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# Construction Rules for the Morningstar® Minority Empowerment Index<sup>SM</sup>

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## Morningstar Indexes

June 2021

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### Overview

The Morningstar® Minority Empowerment Index<sup>SM</sup> is designed to provide exposure to U.S. companies that have strong racial and ethnic diversity policies embedded in their corporate culture and that ensure equal opportunities to employees irrespective of their race or nationality. The index pursues social objectives by selecting companies with high Minority Empowerment Scores, while companies with controversies are deemed ineligible. Built with the data and risk ratings methodology from Sustainalytics, the individual indicators used in the determination of the Minority Empowerment Scores are selected in collaboration with the NAACP.

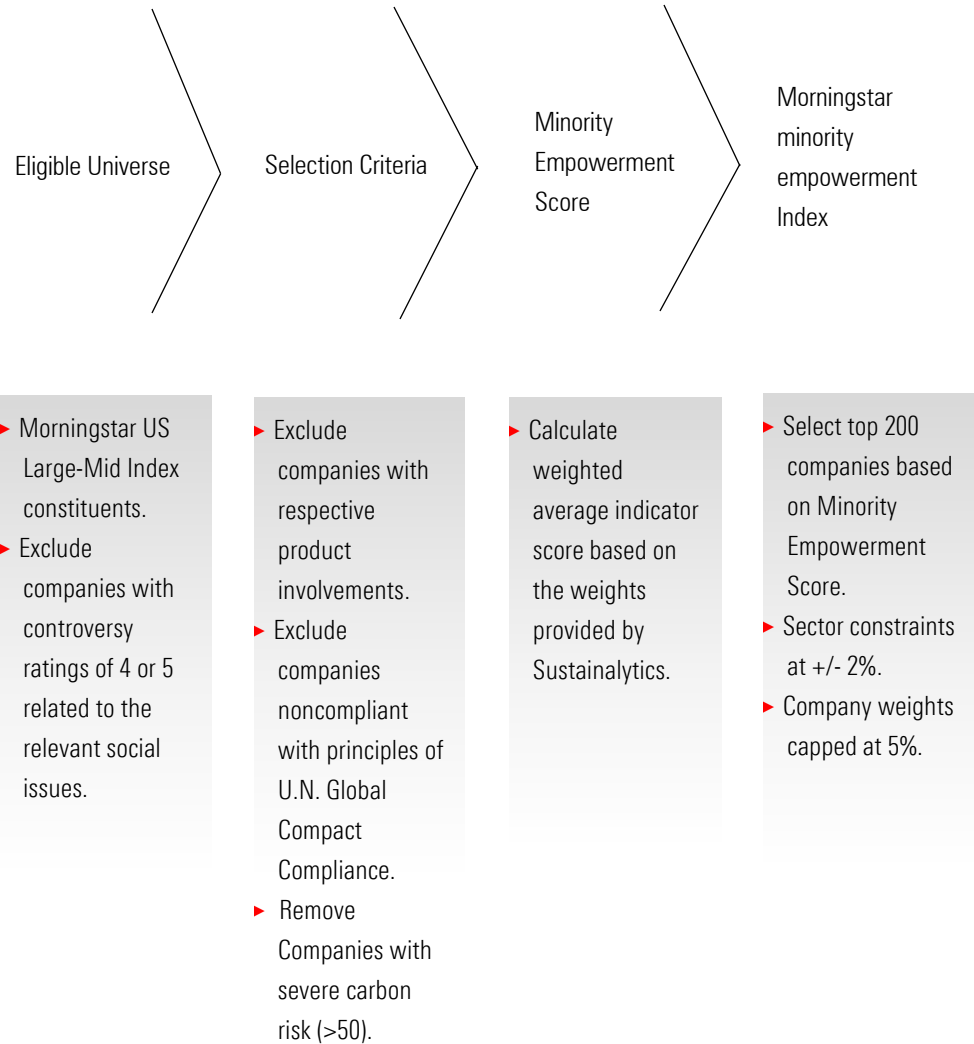
For more information on the computation of the Minority Empowerment Score, refer to Appendix 1.

