal mean net expense ratio by Stewardship Grade Overall for both subsamples. Below the F-statistics, Table 5 presents the mean difference comparisons between the expense ratios paired by Stewardship Grades. The results indicate that the higher graded groups of funds have lower average expense ratios for All Funds at every comparison level except A-graded less B-graded fund Net Expense Ratio. When we group funds by load and pure no-load - the signs of the differences remain as expected, but the statistical significance is concentrated in the differences between higher-rated A and B funds and lower-rated D and F funds.

TABLE 5

ANALYSIS OF VARIANCE
Net Expense Ratio (%)

Dependent variable is the Net Expense Ratio versus Morningstar Stewardship Grade. Comparisons of mean expense ratios by Stewardship Grade. Sales fees include loads and 12b-1 fees. Categories include all funds, funds that charge sales fees including funds that charge only a 12b-1 fee, and pure no-load funds that charge no sales fee. The number of funds in each category by Morningstar Stewardship Grade are as follows: Charges Sales Fees - A: N=10; B: N=47; C: N=136; D: N=91; F: N=11; No Sales Fees - A: N=29; B: N=85; C: N=174; D: N=48; F: N=5. For All Funds the sample size for each Stewardship Grade is the sum of the category Ns.

	All Funds	Charges Sales Fees	No Sales Fees
N	661	308	353
Model F Value	37.17 ***	8.73 ***	21.87 ***
		Net Expense (%)	
Stewardship Grades Differences		**Mean Differences by Stewardship Grade**	
A – B	-0.047	-0.003	-0.021
A – C	-0.181 ***	-0.083	-0.144 **
A – D	-0.432 ***	-0.239	-0.392 ***
A – F	-0.612 ***	-0.476 ***	-0.419 ***
B – C	-0.134 ***	-0.080	-0.123 ***
B – D	-0.385 ***	-0.235 ***	-0.370 ***
B – F	-0.565 ***	-0.473 ***	-0.398 ***
C – D	-0.251 ***	-0.155 ***	-0.248 ***
C – F	-0.431 ***	-0.393 ***	-0.275
D – F	-0.180	-0.238	-0.027
Mean Square Error	0.1038	0.1062	0.0621

*** Significant at 1%; **significant at 5%; * significant at 10%.

Table 6 presents ANOVA results that reject the null hypothesis that average turnover is equal across funds with different Stewardship Grades Overall for all funds as well as for funds that charge sales charges and pure no-load funds. The comparisons-of-means tests here indicate fewer statistically significant differences among the Stewardship Grade Overall pairs. The result that turnover for A-graded less B-graded funds is insignificant. But the mean turnover rate for A-graded and B-graded funds less C-

graded and D-graded funds is statistically significant. The results are consistent with the proposition that funds with lower Stewardship Grades have higher portfolio turnover, imposing higher trading costs and possibly capital gains taxes on investors.

TABLE 6

ANALYSIS OF VARIANCE
Turnover (%)

Dependent variables is Turnover Ratio versus Morningstar Stewardship Grade. Comparisons of mean turnover and alpha by Stewardship Grade. Categories include all funds, funds that charge sales fees including funds that charge only a 12b-1 fee, and pure no-load funds that charge no sales fee. The number of funds in each category by Morningstar Stewardship Grade are as follows: Charges Sales Fees - A: N=10; B: N=47; C: N=136; D: N=91; F: N=11; No Sales Fees - A: N=29; B: N=85; C: N=174; D: N=48; F: N=5. For All Funds the sample size for each Stewardship Grade is the sum of the category Ns.

