Morningstar® Developed Markets Large Cap Dividend Leaders Select Index

A balanced approach to equity income.

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Contents

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Yield alone does not tell the full story of any investment. Some stocks may have come to offer high yields from declining share prices, owing to weak or deteriorating fundamentals that may lead to further price declines or unsustainably high payout ratios. Other high-yielding stocks may be involved in controversies or controversial lines of business. The Morningstar Developed Markets Large Cap Dividend Leaders Select Index aims to deliver exposure to high-yielding dividend payers, while mitigating these risks by screening for dividend sustainability and environmental, social, and governance characteristics. It has tended to offer a significantly higher yield than the market, with comparable volatility.

Key Takeaways

- Aggressively chasing dividend yield can lead to high risk, as the highest-yielding stocks often have weak fundamentals, poor momentum, and high payout ratios they might not be able to maintain.
- The Morningstar Developed Markets Large Cap Dividend Leaders Select Index is designed to mitigate these risks by screening for dividend sustainability and consistency, as well as ESG characteristics. It is built for investability, with rules to avoid unnecessary turnover and a weighting approach that favors larger stocks, which tend to be cheaper to trade.
- This index offers a distinctive, yield-fluid portfolio. It has typically exhibited a deep value orientation, heavy exposure to financial-services stocks, and underweighting to the US. market.
- Efficient portfolio construction has led to solid long-term performance against the broader high-dividend-paying market segment, as measured by the Morningstar Global Markets High Dividend Yield Index. This was largely because of more favorable stock exposure within sectors, rather than from sector tilts.

Yield Alone Does Not Tell the Full Story

Equity income can be appealing for many reasons. High-dividend-paying stocks not only offer current income streams, but they tend to be less sensitive to interest rates than bonds and offer greater growth potential with respect to both the cash distributions and capital appreciation. Dividend distributions can also help cushion declines during market downturns and give investors the fortitude to stick with stocks through their rough patches.

However, yield alone does not tell the full story of any investment. Aggressively chasing it can lead to unintended risk. For example, the highest-yielding stocks may have weak or deteriorating fundamentals that could threaten the sustainability of their dividend payments and their price performance.

The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index is designed to provide exposure to high-dividend-yielding stocks, while screening for dividend consistency and sustainability, as well as for ESG characteristics.

Screening for Yield and Sustainability

Portfolio construction begins from the Morningstar Developed Markets Large Cap Index, which covers the top 70% of the investable market by market capitalization. Real estate investment trusts are not eligible for inclusion.

To qualify for inclusion in the Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index, stocks must have a positive dividend yield for the past 12 months, a non-negative five-year dividend-growth rate, and a forward dividend-payout ratio of less than 75%. These quality screens help mitigate exposure to stocks that might not be able to sustain their dividend payments.

There are additional sustainability filters to eliminate firms with exposure to tobacco and weapons, significant controversies, severe ESG risk, and noncompliance with the principles of the United Nations Global Compact. Companies with significant exposure to thermal coal are also not eligible.
Eligible stocks are ranked on their trailing 12-month dividend yield, and those that rank in the top 100 are targeted for inclusion. To mitigate unnecessary turnover, existing constituents may remain in the index if they rank in the top 125.

