
Morningstar Medalist Rating™ for 529 Plans

Methodology

Morningstar Manager Research

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Contents

- 1 Overview
- 2 The Morningstar Medalist Rating for 529s
- 4 Methodology
- 5 Pillar Evaluation
- 9 Research Process

Editor's Note October 2023

In 2023, the name of the rating was updated from the Morningstar Analyst Rating to the Morningstar Medalist Rating. The methodology was otherwise unchanged from the previous version dated July 20, 2020.

Important Disclosure

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Overview

Morningstar has conducted qualitative, analyst-driven research on 529 plans since 2004 and rated plans since July 2012. An essential complement to our database of investment information and our suite of quantitative research tools, such as the Morningstar Medalist Rating for 529 investment options, Morningstar's 529 plan analysis has always focused on helping individuals saving for education expenses make better investment decisions. The Medalist Rating and accompanying report seek to:

- ▶ Identify 529 plans that adhere to best practices and feature investment options that we expect to collectively outperform relevant Morningstar Category peer groups on a risk-adjusted basis over the long term.
- ▶ Call out 529 plans that fail to meet best practices and offer investment options that we expect to collectively turn in middling or subpar investment results versus relevant Morningstar Category peer groups on a risk-adjusted basis over the long term.
- ▶ Give individuals saving for college, K-12, or other qualified education expenses clear expectations for the likely behavior of a plan's investment options in different market environments.
- ▶ Place the investment options in comparative and historical context in terms of criteria such as expenses, manager tenure, investment style, and asset size.
- ▶ Monitor the plan's investments for changes that could materially affect the suitability and investment opinion.

Independent Research

Morningstar is committed to the principle of independence. We neither charge to rate plans nor do we permit 529 plans to commission ratings from us. Morningstar commercializes its 529 plan research by including ratings and reports in various products and services and through licensing its intellectual property.

Morningstar manager research analysts produce their 529 plan analysis for the benefit of investors and financial professionals, not for the states or the program managers running the plans. Morningstar separates its analyst team from commercial activities to avoid any real or perceived conflicts of interest. Analysts focus on providing in-depth, accurate, and useful analysis that equips investors to select a 529 plan. When a plan has elements that fail to meet best practices and offers investment strategies that we expect are likely to collectively turn in subpar investment results, an analyst will not hesitate to express a negative view.

How We Decide What to Cover

We strive to ensure that education savers and plan selectors have access to our analysts' qualitative opinions across a broad spectrum of plans. Hence, coverage is not determined by quantitative screens on performance or limited to only a "best of breed" universe (although we do aim to cover and closely monitor what we believe are the best offerings), and analyst teams have ample discretion in determining their coverage universe. In determining coverage, analysts focus on investment merit and investor demand. Assets under management in 529 plans are one gauge of investor interest, but analysts may also cover new and/or small plans if they have merit. In addition, Morningstar frequently canvases its analyst team and external users of our research to identify 529 plans that might merit coverage. A coverage committee internal to the manager research team must approve all coverage decisions.

The Morningstar Medalist Rating for 529 Plans

The Morningstar Medalist Rating for 529 plans is the summary expression of our forward-looking analysis of a 529 plan. We evaluate each plan's investment options, including but not limited to its age-based options, target-enrollment options, and static options, though we ultimately assign Morningstar Medalist Ratings at the plan level to express our view of the overall offering.

The Morningstar Medalist Rating for 529 plans is expressed on a five-tier scale running from Gold to Negative. The top three ratings of Gold, Silver, and Bronze all indicate that our analysts think highly of a 529 plan. The difference between them corresponds to differences in the level of analyst conviction in a plan's ability to continue following best practices and offer investments that will collectively outperform peers on a risk-adjusted basis over a holding period of at least five years. To identify plans with investment options that we believe will outperform, Morningstar analysts look for plans that follow several best practices across our key pillars of evaluation, including but not limited to:

- ▶ Ensuring the age-based or target-enrollment options utilize a well-researched asset-allocation approach and a robust process for selecting underlying investments.
- ▶ Offering an appropriate set of options to meet investor needs.
- ▶ Hiring a skilled investment management team to oversee the lineup.
- ▶ Utilizing talented investment managers that underpin the investment options.
- ▶ Tapping investment managers with exemplary stewardship practices.
- ▶ Strong oversight from the state.
- ▶ Keeping fees low relative to peers.