	All Funds	Charges Sales Fees	No Sales Fees
N	660	308	352
Model F Value	11.63 ***	4.08 **	10.94 ***
Stewardship Grades Differences	**Turnover (%) Mean Differences by Stewardship Grade**		
A – B	-11.72	-19.31	-9.39
A – C	-35.62 ***	-35.93 *	-39.75 ***
A – D	-40.32 ***	-41.32 **	-53.59 ***
A – F	-30.78	-49.18 **	-8.90
B – C	-23.91 ***	-16.62	-30.36 ***
B – D	-28.60 ***	-22.00 **	-44.19 ***
B – F	-19.08	-29.87	0.49
C – D	-4.69	-5.38	-13.84
C – F	4.83	-13.25	30.85
D – F	9.52	-7.87	44.67
Mean Square Error	2312.86	7803.98	2548.01

*** Significant at 1%; ** significant at 5%; * significant at 10%.

We also perform F-tests (not reported hear but available from the authors) for the null hypothesis that the mean Morningstar reported Sharpe ratio for the unique portfolio funds is equal across Stewardship Grade Overall for all share classes, pure no-load, and load share classes. We fail to reject this hypothesis for all share classes and for the two subsamples. The results indicate no statistically significant difference in risk adjusted return as measured by the Sharpe ratio across funds with different grades.

To explore the possible link between Stewardship Grade Overall and fund return performance further, we follow much recent mutual fund research and employ Carhart's (1997) four-factor model:

$$r_{\text{it}} = \alpha_i + \beta_{1i} \cdot (Mkt - Rf)_t + \beta_{2i} \cdot SMB_t + \beta_{3i} \cdot HML_t + \beta_{4i} \cdot MOM_t + e_{it},$$

where r_{it} is the excess return of the one-month return on a portfolio of mutual funds and the return on a 1-month U.S. T-bill for the same month. (*Mkt– Rf), SMB*, *HML*, and *MOM*, are the usual Carhart factors.[7] We calculate portfolio excess returns by subtracting the 1-month T-bill return for each month in our

sample period from the equally weighted return on the portfolio of share classes with the same Stewardship Grade Overall. Table 7 presents OLS estimation results for the Carhart regressions for the 36-month sample period January 2005 – December 2007. Panel A presents the results for the full sample. Panels B and C present the results for the pure no-load and load samples respectively. The figures in parentheses under the Stewardship Grades indicate the number of share classes in each portfolio excess return calculation. The t-statistics are in parentheses under the parameter estimates. Our primary interest in Table 7 is in the first column. In Panel A, alpha is positive and statistically significant for the equally weighted portfolio of all funds with Stewardship Grade Overall of A. While alphas for the remaining Stewardship Grade Overall

TABLE 7

CARHART FOUR FACTOR REGRESSION RESULTS

The estimated equation is $r_{it} = \alpha_i + \beta_{1i} \cdot (Mkt - Rf)_t + \beta_{2i} \cdot SMB_t + \beta_{3i} \cdot HML_t + \beta_{4i} \cdot MOM_t + e_{it}$. The dependent variable r_{it} is the excess return on equally weighted portfolios of the share classes of funds with at least 24 consecutive monthly returns in the sample period January 2005-December 2007. Monthly mutual fund returns are taken from the Morningstar Principia database. The monthly factors are provided by French.

Stewardship Grade	Alpha	Mkt-Rf	SMB	HML	Mom	R-squared
PANEL A: Equally Weighted Portfolios of All Unique Share Classes by Grade						
A (41)	0.1262 (2.06)**	0.9154 (33.85)***	0.2178 (6.77)***	0.0127 (0.39)	-0.0037 (-0.12)	0.986
B (135)	0.1353 (1.27)	0.9737 (20.66)***	0.1411 (2.52)**	0.1231 (2.16)**	0.1343 (3.11)***	0.960
C (323)	0.0862 (0.96)	0.9794 (24.71)***	0.1259 (2.67)**	0.0046 (0.10)	0.1417 (3.91)***	0.972
D (145)	0.0370 (0.31)	1.0012 (19.26)***	0.1077 (1.74)*	0.0311 (0.49)	0.1668 (3.51)***	0.954
F (16)	0.0918 (0.69)	1.0454 (17.83)***	0.1599 (2.29)**	0.0434 (0.61)	0.1945 (3.63)***	0.949
PANEL B: Equally Weighted Portfolios of Unique No-Load Share Classes by Grade						
A (30)	0.1788 (2.71) **	0.9334 (32.09) ***	0.2365 (6.84) ***	-0.0474 (-1.35)	-0.0005 (-0.02)	0.985
B (48)	0.1418 (1.41)	0.9554 (21.53) ***	0.1164 (2.21) **	0.1324 (2.47) **	0.1055 (2.60) **	0.962
C (94)	0.1343 (1.35)	0.9879 (22.56) ***	0.1321 (2.54) **	-0.0122 (-0.23)	0.1580 (3.95) ***	0.967
D (51)	0.1163 (0.75)	1.0243 (14.90) ***	0.0667 (0.82)	0.0653 (0.79)	0.2647 (4.21) ***	0.925
F (11)	0.1217 (0.71)	1.1057 (14.70) ***	-0.0648 (-0.72)	0.1565 (1.72) *	0.2215 (3.22) ***	0.912

