

# Morningstar® Dividend Leaders Index and Morningstar® Dividend Composite Index

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## A Case for Dividends

Dividends are one of the few constants in the world of investing, contributing about a third of the stock market's total returns historically. Dividend-paying stocks offer solutions to a host of investment problems by providing:

### *More predictable returns*

Over long stretches of time, a stock's return tends to correlate with its dividend yield plus subsequent dividend growth. In any given year, other factors—earnings swings, market fads—can overwhelm this rule. But, over a longer time horizon, these cyclical variations smooth. The more predictable dividend payments are the more likely returns will stay in a predictable range.

### *Lower volatility*

When the bulk of a stock's total return is built with steady dividends, there's less reason for investors to obsess about earnings estimates, management soap operas, merger rumors, and the like. The company acquires a long-term, low-turnover base of owners who have reasonable expectations—and little reason to sell at every bump in the road.

### *Management discipline*

The best dividend-paying firms are compelled by the expectations of shareholders to continue making dividend payments, lest they risk alienating the kind of owners they've worked hard to attract. This imposes a discipline on management's decision making that is manifested in a conservative balance sheet, the efficient generation of cash, and a focus on core operations.

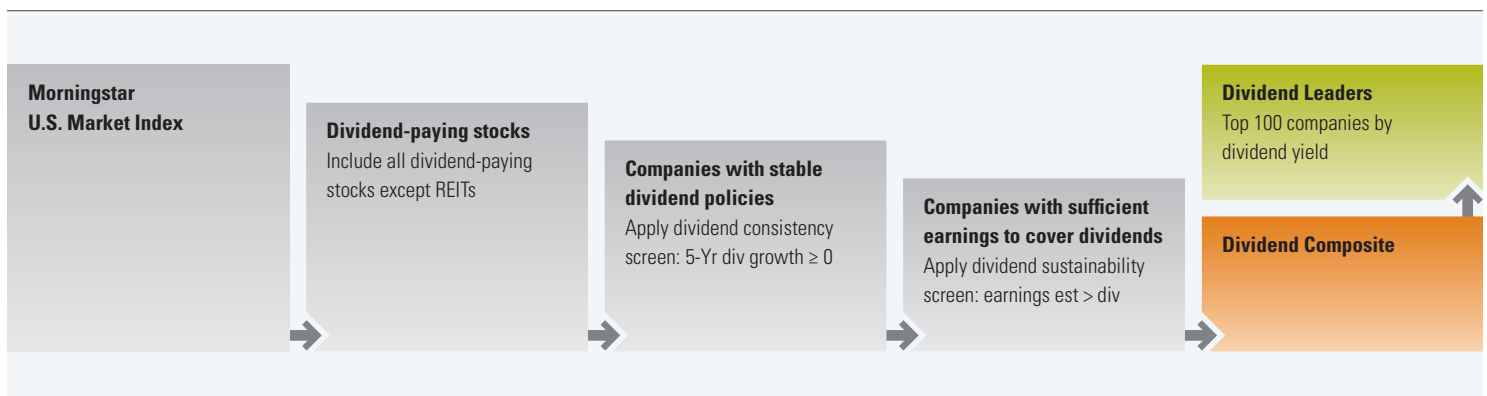
## Morningstar Dividend Leaders and Dividend Composite Indexes

With the goal of helping investors, and the advisors who serve them, understand and access this part of the equity market, Morningstar has introduced the Dividend Leaders and Dividend Composite indexes. Our key objective in designing these indexes was to generate a high-yield portfolio by selecting quality companies without compromising investment scalability.

We screen the stocks in the Morningstar US Market Index—a broad market index targeting 97% of the overall market capitalization—for dividend consistency and sustainability. All stocks that pass both screens form the Morningstar Dividend Composite Index, the top 100 stocks ranked by dividend yield form the Morningstar Dividend Leaders Index. Dividend consistency

A company's current dividend must be equal to or greater than the dividend paid five years ago. This ensures the company has a well-established and stable history of dividend payment.