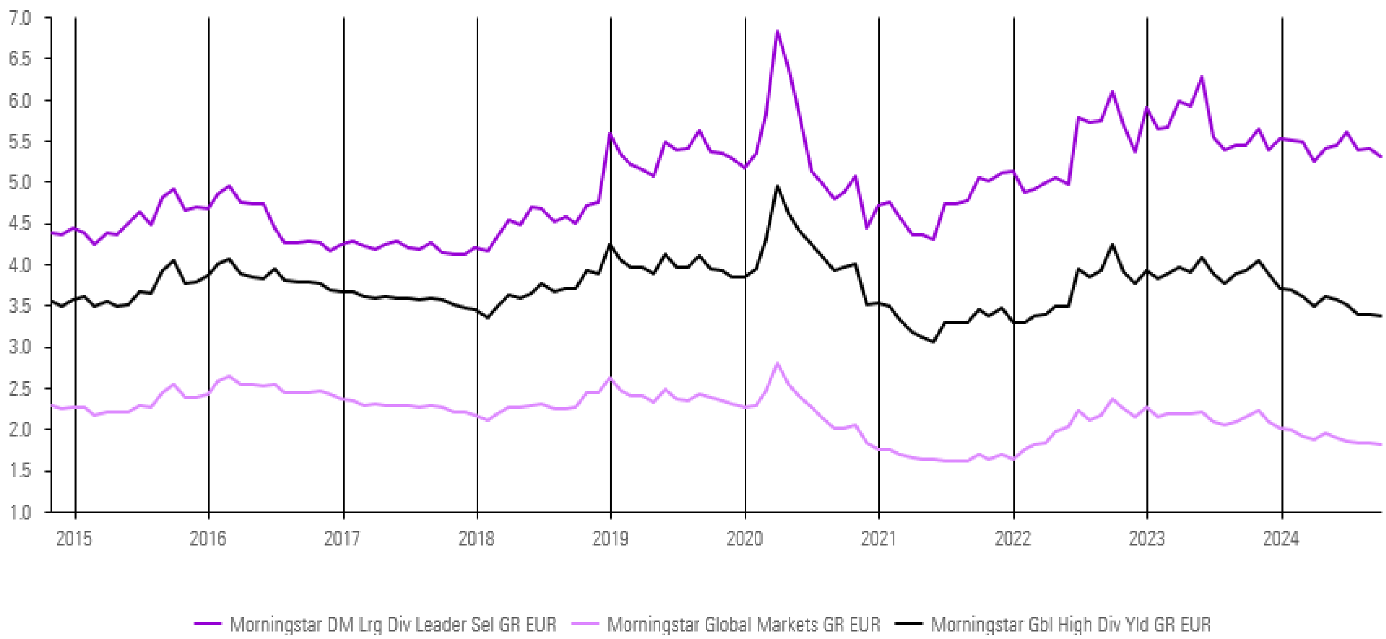
The index is weighted in proportion to the value of dividends each constituent has paid out over the past 12 months. This tends to give the index a higher yield than would be feasible with market-cap weighting, while still pulling the portfolio toward larger companies. This approach is also less susceptible to the bias toward stocks with poor momentum and deteriorating fundamentals that yield-weighting can create. To improve diversification, individual stock weightings are capped at 5% and sector weightings are capped at 40%.

A Distinctive Large-Value Portfolio

Like most dividend income strategies, this portfolio has a pronounced value tilt. Yet, it has some distinctive features relative to the broader high-yielding segment of the market, as measured by the market-cap-weighted Morningstar Global High Yield Index. This benchmark represents the higher yielding of the global dividend-paying universe with no quality or ESG screens.

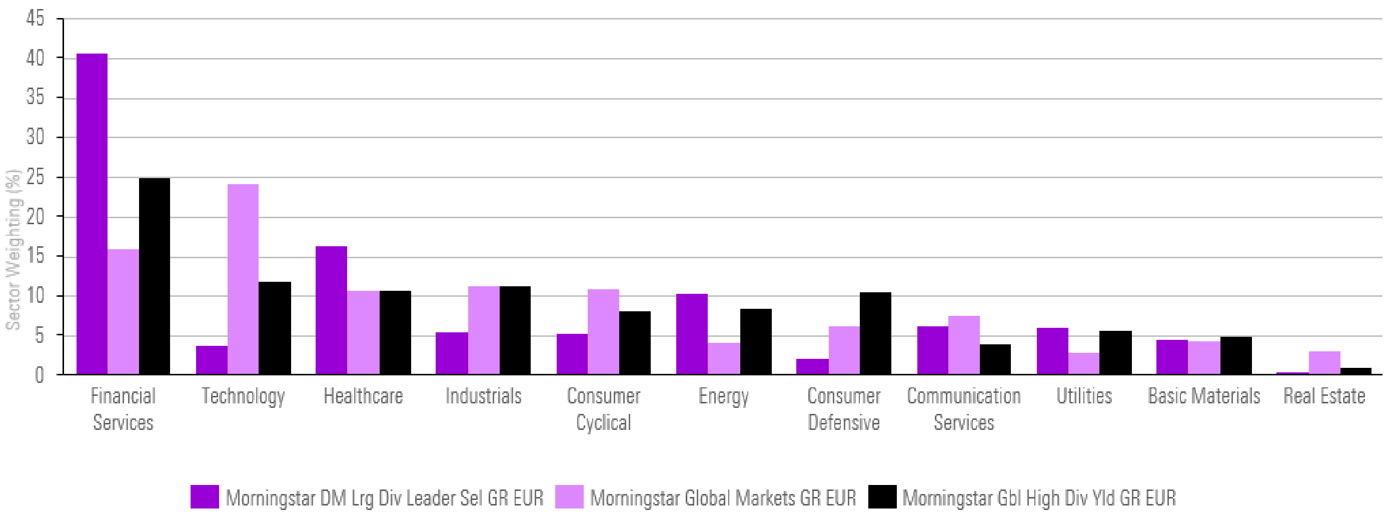
The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index has tended to have a higher dividend yield, more balanced regional exposure, and greater exposure to the financial-services sector than the Morningstar Global Markets High Yield Index. In fact, the financial-services exposure is bumping up against the 40% sector cap. These stocks tend to score well on yield, without unsustainably high-dividend-payout ratios.

