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RE: Morningstar Category Classifications Discussion Paper

Dear David,

It is my pleasure to provide some input into Morningstar's endeavour to create a new and improved mutual fund classification system. Overall, I support Morningstar's proposal. What follows, however, focuses on areas of your May 26, 2006 discussion paper where I either disagree or want to provide additional information for your consideration prior to finalizing your classifications.

Note that, throughout, I pose questions that I intend to serve as 'food for thought' or to draw attention to an area that may require greater clarification.

Global Fixed Income

The criterion for such funds to invest less than 90% in debt of Canadian issuers seems too loose. Also, I did not see any significant minimum threshold with respect to exposure to foreign currencies and/or foreign issuers.

In other words, it is my opinion that a global bond fund should, at a minimum provide exposure to foreign currency if not to yield curves outside of Canada. The stated criteria for global bond funds don't appear to require significant exposure to either. A couple of actual examples illustrate these issues.

DFA Global Five Year Fixed Income fund hedges all currency by policy but does invest in the debt of foreign issuers[1]. Many other funds have long invested in debt of Canadian issuers denominated in foreign currencies. This provides currency diversification but no diversification by yield curve. Hence, I would like to see Morningstar's global fixed income criteria more clearly defined with respect to exposure to foreign currencies and foreign yield curves.

[1] This is the result of Fama and French's two-factor fixed income model which assumes that (short) duration and (high) credit quality (with lots of liquidity) explain the vast majority of fixed income returns. Their fund also goes foreign to the extent that the two factors are satisfied to obtain greater diversification by yield curve.

Portfolio Income Funds

Is it prudent to compare *distribution yield* to a *benchmark yield*?

In my opinion, this is not a fair comparison and would allow fund companies too much latitude to pretty much pick the category into which they want to be placed (i.e. Portfolio Income vs. Canadian Neutral). The reason is that there exist many funds that simply set their distributions at a level that far exceeds the underlying portfolio's actual "yield" (i.e. dividends and interest).

Also, do *income generating* securities refer to *fixed income* or anything that offers regular cash payments (i.e. stocks that pay a dividend, income trusts, or other cash-paying securities)? The distinction is not apparent.

Funds like *Clarington Canadian Income* (MFID: 2248), *R Monthly Income Balanced* (2823) and *BMO Monthly Income* (2442) offer high levels of monthly cash distributions. However, each pays distributions that far exceed the actual income generated by each.

I would urge you to consider comparing funds' pure yields – completely independent of distribution yields – with benchmark yields. That way, the comparison would be more meaningful and indicative of the types of underlying securities and portfolio risk and return characteristics.

Target Date Funds

I agree fully with the idea of grouping target date funds by time horizon. However, I wonder how you will treat today's 10-Year funds in three years (which will then be 7-Year funds) if at that time new 10-Year funds are launched? Will you simply let funds sit in a particular group until they move down to shorter maturities (i.e. so that it takes five years for today's 10-Year funds to move down to the 5-Year category)?

In my opinion, letting funds naturally move between categories with the passage of time seems to be the best compromise without making this task overly complex. However, I would suggest that a Target Date fund be assigned to the category that is closest to its remaining maturity.

Otherwise, funds with a time-to-maturity of six years will be compared to 10-Year funds – when they're actually more similar to 5-Year funds.

Equity Income Funds

Consistent with my above comments on Portfolio Income funds, I would urge you to reconsider the use of a fund's *distribution yield* as a qualifying criterion for this class.

Based on the stated definition of *distribution yield*, this class may inadvertently catch funds that pay large capital gains distributions in a single year. For instance, Trimark Canadian fund paid a large distribution in the late 1990s that was in the range of 8%-10% of its NAV. The fund's dividend yield may or may not exceed that of the index, but capital gains distributions should not factor into a fund's "yield" given their unpredictable nature.

Also, how will T-series units be treated for classification purposes? Case in point: *Fidelity Canadian Disciplined Equity A* (72380). This fund paid no distributions for the twelve month period ending May 31, 2006. Fidelity Canadian Disciplined Equity T-Series, however, pays monthly distributions equal to about 2.4%[2] - a level that might place it in the Equity Income category.

Clearly, this fund should probably be in the Canadian Large Cap category. But the T-Series may qualify for the Equity Income category. Which classification will prevail?

Equity High Income Funds

The discussion paper notes that this category will not be defined along geographic lines, which implies (to me) that domestic funds may be grouped with foreign funds if they share a goal of generating a high level of income or cash. Given that the benchmark yield is based on that of the S&P/TSX Composite Index, I'm unclear why foreign funds that happen to target a high distribution rate (i.e. *Templeton International Stocks T-Series* - 76042) might be included in this category with the likes of Canadian income trust funds or others that offer a high fixed distribution level.

Sample Category Assignments

I agree with most of the sample classifications included in the appendix to your discussion paper. However, the following are a few examples where I will challenge the sample classification.

CI Signature High Income

While its objective is to generate regular income the fund is driven by the team's macro calls. In the past, it has vacillated from as much as 75% invested in equities (including income trusts) to a more neutral stance between equities and fixed income securities. This could just as easily be assigned to the Canadian TAA category.

Dynamic Canadian Dividend Fund Ltd & Standard Life Canadian Dividend Growth A

The Dynamic fund is classified as Equity Income while the Standard Life fund is grouped into the Canadian Large Cap class. Checking PALTrak as of May 31, 2006 shows that the fund assigned to the Equity Income group has a lower dividend yield than the fund assigned to Canadian Large Cap group. Hence, this appears to be an inconsistency.

I am interested to see how hybrid funds like PH&N High Yield and Trimark Advantage Bond would be treated under your proposed methodology, but I admit that those are very difficult funds to classify without having a small category with a small number of funds.

While some of my comments may strongly challenge some of your proposed criteria, I offer my input in the spirit of helping you design the best system possible. Having dealt with this issue in

[2] Based on distributions for Jan 1 through Apr 30 2006 ($0.69 per unit) and average month-end prices ($28.47615 per unit); Fidelity Canadian Disciplined Equity T-Series had a distribution rate of 2.423%.

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the past, I understand the challenges of defining such a comprehensive set of rules. So, I know that no method will form the perfect system. However, I hope my input – along with that of many others – will assist in this difficult endeavour.

I would be happy to further discuss any of the above or any other issue with respect to classification rules.

Sincerely,

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