TABLE 7

CARHART FOUR FACTOR REGRESSION RESULTS
(Continued)

PANEL C: Equally Weighted Portfolios of Unique Load Share Classes by Grade						
A (11)	-0.0173 (-0.16)	0.8663 (17.82)***	0.1668 (2.89)***	0.1765 (3.00)***	-0.0102 (-0.23)	0.947
B (87)	0.1236 (0.99)	1.0064 (18.28)***	0.1855 (2.83)***	0.1061 (1.59)	0.1864 (3.70)***	0.952
C (180)	0.0258 (0.32)	0.9687 (27.18)***	0.1180 (2.78)***	0.0258 (0.60)	0.1211 (3.72)***	0.976
D (51)	-0.0059 (-0.06)	0.9888 (22.11)***	0.1298 (2.44)**	0.0129 (0.24)	0.1139 (2.79)***	0.965
F (5)	0.0783 (0.60)	1.0180 (17.55)***	0.2621 (3.80)***	-0.0080 (-0.11)	0.1823 (3.44)***	0.952

*** Significant at 1%; ** significant at 5%; * significant at 10%.

portfolios are positive, they are statistically insignificant. Panel B shows the same result for the portfolios constructed of pure no-load share classes. Panel C presents the results for the load share classes. Here the alphas are insignificant for all of the governance grades. These results are slightly different than indicated by Morningstar's reported Sharpe ratios. The Carhart alpha results suggest mutual funds with the highest Stewardship Grade Overall may outperform similarly constructed portfolios in the market; however, this appears to be true only for pure-no load mutual funds.

Table 7 also suggests interesting differences exist in fund portfolio exposures across different Stewardship Grades Overall. For example, in each panel, the coefficients on the market factor (*Mkt– Rf)* are all highly significant and close to one, but they also increase as Stewardship Grade Overall declines. This indicates lower Stewardship Grade Overall funds may choose, on average, portfolios with greater market risk. In addition, the momentum factor coefficient, (*MOM)*, is statistically insignificant for the A-graded portfolios in each panel, but positive and statistically significant for portfolios formed with funds from all other Stewardship Grades. The momentum coefficients also increase as portfolio Stewardship Grade Overall worsens. Because turnover increases as Stewardship Grade Overall declines, the momentum result could indicate funds with weaker grades "chase" returns. That is, in order to catch up to fund benchmarks or rival fund performance (or just more closely track them), fund managers at lower Stewardship Grade Overall funds may trade more in stocks whose returns have more than average recent momentum. Stewardship Grade Overall may, therefore, be an indicator of the types of portfolio exposures facing investors in different mutual funds.

The results presented above are consistent with the somewhat mixed evidence on the relationship between fund governance and fund returns in the literature. A mutual fund board's limited ability to influence directly the investment adviser may explain the inconsistency in this empirical connection. A fund board's key responsibility is to negotiate and approve contracts between the fund and parties that provide the fund's essential services such as investment management and distribution. Thus, a mutual fund's board directly influences the fees the fund pays for investment management, custodial services, transfer services, auditing, and so on. The fund ultimately passes these costs on to investors in the form of management fees and other charges the fund levies. However, once the contract with the fund investment advisor is set, direct responsibility for investment decisions falls to the fund manager. Fund boards are not directly responsible for the portfolio returns. The board's influence on the investment adviser derives from its ability to sever the fund's contract with the mutual fund management company that provides the investment adviser. However, as Tufano and Sevick (1997) point out, boards too rarely fire management

companies for this threat to seem credible. This may help explain the limited evidence of a connection between measures of fund governance and returns.