Exhibit 1 Yield History



Date range: 10/1/2014-9/30/2024. Source: Morningstar Direct.

Exhibit 2 Sector Composition



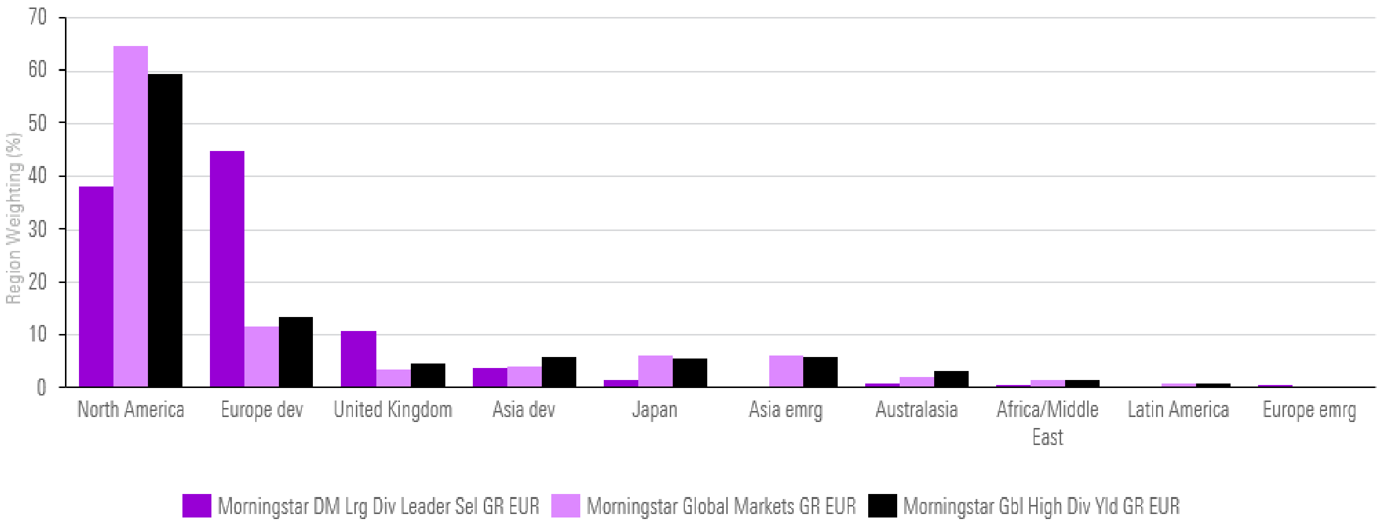
Data as of: 9/30/2024. Source: Morningstar Direct.

Many large financial-services companies are heavily regulated and must meet strict capital requirements. To avoid running afoul of these limits, these firms generally stick to conservative dividend-payout ratios that they believe they can sustain. As such, stocks in this sector typically do not have trouble meeting the index's dividend-payout-ratio screen.