Plans usually have dozens of investment options, so our analysis emphasizes the options with the most assets. The largest options by asset size often are aimed at beneficiaries of particular ages (these options are known in the 529 industry as "age-based" or "target-enrollment" options).

The Medalist Ratings should be interpreted as follows:

Gold

These are our highest-conviction recommendations. To earn a Gold rating, a plan must distinguish itself across the key pillars that are the basis for our analysis. These plans follow all or most best practices and as a result offer investment options that we expect are likely to endure and collectively outperform relevant peer groups within the context of the level of risk taken over the long term (defined as a full market cycle or at least five years).

Silver

These sit just below Gold but are also among our highest-conviction plans. While these are worthy plans with many positive features, they don't necessarily rise to the standard of best in breed. They largely follow best practices and offer investment options we expect to collectively outperform relevant peer groups on a risk-adjusted basis over the long term (again, defined as a full market cycle or at least five years).

Bronze

We do not expect these plans to stand out like Gold or Silver offerings, but we still expect them to serve investors well. These plans have advantages that clearly outweigh any disadvantages across the pillars, giving us the conviction to award them a positive rating. Although they do not follow best practices to the same extent as Gold- or Silver-rated plans, we expect their investment options to collectively outperform relevant peer groups on a risk-adjusted basis over the long term.

Neutral

As a whole, we do not believe these plans follow best practices and therefore do not expect their investment options to collectively outperform over the long term, meaning a full market cycle or at least five years. A promising but unproven plan may also receive this rating until we see further evidence that its investment options have potential.

Negative

These plans possess at least one major flaw and generally fail to meet industry best practices. We believe these plans' investment options are inferior to most competitors' and will likely underperform relevant peer groups within the context of the level of risk taken, over a full market cycle.

Morningstar may also use one other designation in place of a rating:

Under Review

This designation means that a change at a rated plan requires further review to determine the impact on the rating.

Methodology

In more than two decades of manager research, Morningstar's global analyst team has identified five key areas that we believe are crucial to predicting the future success of managed investments: People, Parent, Process, Performance, and Price. These five pillars form the spine of our research approach, and we evaluate each of them when assessing a managed investment strategy or group of investments, like a 529 plan. In so doing, we not only evaluate each pillar but also the interaction between them, which we believe is crucial to understanding the investments' overall merit.

We believe that our assessments of People, Process, and Parent are strong factors in predicting performance before fees, while price is a strong predictor after fees. Given that, we've focused on those elements of the framework and absorbed the Performance Pillar into the People and Process Pillars to ensure performance analysis takes place as part of a broader assessment of a plan's investment options' strategies and the people behind them.

State income tax benefits vary widely from state to state, and some states have no state tax benefit for investing in a 529 plan. Given the variability of state tax benefits for investors based on personal considerations such as residency, income level, size and frequency of contributions, and other factors, we do not treat tax benefits as a predictor of performance, and therefore it is not included in our ratings assessment.

Scoring Pillars

Morningstar analysts score the People, Process, Parent, and Price Pillars on a 1 to 5 basis (the scores must be approved by the relevant Morningstar ratings committee). The scores also are expressed as Low, Below Average, Average, Above Average, and High.

Deriving the Rating




We start with the assumption that a plan's investment options will behave in line with their peer groups. The pillar scores are then used in conjunction with the set weights to derive a score that reflects our analyst's views of a plan's potential to follow best practices and outperform. We weight the pillar scores as follows:

People:	30%
Process:	30%
Price:	30%
Parent:	10%
Performance:	0%

The equation to derive the analyst's level of conviction in the plan's merit is:

$$\text{Score} = (0.3 * \text{People Score}) + (0.3 * \text{Process Score}) + (0.3 * \text{Price Score}) + (0.1 * \text{Parent Score})$$

To determine a plan's rating, analysts typically assign ratings according to the following scores.

 Gold	≥ 4.5
 Silver	= 4.0 to < 4.5
 Bronze	= 3.5 to < 4.0
Neutral	= 2.5 to < 3.5
Negative	< 2.5

However, our analysts retain discretion to override these scores if they perceive a unique characteristic that they believe will outweigh the combined effects of other pillars.