Together, results from Tables 4 through 7 provide evidence that Morningstar captures some of the relationship between a number of mutual fund governance variables and fund expenses found in previous empirical research. Connections between various governance variables and fund expenses are complex and involve data that many fund investors or their advisers might find inconvenient and costly to discover. Analyzing these connections effectively would challenge many retail investors. Stewardship Grade Overall, by comparison, may capture multiple individual governance characteristics. It is straightforward to interpret, easily available, and provides meaningful information to investors about fund expenses and turnover. It may also provide information about returns and risk. Stewardship Grade Overall sorts funds into groups by expense ratio, with A and B graded funds having the lowest average net expense ratios and turnover rates. The differences between expenses and turnover are statistically significant and appear to be economically meaningful as well.

This suggests investors can use Stewardship Grades to classify quickly high-cost, high-turnover funds. Based on this evidence, eliminating funds with Stewardship Grades of C or below from consideration would lead investors to choose among funds that have lower average operating expenses and turnover rates. This holds for investors confident in making their own investment decisions as well as those sophisticated enough to select no-load, no-12b-1 fee funds. It also holds for investors who lack the time, inclination, or background to make their investment decisions. Such investors may employ financial advisers to assist them in their investment decisions and pay for these services through loads and 12-b1 fees. Our results indicate that even investors who pay sales charges can experience lower operating expenses by selecting funds with Stewardship Grade Overall of A or B. Further, investors who limit their selection to funds with overall A grades, may be subject to less market and momentum risk. Finally, for pure no-load fund investors, A-graded funds may outperform relative other funds with similar risk.

As a matter of practice retail investors commonly construct (and investment advisers commonly recommend) fund portfolios based on style and market capitalization characteristics rather than directly on Carhart's model. To get a picture of the cost consequences of categorizing funds and investing by size and style, Figures 1 and 2 chart the mean net expense ratio for the pooled sample of load and no-load share classes according to Morningstar's market-cap and growth style categories against Stewardship Grade Overall for all 2,595 share classes in our sample.

