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Morningstar's Letter to the SEC

John Rekenthaler

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New and Improved

A few weeks back, I saluted the SEC's proposal on mutual fund reporting, snappily entitled *Investment Company Reporting Modernization*. Since then, Morningstar has penned an official comment letter by Director of Policy Research Scott Cooley and two subject-matter experts, Ben Alpert and Sagar Patel.

That letter's key points:

Holdings Identification

Under current reporting rules, funds can hide derivative positions by stashing them in a junk drawer called "Other Holdings." Also, some officially listed securities are impossible to identify. Sometimes their names are truncated, so that the listed description could apply to several issues besides the one held by a fund. In other instances, as with customized derivatives, the name alone is insufficient. It does not indicate how the security will behave.

There are also cross-border difficulties. Morningstar's letter cites an example:

In many markets including Germany, Brazil, and Korea, "equity-preferred" has a broadly different meaning from in the United States. While preferred shares issued in the U.S. are generally redeemable at a fixed value in the event of a change of control, equity-preferred is nonvoting common equity, fully participating in the upside upon a change of control, in these other markets.

In the case of equity-preferred securities, unlike with the Other Holdings drawer or with customized derivatives, a well-informed researcher could accurately model the holding's behavior. Assuming that the translation is accurate, that is. Perhaps the security is a different flavor of equity than preferred, but is labeled as such in the translation.

Ideally, every holding in a portfolio would be listed. Standardized instruments would be accompanied by a unique descriptor that permits complete identification, thereby bypassing the need for guesswork and/or problems of translation. Custom derivatives would be accompanied by enough ancillary information so that informed outside parties could model the derivative's behavior.

As that is what the SEC has proposed, Morningstar fully supports the commission on securities identification.

Portfolio Reporting

Thirty years ago, when Morningstar began operations, the state-of-the-art technology for collecting fund portfolios was to request paper reports, then retype the holdings listed on those reports into a database. (In the company's very early days, half the staff was typists.)

Today, of course, the process is more streamlined, but it's far from optimal. The SEC requires that funds register their portfolios electronically, which would seem to be a major step forward. However, because the SEC does not specify a data protocol to fund companies, the result is an electronic Babel. Scraping the SEC's files is an arduous task--so arduous that Morningstar declines the privilege, going instead either to fund custodians or to the fund companies directly.

The SEC's modernization proposal silences the cacophony by requiring that all funds use a single mandated format. That is a major advance that will, at long last, place the commission's database firmly in the 21st century.

However, Morningstar urges the SEC to push portfolio reporting an additional step. For the past two decades, fund companies have been required to publish their portfolios quarterly. Morningstar would like to make that requirement monthly. (The SEC proposal has monthly disclosure only to the commission.) The cost of making the extra filings is effectively nil for electronic portfolios, and there is ample precedent for monthly disclosure.

On the latter point:

More than half of U.S. mutual funds already voluntarily disclose their portfolios to Morningstar and other third parties on a regular basis. [The asset-weighted figure for monthly disclosure is 79%]. Additionally, monthly portfolio disclosure--whether mandated or voluntary--has become the norm in many advanced financial markets around the world. For example, in the United Kingdom, Canada, and the Netherlands, among others, the vast majority of funds make public disclosure of their portfolios on a monthly basis.

Funds are even more generous with their nonpublic disclosure:

Moreover, we note that funds' Statements of Additional Information reflect that many of them provide very frequent portfolios--sometimes even daily--to investment consultants and other interested parties. If fund managers do not find it overly onerous to provide portfolios frequently to third parties, should not the actual owners of these assets also be entitled to receive timely updates on their portfolio holdings.

Morningstar urges the SEC to extend the electronic-reporting format to all types of registered investment companies: open-end funds, exchange-traded funds, closed-end funds, and unit investment trusts. The reporting frequencies can and should vary according to the fund type, but the format should not.

Risk Metrics

The SEC will require fixed-income funds to report certain risk metrics. The commission is still considering the details, so it has not yet specified what will be expected. In general, though, these metrics are calculations that are commonly available to portfolio managers who run the funds, but not to the shareholders who own them. Examples include how a fund might behave in response to movements in interest rates or to a change in the shape of the yield curve.

These calculations would not be completely comparable, as all fund companies do not share the same risk model.

The SEC is best positioned to decide what metrics will be selected; Morningstar has no advice to offer for that. Morningstar's main recommendation on this topic is for the SEC to require detailed information so that investors and researchers can create their own risk metrics. Secondarily, Morningstar recommends that the calculations be standardized as much as possible. While the inputs will vary according to each company's risk model, the calculation itself should be fixed, so that different companies aren't using different definitions for--to cite one example--"effective maturity date."

Securities Lending

Finally, the commission advocates several enhancements to reporting on securities lending. Morningstar supports those efforts, which should not only help to expose systemic risks, but which also will give fund shareholders better information about the fees that they pay.

We further support the SEC's proposal to provide more-granular information about funds' fee income from securities lending. We believe that fund investors are entitled to know the revenue split between the fund manager, the lending agent, and the fund itself. Collecting

and publishing this additional information will allow investors to learn whether they are being adequately compensated for [the risks of] securities lending, at least in comparison with other funds.

Morningstar has no additional suggestions on this topic.

The Gods Are Laughing

Ah, the hubris of a mortal to suggest, however delicately, why not 100% equities? The market gods promptly responded.

Perhaps that column will end up as a bookend to *BusinessWeek*'s famous "The Death of Equities" cover, which is (incorrectly) remembered as being issued at the bottom of the stock market in 1982, and (again incorrectly) as having predicted that stocks would never again be a good investment. Well, if it's fame, bring it on. Infamy beats no fame at all.

Besides, gods, I have a better target for you. Javier Estrada of IESE Business School emailed me from Spain:

For whatever it is worth, when this issue comes up I like to emphasize that an all-equity portfolio not only has a return advantage (in the long term) but also a risk advantage. The latter, of course, depends upon how you define risk. If you do it as volatility, then obviously the all-equity portfolio is very risky. But if you define it as "long-term terminal wealth when tail risks strike" then the all-equity portfolio is less risky than an all-bond portfolio for periods as short as 10 years (and obviously even more so for periods of 20 and 30 years.)

There you go gods--a new target! And should you wish to do the work before further laughter, or perhaps hurling a thunderbolt or two, here are a couple of papers that Estrada has written on the subject.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.