### Index Inception Date and Performance Inception Date

The inception date of the index is May 29, 2018, and the performance inception date is Dec. 15, 2017, when the first back-tested index value was calculated

## Index Construction

**Exhibit 1** Morningstar Minority Empowerment Index Construction Process



## Assigning Stocks to the Index

### Selection Universe

At each reconstitution, constituents of the Morningstar Minority Empowerment Index are derived from the Morningstar US Large-Mid Index (benchmark). For more details on benchmark construction, refer to the [Construction rules for the Morningstar US Market Index](#).

### Security Selection

To be eligible for the index, all constituents must meet the following criteria:

- ▶ Security must have at least five of the following indicator scores. For details regarding individual indicators, please refer to Appendix 1.
  - ▶ Board diversity
  - ▶ Discrimination policy
  - ▶ Scope of social supplier standards
  - ▶ Freedom of association policy
  - ▶ Diversity programs
  - ▶ Community development programs
  - ▶ Health and safety management system
  - ▶ Conflict minerals programs
  - ▶ Media ethics programs
  - ▶ Human rights programs
  - ▶ Editorial guidelines
  - ▶ Advertising ethics
  - ▶ Human capital development
  - ▶ Responsible product offering
  - ▶ Responsible marketing policy
  - ▶ Human rights policy
  - ▶ Gender pay equality programs
  - ▶ Gender pay disclosure
  
- ▶ Exclude securities noncompliant with the principles of the U.N. Global Compact.
- ▶ Security must have current Carbon Risk Rating.
- ▶ Exclude securities classified under the Sustainalytics subindustry Security Services and Correctional Facilities
- ▶ The security should not belong to the severe carbon risk category.
- ▶ Exclude securities that
  - ▶ Derive more than 5% of revenue from predatory lending activities
  - ▶ Are involved in the manufacturing of riot control weapons
  - ▶ Derive more than 5% of revenue from tobacco products production

- ▶ Security controversy rating must be 3 (out of 5) or lower for the following incidents:
  - ▶ Employee incidents
  - ▶ Social supply chain incidents
  - ▶ Society and community incidents

- ▶ **Portfolio Selection:**

Securities with the highest Minority Empowerment Score are selected. The score calculation is explained in Appendix 1. The process is repeated until 200 stocks are selected from the parent index, subject to the following constraints:

- ▶ Sector active weight constraints: To minimize deviation from corresponding weights in the parent index, the sector weights in the index are maintained within a lower and upper bound calculated as:
  - ▶ Lower bound =  $\text{Max}(\text{Weight in the benchmark} - 2\%, \text{Weight in the benchmark} / 2)$
  - ▶ Upper bound =  $\text{Min}(\text{Weight in the benchmark} + 2\%, \text{Weight in the benchmark} * 2)$

The constraints are enforced by the locally optimal (greedy) selection algorithm explained in Appendix 2. Minimum controversy and empowerment scores eligibility criteria above take precedence over meeting the weight constraints if they are in conflict. If there are not enough eligible securities available to meet the minimum sector weight constraint, the constraint is relaxed.

- ▶ Buffer rules: A current constituent has absolute priority to remain in the portfolio over the new entrants, so long as its Minority Empowerment Score percentile rank is better than the portfolio's coverage of the benchmark in its peer group plus the buffer margin of 25%.

### **Number of Stocks**

The index targets 200 stocks based on a transparent ranking system subject to selection and eligibility criteria at reconstitution. The actual number of securities may be higher than 200 in case of multiple share classes of a company.

### **Index Weighting**

The index uses float market cap weighting. Individual company weight is restricted to 5% to avoid concentration risk. If individual company weights exceed 5%, weights are redistributed among remaining companies belonging to the same sector. If this redistribution is not feasible, the excess weights will be redistributed across the portfolio, in which case sector constraints may be relaxed.

## **Index Maintenance and Calculation**

### **Scheduled Maintenance**

The index is rebalanced quarterly in March, June, September, and December, and reconstituted annually in December, on the Monday following the third Friday. If Monday is a holiday, it is effective on the immediate following business day.

Because the reconstitution of the Morningstar Minority Empowerment Index is less frequent than the Morningstar US Market Index, the securities excluded from the Morningstar US Market Index at the reconstitution effective date are also deleted from the Morningstar Minority Empowerment Index. During quarterly reviews, constituents with a controversy rating greater than 3 related to social issues are deleted from the index and weights are rebalanced to enforce 5% security capping.