Figure 1

Mean Net Expense Ratio by Size and Stewardship Grade for all 2,597 Share Classes

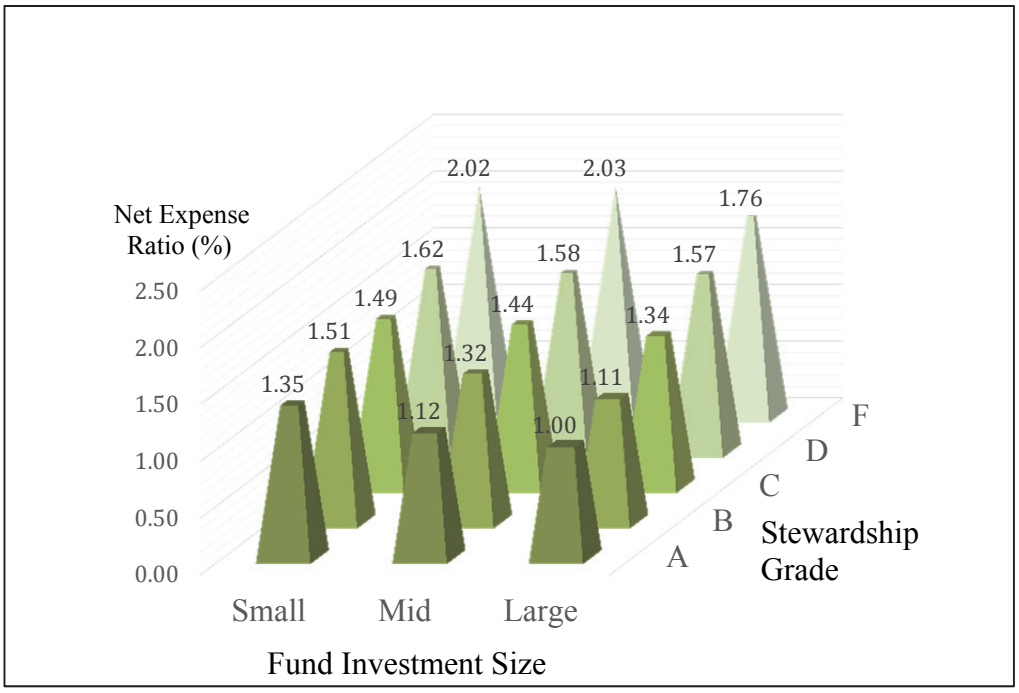
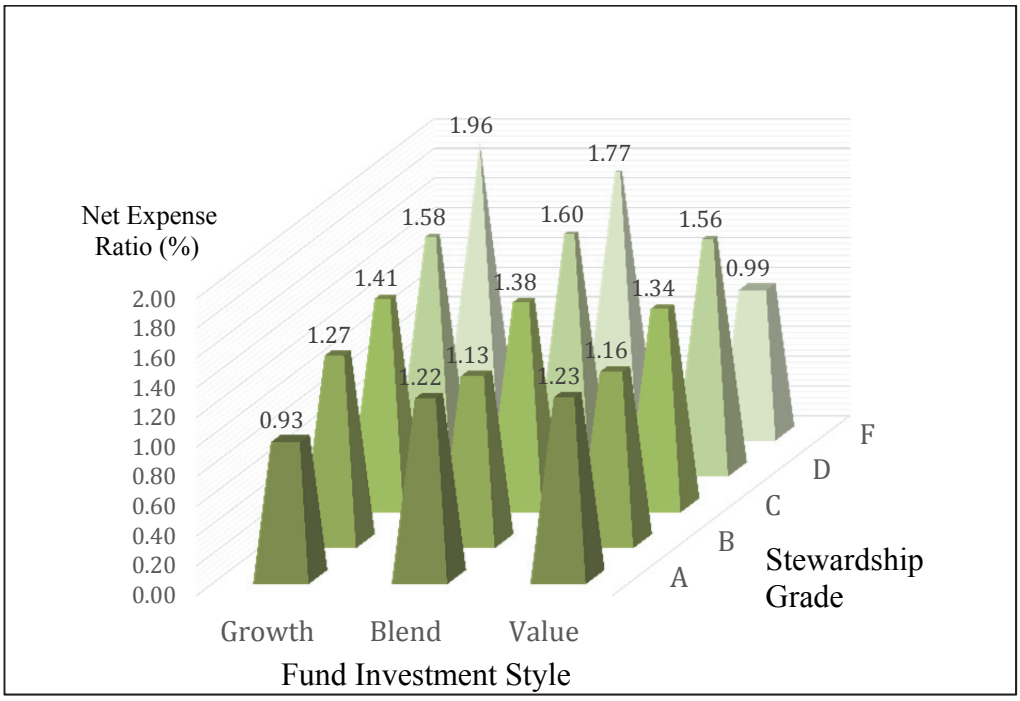


Figure 2

Mean Net Expense Ratio by Style and Stewardship Grade for All 2,597 Share Classes



Figures 1 and 2 illustrate the potential benefit to using Stewardship Grade Overall in allocating funds across investment style. Figure 1 shows that expense ratios rise consistently as Stewardship Grade Overall declines. Mean net expense ratio also increases moving from Large-cap to Small-cap funds for any Stewardship Grade Overall. Figure 2 presents the same information for the pooled sample of load and no-load funds by governance grade for Value, Blend, and Growth investment styles.