Pillar Evaluation

People

The overall quality of the investment managers behind the 529 investment options is a significant key to evaluating the lineup of options on offer and whether those investments are likely to deliver superior performance relative to peers.

Plans that follow best practices hire a skilled investment-management team to construct the age-based or target-enrollment options. We have a higher conviction in teams that also oversee the menu design, utilize talented investment managers that underpin the investment options, and ensure the managers involved have strong stewardship practices.

Evaluating the various investment teams requires that analysts assess: the individuals who make the key investment decisions on the portfolios; how conflicts are resolved, and if there is more than one person involved; resources that directly support the managers' work on the strategy; other resources that are not part of the team; the expertise and relevance of available resources to the strategy; how incentive pay influences decision-making and team stability; and performance of relevant investment strategies run by the people behind the investment options.

The relevant personnel are assessed based on a number of criteria:

- ▶ Experience and ability.
- ▶ Fit and structure.
- ▶ Workload.
- ▶ Communication/information flow.
- ▶ Temperament.
- ▶ Alignment of interests.
- ▶ Key-person risk.
- ▶ Team stability.
- ▶ Stewardship of the investment managers involved.
- ▶ Performance of strategies run by the investment managers.

Process

Morningstar analysts are style-agnostic, meaning that for equity strategies, we do not prefer value to growth or momentum, or vice versa. For fixed-income strategies, both high-quality and credit-sensitive styles are viable. For multi-asset class strategies, including age-based or target-enrollment investment options and static allocation options, a wide range of approaches to asset allocation can succeed. Plans that follow what we believe to be best practices offer age-based or target-enrollment options that utilize a well-researched asset-allocation approach and a robust process for selecting underlying investments; provide an appropriate set of investment options to meet investor needs without too much overlap among the offerings; and hire investment managers who use strong processes at the underlying strategy level.

In evaluating the various processes involved, we look for age-based and target-enrollment investment options 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 portfolios should be constructed in a manner that is consistent with the investment process and performance objective. We seek to understand the context in which managers think about risk and how this is expressed when constructing their portfolios.

Our analysts make extensive use of Morningstar's global database and holdings-based analytical capabilities to evaluate the investment options' portfolios, as many 529 investment options ultimately invest in mutual funds, exchange-traded funds, collective investment trusts, and other vehicles. We look for underlying strategies with a process distinctive enough to generate standout results in the future.

More specifically, we seek to understand:

- ▶ The investment philosophy that underpins the plan's investment options.
- ▶ The key "edge" of the process as executed by the investment manager(s).
- ▶ Elements that are systematic and repeatable, if any.
- ▶ The fit of the process with the resources backing the 529 plan and with the size of the asset base tied to it (including all investment options across the plan).
- ▶ Whether the process has been consistently applied, as demonstrated by the composition of the investment options over time.
- ▶ The risks entailed in the process, from portfolio-bias and ability-to-execute points of view.
- ▶ The investment managers' approach to risk management and diversification.
- ▶ Our expectations for performance in different market environments, assuming the process is adhered to.
- ▶ Whether or not we believe the process can add value across the cycle versus the relevant peer group on a risk-adjusted basis.
- ▶ The suitability of investment options for different types of college savers given the risks we would expect to see in its portfolio.
- ▶ Any historical changes in approach or style, and the reasons for those changes.
- ▶ Performance of the processes implemented by the investment managers.

Parent

This portion of the methodology does not evaluate the 529 plan participants, who are often parents of a child who ultimately will benefit from the 529 account's savings. Rather, "parent" in this context refers to the organizations behind the 529 plan: The state entity offering the plan and other groups or individuals overseeing the plan, including consultants and other advisory or governance boards, but excluding the stewardship practices of the program and investment manager, which are evaluated in the People Pillar.

We believe the parent organizations behind the 529 plans are of utmost importance when evaluating investments. Although other factors may have more immediate impact, a 529 plan would not be sustainable without backing from the state. Further, the state, consultants, and other advisory or governance boards set the tone for key elements of our evaluation, playing a direct role in selecting the plan's program and investment manager and setting the plan's fees, which are critical to the investments' success.