### **Corporate Action**

The treatment of corporate actions will be as per the market-capitalization-weighted indexes. It can be found in the [Morningstar Indexes Corporate Actions Methodology rulebook](#).

### **Index Calculation and Price Data**

Details about index calculations and price data can be found in their respective rulebooks: [Morningstar Indexes Calculation Methodology](#) and [Equity Closing Prices Used for Index Calculation](#).

### **Methodology Review and Index Cessation Policy**

The index methodology is continually reviewed to ensure it achieves all stated objectives. These reviews take into account corporate action treatment, selection, and maintenance procedures. Subscribers to the index will be notified before any methodology changes are made. For more details, refer to the [Morningstar Indexes Methodology Change Policy](#).

Morningstar also notifies all subscribers and stakeholders of the index that circumstances might arise that require a material change to the index, or a possible cessation of the index. Circumstances that could lead to an index cessation include, but are not limited to, market structure change, product definition change, inadequate supply of data, insufficient revenue associated with the index, insufficient number of clients using the index, and/or other external factors beyond the control of the Morningstar Index Committee.

Because the cessation of the index or benchmark index could disrupt subscriber products that reference this index, all subscribers are encouraged to have robust fallback procedures if an index is terminated. For more details, refer to the [Morningstar Index Cessation Process](#).

### **Data Correction and Precision**

#### **Intraday Index Data Corrections**

Commercially reasonable efforts are made to ensure the accuracy of data used in real-time index calculations. If incorrect price or corporate action data affects index daily highs or lows, it is corrected retroactively as soon as is feasible.

### **Index-Related Data and Divisor Corrections**

Incorrect pricing and corporate action data for individual issues in the database will be corrected upon detection. In addition, an incorrect divisor of an index, if discovered within five days of its occurrence, will always be fixed retroactively on the day it is discovered to prevent an error from being carried forward. Commercially reasonable efforts are made to correct an older error subject to its significance and feasibility.

For more details, refer to the [Recalculation Guidelines](#).

### **Computational and Reporting Precision**

For reporting purposes, index values are rounded to two decimal places and divisors are rounded to appropriate decimal places.

## Appendixes

### Appendix 1: Minority Empowerment Score Calculation

The Minority Empowerment Score is calculated as a weighted average of the following indicator scores. The indicator weights are determined by Sustainalytics based on the indicator's importance to determine a company's performance

$$\text{Minority Empowerment Score} = \frac{\sum_i^n w_i * S_i}{\sum_i^n w_i}$$

Where:

Wi = Weight of Indicator i for a given company

Si = Score of Indicator i for a given company

- ▶ Board diversity: This indicator assesses the level of gender and/or national diversity on the board.
- ▶ Discrimination policy: This indicator assesses the quality of a company's policies to eliminate discrimination and ensure equal opportunity.
- ▶ Scope of social supplier standards: This indicator provides a general assessment of whether a company has supply chain/contractor policies and the scope of social standards, including items such as nondiscrimination.
- ▶ Freedom of association policy: This indicator provides an assessment of the quality of a company's freedom of association and collective bargaining policy.
- ▶ Diversity programs: This indicator assesses the strength of a company's initiatives to increase the diversity of its workforce.
- ▶ Community development programs: This indicator gauges the strength of a company's local community development programs. It does not focus on cash donations, but formal programs that promote long-term economic development among communities directly affected by the company's operations.
- ▶ Health and safety management system: This indicator assesses the strength of a company's initiatives to manage employee health and safety and prevent accidents and occupational illnesses.
- ▶ Conflict minerals programs: This indicator measures the strength of a company's initiatives to eliminate conflict minerals from its products and its supply chain. The term *conflict minerals* refers to tantalum (coltan), tin (cassiterite), tungsten (wolframite), and gold (together, they are commonly referred to as the 3TG), which have originated in conflict-affected or high-risk regions and may be used to financially support the conflict or human rights abuses. The most prominent example is the

Democratic Republic of Congo, where conflict minerals have been linked to the illegal trafficking of these mineral ores and to egregious human rights violations in the eastern conflict regions of the country.