The pattern is similar to the previous graph as net expense ratio generally increases as governance grade declines across the different investment styles, but the differences are most notable moving from A and B to the C, D, and F graded funds. While net expenses for A and B graded funds are similar across growth categories, the expenses climb moving from Value to Growth in the C, D, and F governance grade groups. Growth funds in particular show a pronounced increase in expense ratio as Stewardship Grade Overall declines.

A remaining issue for investors is whether screening out lower Stewardship Grade Overall funds restricts their opportunity set. The analysis above indicates strongly that investors benefit when investing by market capitalization or by growth style if they restrict themselves to funds with A and B Stewardship Grades Overall. Table 8 breaks our sample of 2,597 share classes down by both market-cap and growth following Morningstar's familiar 9-cell style box. For each market-cap and growth combination, Table 8 reports the number of pure no-load and load share classes available to investors for each Stewardship Grade Overall. It breaks down the mean net expense ratio similarly. Table shows there are eleven Large-Cap Value funds with Stewardship Grade Overall of A. The five A-graded Large-cap Value pure no-load share classes have an average net expense ratio of 0.79%. The six A-graded Large-cap Value load share classes have average net expense ratio of 1.50%. Interestingly, the difference between mean load and mean no-load fund expense ratios for share classes with the same Stewardship Grade Overall is generally greater than the difference between the mean net expense ratios of the highest and lowest Stewardship Grade Overall funds. This holds for both load and pure no-load funds. Clearly retail investors who do not require, or do not receive, services higher expense ratios and sales fees cover should not invest in load funds. Regardless of load or investment style, the statistics in Table 8 bear our indications from our previous analysis: investors generally face lower expense ratios if they choose higher Stewardship Grade Overall funds. There appears to be a sufficient number of funds to offer investors, investment advisers, and retirement plan administrators robust choice even if they limit themselves to the top two Stewardship Grades Overall.

TABLE 8

DISTRIBUTION OF SHARE CLASSES BY STEWARDSHIP GRADE OVERALL, INVESTMENT STYLE, AND SALES CHARGE CHARACTERISTICS

Number of share classes and mean net expense ratios stratified by the Morningstar style categories and Stewardship Grade overall for Pure no-load and load share classes. Pure no-load share classes do not charge any sales fees, including 12-b1, front or back-end loads. Our full sample of 2,597 share classes includes 817 pure no-load share classes and 1,780 load share classes. Expense ratios are in percent of net assets.

	Pure No-Load Share Classes						Load Share Classes					
	Value		Blend		Growth		Value		Blend		Growth	
Large-Cap	N	Exp. Ratio (%)	N	Exp. Ratio (%)	N	Exp. Ratio (%)	N	Exp.Ratio (%)	N	Exp. Ratio (%)	N	Exp. Ratio (%)
A	5	0.79	7	0.74	17	0.68	6	1.50	8	1.36	8	1.28
B	18	0.70	59	0.66	37	0.77	29	1.45	127	1.25	70	1.36
C	56	0.84	95	0.88	119	0.88	154	1.49	214	1.56	232	1.59
D	24	0.99	35	1.01	58	1.06	79	1.69	96	1.79	146	1.80
F	1	0.99	3	1.23	3	1.21	-	-	16	1.87	12	1.95
Mid-Cap	**Value**		**Blend**		**Growth**		**Value**		**Blend**		**Growth**	
A	1	0.92	3	0.77	3	0.81	-	-	6	1.36	7	1.23
B	3	0.72	10	0.91	21	0.85	4	1.42	12	1.60	43	1.60
C	18	0.96	34	0.95	55	0.96	28	1.61	74	1.69	109	1.71
D	7	1.19	5	1.14	24	1.15	17	1.89	16	1.88	53	1.68
F	-	-	-	-	4	1.35	-	-	-	-	21	2.15
Small-Cap	**Value**		**Blend**		**Growth**		**Value**		**Blend**		**Growth**	
A	1	1.01	9	1.02	1	0.82	2	1.78	12	1.61	-	-
B	1	1.37	5	1.11	11	1.09			13	1.78	21	1.67
C	10	1.07	10	0.91	20	1.06	18	1.69	19	1.59	52	1.75
D	5	1.09	9	1.09	9	1.11	11	1.82	15	1.87	21	1.90
F	-	-	-	-	1	1.30	-	-	-	-	9	2.10

