

# Morningstar evolving well beyond its origins analyzing mutual funds

Led by CEO Kunal Kapoor, firm is moving way past ratings — and financial advisers are paying close attention



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Seventeen months into his tenure as CEO of Morningstar Inc., Kunal Kapoor finds himself in a familiar situation — selling to advisers, yet competing with them in some areas.

Morningstar has radically reshaped itself since the days when its founder, **Joe Mansueto**, produced mutual fund reports at his kitchen table. The \$4.4 billion company now has nearly 5,000 employees worldwide, but the days when it focused purely on mutual fund data ended with

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While data remains its largest source of revenue, Morningstar has evolved into a business services company. Many of

its products and services are aimed at financial advisers, ranging from a data aggregation platform to services that help advisers counsel on private equity investments and navigate fiduciary regulation.

"We have a fantastic shared mission with financial advisers and the end investors, and that's the source of our tight relationship with advisers," Mr. Kapoor said.

A big part of that shared mission is dealing with the effects of automation and fee compression on the advisory industry — developments that have been helped along by Morningstar itself. Investors have increasingly turned away from high-cost, commission-based funds in favor of low-cost index funds, an approach that Morningstar has long advocated. And many of the tasks that advisers traditionally have performed, such as creating and monitoring portfolios, are becoming increasingly automated — services that Morningstar also offers.

What troubles advisers most is not Morningstar's data resources, but its increasing expansion into the advisory and the investment management business. For example, it offers a managed portfolio service to advisers, using mutual funds, individual stocks and ETFs; the service's net inflows grew 38% last year. The company's



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The big worry for Morningstar — and the advisers it's cultivating — is whether the company can maintain its objectivity as it moves into the money

management field.

## PUSHING THE BOUNDARIES

"All firms are encroaching; Schwab and Vanguard are doing the same thing," said Tom Balcom, founder of 1650 Wealth Management. "The question for Morningstar is how to keep the Chinese wall between analysts and those who choose the funds for their portfolios."

And, of course, portfolio management is a traditional domain of financial advisers.

"I think they have pushed the boundaries of how far they can go in evaluating funds and different investment products," said Steve Janachowski, CEO of Brouwer & Janachowski. "They are a for-profit venture, so they have

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**compete with independent advisers, but they do, and Morningstar does the same thing."**

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Morningstar raised eyebrows in March 2017 when it filed with the Securities and Exchange Commission to launch nine mutual funds for use in its managed portfolios that are specifically for financial advisers. The filing says that the move is designed to generate cost savings that will be passed down to the investor level by replacing the third-party mutual funds currently used in Morningstar Managed Portfolios. Because the filing is still in its quiet period, Mr. Kapoor declined to answer questions about the funds.

Some advisers remain skeptical about **Morningstar's ability to manage money**, as opposed to its ability to evaluate money managers.

"It's too soon to tell if they will be successful managing money," Mr. Janachowski said. "It's one thing to evaluate managers, and it's another thing completely to pull the trigger. A lot of people can be armchair quarterbacks, but can they play the game?"

Others worry that Morningstar's entry into fund management could cause conflicts of interest.

That's precisely the reason that Kashif Ahmed, president of American Private Wealth, doesn't use Morningstar's managed account services. "I feel that there's a conflict of interest," Mr. Ahmed said. "Now they are putting out their own mutual fund products, and that bothers me."

Mr. Kapoor said that Morningstar wants to be a partner, not a usurper, in an increasingly complex advice industry.

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management, they've asked us to partner with them in this space," he said. "Our [managed account] offering is only available to individuals who work with advisers. So it is a service for advisers, not one that competes against advisers. Our goal is to serve advisers who want to pick investments themselves through our data, research and software offerings, and for those that choose to outsource investment management, we serve them by building portfolios for them."

## CHALLENGES

Morningstar's rating system for funds is a perennial target for attacks. Most recently, in October, the Wall Street Journal argued that the company's assessment is a poor guide to how funds will perform going forward.

Mr. Kapoor and several others at Morningstar fired back at the newspaper's analysis, with Mr. Kapoor noting that the Journal's own analysis showed funds rated higher by Morningstar outperformed lower-rated ones. "That's tilting the odds of choosing a good fund in investors' favor," he wrote in a letter to the paper's editors.

But critics worry that the venerable star ratings, based largely on risk-adjusted past performance, don't do what investors think they can do, which is pick winners.

"Morningstar's ratings have infinitesimally small predictive power now," said David Snowball, editor at the Mutual Fund Observer. "And in a three-year window, gold and silver ratings are contrarian."

Jim Lowell, chief investment officer of Adviser Investments, a money manager, is also skeptical of Morningstar's ratings. Nevertheless, the ratings have the power to direct assets to funds and ETFs. "They

Awards & Recognition  
"Their data is a gold mine — you just have to be the miner."

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Morningstar has put considerable resources into expanding its ratings to cover stocks and debt, but the effort is weighed down by the company's longstanding image as a mutual fund specialist.

Rita Lee, director of research at Brouwer & Janachowski, uses Morningstar, which costs \$18,000 a year for a single user, for fund information.