- ▶ **Media ethics programs:** This indicator assesses the strength of a company's initiatives to ensure good governance, ethics, and integrity throughout its content creation or dissemination activities, that is, to ensure impartiality, transparency, objectivity, fairness, age-appropriateness, independence, plurality, and inclusiveness (diversity of content, topics, and viewpoints).
- ▶ **Human rights programs:** This indicator assesses the strength of the company's initiatives to comply with its obligation to respect human rights.
- ▶ **Editorial guidelines:** This indicator provides an assessment of the company's commitment to address media ethics issues during content creation and dissemination.
- ▶ **Advertising ethics:** This indicator provides an assessment of the presence and strengths of a company policy on advertising ethics.
- ▶ **Human capital development:** This indicator assesses the strength of a company's initiatives to recruit, retain, and develop human capital to avoid a shortage of skilled labor.
- ▶ **Responsible product offering:** This indicator assesses the strength of a financial institution's initiatives to market products and services responsibly, so as to avoid predatory lending and minimize risks to clients.
- ▶ **Responsible marketing policy:** This indicator provides an assessment of the quality of a company's responsible marketing policy.
- ▶ **Human rights policy:** This indicator provides an assessment of the strength of the company's commitment to respect human rights in within its sphere of influence.
- ▶ **Gender pay equality programs:** This indicator assesses the strength of programs a company has implemented to ensure gender pay equality. This includes initiatives to identify, measure, and close the gender pay gap.
- ▶ **Gender pay disclosure:** This indicator assesses the strength of a company's disclosure related to the gender pay gap.

## **Appendix 2: Construction Algorithm**

MS – lowest stock score in cap-only portfolio (upper bound lowest score for collar constraint).

NC – number of grouping constraints (for sector and region constraints, NC = 2).



TGT—target coverage of the benchmark index by modified market cap (weighting scheme).

Initialize TGT to target number of stocks, N, divided by number of stocks in the benchmark index.

Build portfolio achieving TGT coverage of benchmark:

Phase 1: Achieving Minimum Weights Per Each Peer Group

For n in NC...1:

While any group minimum weights not met  
     and best qualifying stock score > MS  
     and target market cap not reached

Add best-scoring stock from the opportunity set that doesn't violate any group maximum  
 and at least n of the groups it belongs to are under minimum

Phase 2: Filling the Remaining Portfolio

While target market cap not reached

Add best-scoring stock from the opportunity set that doesn't violate any group maximum

While number of stocks in the constructed portfolio is not equal to N and binary search step size is above threshold, perform binary search of TGT space, repeating construction algorithm above for the new value of TGT at each step.

### Appendix 3: Modification to Rulebook

Section	Description	Update Date
<b>Index Weighting</b>	Treatment of individual company weights exceed 5%	Jun 2021

### **About Morningstar, Inc.**

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. Morningstar offers an extensive line of products and services for individual investors, financial advisors, asset managers, and retirement plan providers and sponsors. Morningstar provides data on approximately 510,000 investment offerings, including stocks, mutual funds, and similar vehicles, along with real-time global market data on more than 17 million equities, indexes, futures, options, commodities, and precious metals, in addition to foreign exchange and Treasury markets. Morningstar also offers investment management services through its investment advisory subsidiaries.

### **About Morningstar Indexes**

Morningstar® Indexes combine the science and art of indexing to give investors a clearer view into the world's financial markets. Our indexes are based on transparent, rules-based methodologies that are thoroughly back-tested and supported by original research. Covering all major asset classes, our indexes originate from the Morningstar Investment Research Ecosystem—our network of accomplished analysts and researchers working to interpret and improve the investment landscape. Clients such as exchange-traded fund providers and other asset management firms work with our team of experts to create distinct, investor-focused products based on our indexes. Morningstar Indexes also serve as a precise benchmarking resource.

### **Morningstar Index Product Committee**

The Morningstar Index Product Committee is comprised of members who possess a wide array of knowledge in relation to Indexes. The Product Committee is responsible for the governance over the creation and maintenance of all Morningstar branded Indexes, ensuring the highest standards are continuously met. Any matters arising from exceptional or undocumented events will be resolved at the discretion of the Morningstar Index Product Committee.

### **Morningstar Index Oversight Committee**

The Morningstar Index Oversight Committee is comprised of informed and qualified professionals who are responsible for the process governance of Morningstar branded Indexes. The Oversight Committee assesses and where appropriate challenges the decisions of Morningstar Indexes with regards to benchmark decisions.

**For More Information**

For any queries, reach out to us via [indexes@morningstar.com](mailto:indexes@morningstar.com).



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