Plans that follow what we believe to be best practices have highly engaged plan sponsors and a culture of stewardship. They also put education savers first and treat savers' capital as if it were their own, insulate the state's oversight team and process from political turmoil, and have procedures in place that help its program and investment managers seek to remain ahead of the pack. In addition, these plans charge reasonable fees and communicate well with savers. Weaker parents typically have less engaged staff or may defer too heavily to the investment manager. States in this group might be characterized by disengagement, subpar oversight, or susceptibility to political pressures. These plan sponsors may agree to offer faddish investments in an attempt to gather assets and have higher charges. They also do a poor job of aligning their interests with those of investors.

A 529 plan also can demonstrate strong stewardship by communicating clearly and openly with college savers about the plan's investment options so that savers have sufficient information to make well-informed choices. This includes, but is not limited to, timely information on fees, performance, and management. This disclosure is critically important for 529 plans because they are not subject to the same regulatory disclosure standards as similar investments that are registered with the SEC, including mutual funds.

Although relatively few 529 parent organizations fall obviously to one extreme or the other, determining where a state and its management entities fall on the spectrum is a key part of our research approach.

Key areas of evaluation include:

- ▶ Engagement and oversight of the state, its consultants, and other advisory or governance boards.
- ▶ Recruitment and retention of talent.
- ▶ Organizational structure.
- ▶ Capacity management.
- ▶ Alignment of interests with education savers.
- ▶ Regulatory compliance.

- ▶ Investment group/culture fostered by the state.
- ▶ Insulation from political turnover.
- ▶ Contract renegotiations with program and investment managers.

Price

Morningstar and independent academic research have shown that investment expenses are one of the better predictors of future outperformance even when evaluating net-of-fee returns.¹ Given this, costs form a critical part of our analysis.

We compare each investment option's fee versus its appropriate Morningstar Category peers and aggregate the results to determine a Price Pillar rating for each plan. We typically emphasize fees charged by a plan's age-based or target-enrollment options, which tend to be the most popular choices among 529 investors.

There has been a long-term shift away from solely transaction-based advisory businesses and a move toward fee-based compensation, where advisor fees are displacing investment product costs.² Advisors who have a fee-based business model have greater flexibility to choose the best plan available for their clients, free from considerations of the impact of that recommendation on their compensation, blurring the lines between advisor-sold and direct-sold plans. Considering this, along with studies that show fees matter regardless of the underlying investment strategy, each investment option's price is evaluated relative to its Morningstar Category peers, irrespective of distribution channel (such as direct-sold or advisor-sold) or the strategy of its underlying funds (such as active management or passive management).³ Plans that we feel follow best practices have low fees versus other plans.

Performance

We do not believe past performance is necessarily predictive of future results, and this factor accordingly receives no explicit weighting in our analysis. Instead, we analyze long-term return and risk patterns to help inform our evaluation of people, process, and parent.

The broad principles behind our evaluation of performance are as follows:

- ▶ We should have clear expectations for performance in different market environments based on our analysis of the investment options' process and portfolio.
- ▶ These expectations are checked against actual performance in such environments.
- ▶ Trailing returns and calendar-year returns are of interest, but they are insufficient in themselves as they are end-point dependent and somewhat arbitrary. We consider many periods and performance aspects to build as comprehensive a picture as possible.
- ▶ It is extremely important that performance be viewed within the context of risks taken, with a focus on downside risk.

1 Johnson, B., 2019. "Morningstar's Active/Passive Barometer." Morningstar.

2 Johnson, B. and Dibenedetto, G., 2020. "2019 U.S. Fund Fee Study." Morningstar.

3 Johnson, B., 2019. "Morningstar's Active/Passive Barometer." Morningstar.

- ▶ Performance for each investment option is viewed relative to the relevant Morningstar Category and category peers. Other benchmarks or custom peer groups deemed of interest by the analyst and rating committee may also be considered.
- ▶ Performance attributions are evaluated to determine whether the sources of outperformance match our expectations and if they appear to be sustainable.
- ▶ Performance is reviewed in the context of notable changes in assets under management—specifically, if performance tails off as assets grow or if the bulk of outperformance came when the strategy was very small, it is cause for concern.