"A lot of the equity information we get from FactSet," she said, referring to the company that provides financial analytics and software to investors. "At the most recent conference [Morningstar] said, 'We want you to know we're very good at quantitative stock analysis.' I needed more time to absorb that."

## A GOOD FIRST YEAR

Mr. Kapoor took the CEO position at Morningstar on Jan. 1, 2017, succeeding Mr. Mansueto, who remains chairman of the board.

Mr. Kapoor, 42, has spent more than 20 years at Morningstar, where he started as a data analyst. If anyone knows how the company works, it's Mr. Kapoor. He has served as the company's director of mutual fund research, its director of international business strategy, and as president and chief investment officer of Morningstar Investment Services.

"Investing is my passion," Mr. Kapoor said. "One reason advisers like Morningstar, and one reason we all like working here, is that we're trying to solve investor problems. Advisers love that."

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the past 12 months, boosted by an 8.7% increase in its quarterly dividend and a \$500 million buyback program.

Despite the spending on buybacks and dividends, the company sports considerable free cash flow, giving it the ability to expand organically and through acquisitions.

"We run the business in a long-term fashion — we don't do earnings calls or give earnings estimates," Mr. Kapoor said. "We have one shareholder meeting a year, and otherwise answer questions through a document filed once a month."

Morningstar's cash flow gives it plenty of money to develop services for advisers. In 2017, for example, its purchase of PitchBook added \$76 million to its operating expenses. And Morningstar's move to migrate infrastructure — including **Morningstar Direct**, a key adviser service — to the cloud resulted in a \$4.1 million impairment charge last year

Mr. Kapoor argues that the relationship between advisers and Morningstar is symbiotic.

"Advisers do so many things for the people they work with," he said. "It's amazing how much more they have taken on in that regard. And the question isn't whether advice is valuable — it is — but it's how to demonstrate that more fully to individual investors. From my perspective, we will continue to be the source that helps advisers serve the investor and show them the value they bring to the table."

Morningstar's offerings for advisers relate to that "No. 1 challenge and opportunity" of proving their value to investors, he said.

**Morningstar Data**, its largest product by revenue, and put it on adviser-oriented platforms, such as Morningstar Direct. Advisers can use such platforms to gather stock, bond, mutual fund and ETF data to create custom client presentations.

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## GOING BEYOND DATA

Increasingly, however, Morningstar has gone beyond data in its outreach to advisers. Last year, it rolled out the Morningstar Best Interest Scorecard in an effort to help advisers act as fiduciaries to their clients and navigate the Labor Department's now-moribund fiduciary rule. It also introduced solutions for European advisers related to the Markets in Financial Instruments Directive II investment services regulations.

ByAllAccounts, Morningstar's data aggregation platform for advisers, allows them to get daily updates on all of a client's accounts, and delivers analysis and advice for them. The platform, which caters to institutions and family offices, has 800,000 accounts and has grown 40% in the past 12 months. The number of advisers who use the service has grown 30% in the past 12 months, the company said.

**(More: [Morningstar CEO describes future of adviser tech](#))**

"We have used Morningstar Office ever since we opened our doors for business eight years ago," Mr. Balcom of 1650 Wealth Management said. "We also use ByAllAccounts to aggregate accounts for our clients with outside assets. In addition to serving as our portfolio management system, we use Morningstar Office for research of ETFs and mutual funds. None of



Another Morningstar product aimed squarely at advisers: A suite of products that help advisers who delegate investment management to outside vendors. One section of the learning curriculum, which is still in its beta phase, focuses on improving practice management. Another big component of that suite: behavioral coaching.

"The notion is that they have a financial plan, they have outsourced portfolio management to someone else, so the adviser has to make sure that they stay on track to achieve the best outcomes," Mr. Kapoor said. "It gives advisers the techniques and communication plans to help investors overcome the tendencies that destroy wealth."

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Mr. Kapoor is particularly enthusiastic about PitchBook, a private equity data company that Morningstar acquired in 2016.

"It's a fantastic data set. Historically, high-net-worth clients who wanted to invest in private equity went through a well-heeled private equity firm," he said. "Now we're seeing more and more advisers encouraging high-net-worth investors to do it directly." The Pitchbook data, now integrated with Morningstar's public company data, help advisers and their clients sort through what was once a difficult area to research.

This March, to increase the amount of analysis it makes available to investors, Morningstar rolled out new quantitative ratings driven by artificial intelligence that will cover more than 10,000 mutual funds and ETFs. The

Award for Recognition

As the company expands its horizons, Mr. Kapoor has his eye squarely on advisers.

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"People don't realize the scale we are operating on in the adviser space," he said. "Morningstar Office, for example, fields more than 200,000 research queries per month, and more than 800,000 reports are posted to the client web portal a month. And in the first quarter of 2018, there were approximately 38 million transactions imported into Morningstar Office.

"We're doing a lot of things that advisers can say they are excited about," Mr. Kapoor said.

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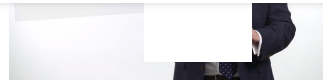
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