The Morningstar Category™ Classifications for Hedge Fund of Funds

Morningstar Methodology Paper
October 8, 2008

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Introduction

The Morningstar Category™ classifications for Hedge Fund of Funds were introduced in 2008 to help investors understand the different types of investment strategies used by hedge fund of funds around the world.

Hedge fund managers typically focus on specific types of hedge funds to invest in. For example, some hedge fund of funds buys funds that primarily invest in event-driven strategies such as merger arbitrage, convertible arbitrage, distressed securities or corporate actions. The Morningstar categories divide the universe of hedge fund of funds s based on these different approaches.

Morningstar supports seven hedge fund of funds categories. These categories and category groupings can help investors make meaningful comparisons between hedge fund of funds. Investors can use these peer groups to identify top-performing funds, evaluate a fund's performance against its peers, and find similar funds. For example, if an investor wanted to evaluate how well a global derivatives fund of funds performed, they could compare its performance to that of the global derivates fund of funds category.

Morningstar assigns a category to each hedge fund of funds based on the source of the funds directionality—the drivers of their returns (with the exception of non-directional fund of funds).

For each Morningstar Fund of Funds categories, except non-directional, funds in the categories will tend to cluster together in Morningstar's quantitative cluster analysis. In addition, regression betas will be used to help in identifying the key drivers of a fund's returns.

Morningstar hedge fund analysts will supplement quantitative findings with secondary research, including a review of the hedge fund's memorandum document, manager-provided investment strategy descriptions and supporting data, conversations with portfolio managers, and portfolio statistics acquired via surveys. Currently, Morningstar does not have access to portfolio holdings for hedge fund of funds and must instead rely on other information provided by the asset managers.

Morningstar regularly reviews the category structure and the hedge fund of funds within each category to ensure that the system meets the needs of investors. The driving principles behind the classification system are as follows:

- Individual funds within a category use similar strategies and techniques to create value.
- Individual funds within a category can, in general, be expected to behave more similarly to one another than to funds outside the category.
- Categories have enough constituents to form the basis for reasonable peer group comparisons.
- The distinctions between categories are meaningful to investors and assist in their pursuit of investing goals.

Fund of Funds

Non-directional
These funds produce returns that cannot be explained well by directional hedge-fund factors. Non-directional funds can invest in any hedge fund strategy and any asset class, but their defining characteristic is producing absolute returns; ones that are not dependent on the performance of financial markets at large. These funds generally show r-squared results of less than 30% in multi-factor regressions using common factors of hedge fund returns. In some cases, if other information proves more valuable than the regression results, Morningstar's hedge fund analysts will have the discretion to make slight exceptions to the r-squared rule.

Any fund that does not qualify for this category will be assigned to one of the directional categories listed below.

Equity
These funds have statistically significant betas to at least one equity index, and primarily (50% or greater) derive their directionality from equity-related hedge fund strategies. Equity funds can diversify across geography or concentrate in a particular region.

Debt
Debt funds have statistically significant betas to at least one debt index or a credit- or duration-spread. These funds primarily (50% or greater) derive their directionality from debt-related hedge fund strategies. Debt funds can diversify across geography or can concentrate in a particular region.

Event
Event funds invest primarily in event-driven strategies, with 50% or more of the portfolio in one or more of the following event-driven strategies: merger arbitrage, convertible arbitrage, distressed securities, and corporate actions. Event funds tend to show high betas to the single strategy Morningstar Index of the same name.

If an event fund could also qualify for the Equity, Debt, or Multi-strategy categories, it shall be placed in the category with which its returns are most strongly related, considering cluster analysis and regression betas.

Fund of Funds (continued)

Global Derivatives
These funds invest primarily (50% or greater) in the Morningstar Global Derivatives categories, which are Global Trend and Global Non-trend. Global Derivatives funds predominantly invest in highly liquid instruments such as futures and options, and use various instruments to trade currencies. The underlying funds' strategies can be systematic or discretionary, technical or fundamental, or any combination of the four. These funds tend to be diversified across Global Trend and Global Non-trend strategies.

Multi-strategy
Multi-strategy funds generally have statistically significant betas to multiple asset classes (e.g., debt, equity, event driven and global derivatives), without enough asset-class concentration to belong to another hedge fund of fund category. That is, no one asset class drives a majority of the funds' directionality.

Miscellaneous
For these funds, either there is not enough data to confidently categorize the fund or the fund follows a strategy that does not have a large enough peer group to merit a separate Morningstar category.