Tax Benefits

529 plans' tax benefits make them attractive investments for education savers. All 529 savers avoid paying taxes on the investments' gains, and in more than 30 states, savers are eligible for additional benefits, such as state income tax credits or deductions. A few states allow their residents to apply the state-tax benefits to any 529 plan in the country, but more often, residents forgo their home state's tax incentives if they choose a plan offered by another state.

We do not consider a state's tax benefits when evaluating its 529 plan. States that offer tax benefits to their residents give those education savers an additional incentive to choose that state's plan over another, but each investor's tax and residency situation is unique. For that reason, the Morningstar Medalist Rating for 529 plans compares plans nationally and is not influenced by state-tax benefits. However, in each plan's write-up, we are sure to highlight state tax benefits that may be available to its investors.

Research Process

Pre-Interview Evaluation

Before interviewing state 529 officials and the program managers, our analysts perform an in-depth review of the plan. The goal is to develop a preliminary investment view and identify any potential areas of concern, thereby ensuring the analysts' questions to the plan sponsor and program manager are targeted to gain insight into the key issues that affect our investment opinion. The following may be taken into consideration as part of the pre-interview evaluation:

- ▶ A completed baseline questionnaire from the asset manager as needed.
- ▶ Plan documents, including the 529 plan's public program description, which includes details on how the investment options are constructed and priced.
- ▶ Any recent news regarding the 529 plan's state oversight, program manager, or investment managers.
- ▶ Morningstar's complete holdings data on the plan's investment options and their portfolio characteristics through time to build our independent perspective on the plan's broad investment exposures and risks.
- ▶ Morningstar proprietary analytics such as style analysis, performance attribution, risk modeling, capacity assessment, and scenario analysis.

- ▶ Performance data through time to ensure the plan's investment options are behaving as we would expect in different market environments given our knowledge of the strategies and analysis of their holdings.

Program Manager and Key Overseer Interview(s)

Our analysts form their initial view of the plan during the pre-interview evaluation, after which they interview the state administrators overseeing the plan, the program manager, or other relevant parties. This often includes the asset allocators who design and implement the age-based or target-enrollment options' glide path and/or managers of key investment-option strategies within the plan. During the interview(s), we focus on the issues we have identified in the pre-interview evaluation and on fleshing out our knowledge of the underlying managers, their processes, and the organizations working to run the plan.

Ratings Committee

After consultation with their peers, analysts produce a ratings note that assesses each of the five key pillars. The analyst then submits this note to the 529 plan ratings committee and defends his or her assessment of the plan and associated investment options. Only when the committee is satisfied with the soundness of the judgments expressed in each area is the final rating approved.

Analysis Creation

We believe transparency is extremely important, and our analysts invest considerable time in writing detailed analysis that is enhanced with our proprietary graphics and calculations. The analyses justify the ratings decision, provide readers with guidance on how the plan's investment options might behave in different market environments, and highlight key developments in performance and portfolio holdings.

Monitoring

Analyst teams monitor the plans they cover for developments that may affect the ratings decision and provide updates on such matters as soon as possible. Plan ratings and reports are otherwise updated once per year (report data is updated monthly). ■■■

About Morningstar Manager Research

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Morningstar views are expressed in the form of Morningstar Medalist Ratings, which are derived through research of three key pillars — People, Process, and Parent. The Morningstar Medalist Rating is the summary expression of Morningstar’s forward-looking analysis of investment strategies as offered via specific vehicles using a rating scale of Gold, Silver, Bronze, Neutral, and Negative. A global research team issues detailed research reports on strategies that span vehicle, asset class, and geography.

Medalist Ratings are not statements of fact, nor are they credit or risk ratings, and should not be used as the sole basis for investment decisions. A Medalist Rating is not intended to be nor is a guarantee of future performance.

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Morningstar Manager Research Services combines the firm's fund research reports, ratings, software, tools, and proprietary data with access to Morningstar's manager research analysts. It complements internal due-diligence functions for institutions such as banks, wealth managers, insurers, sovereign wealth funds, pensions, endowments, and foundations. Morningstar’s manager research analysts are employed by various wholly owned subsidiaries of Morningstar, Inc. including but not limited to Morningstar Research Services LLC (USA), Morningstar UK Ltd, and Morningstar Australasia Pty Ltd.

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