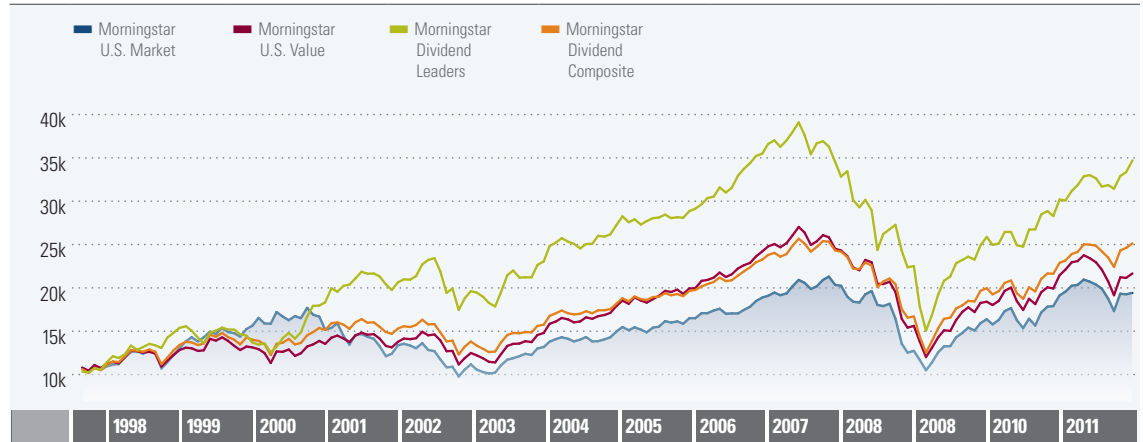
## Dividend Indexes Construction Process



## Morningstar® Dividend Leaders Index and Morningstar® Composite Leaders Index

### Morningstar Indexes Growth of \$10,000

July 1997–November 2011



Source: Morningstar Direct

#### Dividend Composite Index

Number of Holdings	523
Med Mkt Cap (USD mil)	4,523
Price/Earnings	13.43
Price/Book	2.25
Yield %	3.06

#### Dividend Leaders Index

Number of Holdings	98
Med Mkt Cap (USD mil)	4,702
Price/Earnings	15.01
Price/Book	1.98
Yield %	2.31

As of 31 May 2011

#### *Dividend sustainability*

A company's forward-looking earnings estimate must be greater than the indicated dividend per share (i.e., dividend coverage ratio). This favors companies expected to have sufficient earnings to cover their dividends.

#### *Macro-consistent weighting*

In order to retain the primary benefits of market cap weighting (e.g., low turnover and scalable investment capacity), we developed a weighting system we call 'available dividends'. We calculate available dividends for each stock by multiplying dividend per share by the number of shares actually available for purchase (the float).

#### *Broad diversification across companies*

To ensure sufficient diversification in the resulting portfolio, we cap the weights of individual securities at 10% of the portfolio. Further, stocks weighing more than 5% each cannot collectively exceed 50% of the total portfolio.

#### *Rebalancing and reconstitution*

Constituent shares and weights are rebalanced quarterly, and reconstitution occurs once a year in June.

By design, the Morningstar Dividend Composite Index would serve as a good portfolio benchmark. Likewise, the Morningstar Dividend Leaders Index, with its shorter list of names, makes a better index fund. First Trust Advisors has launched

an exchange-traded fund (Ticker: FDL) based on the Morningstar Dividend Leaders Index.

#### **Dividends as an Investment Strategy**

Using stocks with long, attractive dividend-paying records has a place in just about any portfolio—whether it is for someone just beginning to save or already in retirement. The most frequently used income-oriented strategies are:

#### *Core holding for income seekers*

A high-yield portfolio has obvious advantages—more income for investors, a cushion against price declines, and a potential boost to total returns if share prices stagnate. Financial advisors can serve their clients well by increasing exposures to stocks that generate dividends, thus helping address income needs without forcing investment liquidation.

#### *Surrogate for large-cap value segment*

Dividend-paying stocks are invariably value oriented, with the additional benefit of higher income than traditional value stocks. They can work in combination with other value investments to generate more income for the portfolio.

#### *Quality companies with low volatility*

Dividends establish a firm intrinsic value for the stock, help reduce volatility, and act as a check on management's capital-allocation decisions. The more consistent and sustainable a stock's dividend payments, the more likely it will be superior performer in the end.