CONCLUSIONS

Morningstar began publishing Mutual Fund Stewardship Grades in 2004. Stewardship Grade represents Morningstar's assessment of the quality of individual mutual fund governance. Morningstar bases Stewardship grades on variables that previous studies find useful in predicting some mutual fund outcomes – especially expense related outcomes. We examine a sample of 2,597 share classes of actively managed equity funds. Analyzing expense related metrics such as the net expense and turnover ratios, we find that funds with better Stewardship Grades impose lower costs on investors, regardless of Morningstar style characteristics. This result offers investors, retail investment advisers, and retirement plan administrators robust alternatives even when limiting themselves to the top two Stewardship Grades Overall, A and B. The results hold whether the funds charge loads or not.

Even relatively self-reliant retail investors may have difficulty assessing the overall impact of the range of factors that determine the total cost of owning mutual funds. Results from this paper suggest that retail investors may find Stewardship Grade Overall a useful and efficient means of screening out funds that impose excessive cost. Evidence regarding a relationship between Steward Grades Overall and performance is mixed. Results from our examination of Sharpe ratios are consistent with previous studies that suggest no connection between fund governance and fund returns. However, results from our analysis of Carhart alphas suggest mutual funds with the highest Stewardship Grade Overall may outperform similarly constructed portfolios in the market, though this result appears to be present only for pure-no load mutual funds.

While Morningstar claims investors can use Stewardship Grades to improve mutual fund selection, the company provides little guidance to fund investors about how to use the metric to improve fund selection. We find that Stewardship Grade Overall may capture multiple individual governance characteristics, is straightforward to interpret, available to the investing public, and appears to provide meaningful information to investors about fund expenses and turnover. It may also provide information about returns and risk. Our results suggest that investors who pay financial advisers for their services through loads or 12b-1 fees may also find Stewardship Grades helpful in insuring that their advisers are acting in their best interests. Alternatively, the evidence presented here suggests conscientious retail investment advisers should steer their clients to funds with A and B Stewardship Grades.

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ENDNOTES

1. Duffy (2004), for example argues that financial advisors should incorporate governance metrics in developing investment selection criteria. Haslem (2013) argues that investors can benefit from identifying "stewardship funds" and Stewardship Grades may be a useful way of identifying "stewardship funds," or funds with stronger orientation toward shareholders, which may be subject to less agency risks.

2. Some critics argue that taken together investors are constrained in mutual fund choice to the degree that the fund industry is virtually devoid of price competition. Data provided by the Investment Company Institute (ICI) provides some support for this view. According to ICI the average retail investor holds a fund for five years and stays with same investment company for seven years. Further, research by James and Karceski (2006) suggests institutional investors who are less constrained by fund menus and tax considerations than retail investors earn better returns than retail investors holding the same funds.

3. In a working paper, Wellman and Zhou (2005) find that among the initial group of equity mutual funds for which Morningstar reported grades in 2004, higher Stewardship Grade funds provide better return characteristics than lower Stewardship Grade funds. They also find evidence following the initial assignment of grades that money flowed into funds with high marks and out of funds with low marks.

4. For further details on how Morningstar initially set Fund Stewardship Grades its evaluation process see Fact Sheet: The Morningstar Stewardship Grade for Funds, http://quicktake.morningstar.com/DataDefs/FidGradeMethodology.pdf. For further details on the firm's current approach, see Stewardship Grade for Mutual Fund Firms Methodology: https://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/StewardshipGradeMutualFundFirmsMethodology.pdf.

5. In 2011, Morningstar shifted from evaluating governance for individual mutual funds to evaluating governance for the companies that manage the funds. Since then all mutual funds from the same management company have the same Stewardship Grades.

6. For the Mutual Discovery Series fund in Table 1, Morningstar designates the A share class as the unique portfolio fund.

7. The monthly factors for our sample period were generously provided by Ken French from his web site.