Similarly, the index tends to underweight technology stocks relative to the broader Morningstar Global Markets High Yield Index, which itself has less exposure to this sector than the broad market. This owes to the dividend leaders index's more stringent yield target, as growth-oriented sectors, like technology, tend to trade at higher valuations and reinvest more of their cash flows, resulting in lower dividend yields.

There are also notable regional tilts, as shown in Exhibit 3. This index is country agnostic, pursuing the most eligible highest-yielding developed-markets stocks wherever they are found.

Exhibit 3 Regional Composition



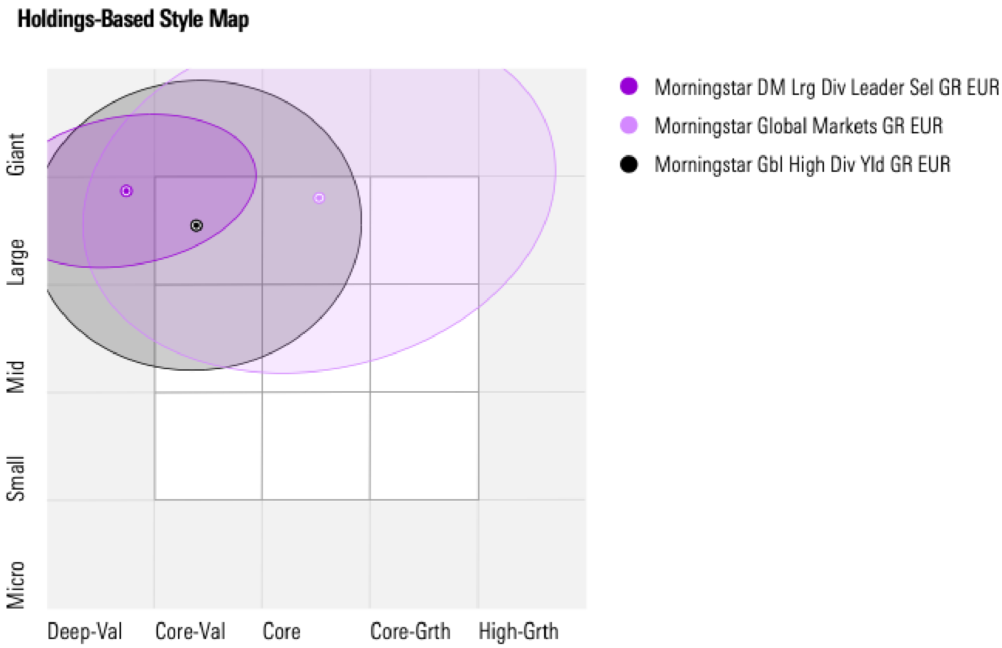
Data as of: 9/30/2024. Source: Morningstar Direct.

This leads to a structural underweighting to the US, where companies tend to offer lower dividend-payout ratios and rely on share repurchases more heavily than non-US firms. US investors tend to react negatively when stocks cut their dividends but have come to accept variability in share-repurchasing activity. Consequently, US stocks tend to have conservative dividend-payout ratios and rely on share repurchases to distribute residual excess cash flows. Outside the US, investors are more accustomed to variable dividend payments, so those companies often offer more generous payout ratios.

Conversely, the dividend leaders index also tends to overweight developed markets in Europe, where many higher-yielding stocks are listed.

Not surprisingly, the Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index tends to have a deeper value orientation than many of its peers, owing to its stringent yield screen. However, unlike its yield-weighted counterparts, it is firmly rooted in large-cap territory. This is because it derives its constituents from a large-cap universe and weights its holdings in proportion to the dollar value of the dividends paid out over the past year, defined as dividends per share times number of shares outstanding. Larger companies tend to pay out more in absolute dollars than smaller companies.

Exhibit 4 Style Plot



Data as of: 9/30/2024. Source: Morningstar Direct.

All else equal, this weighting approach results in lower turnover than yield weighting, as yields are more volatile than the total value of dividends paid out.

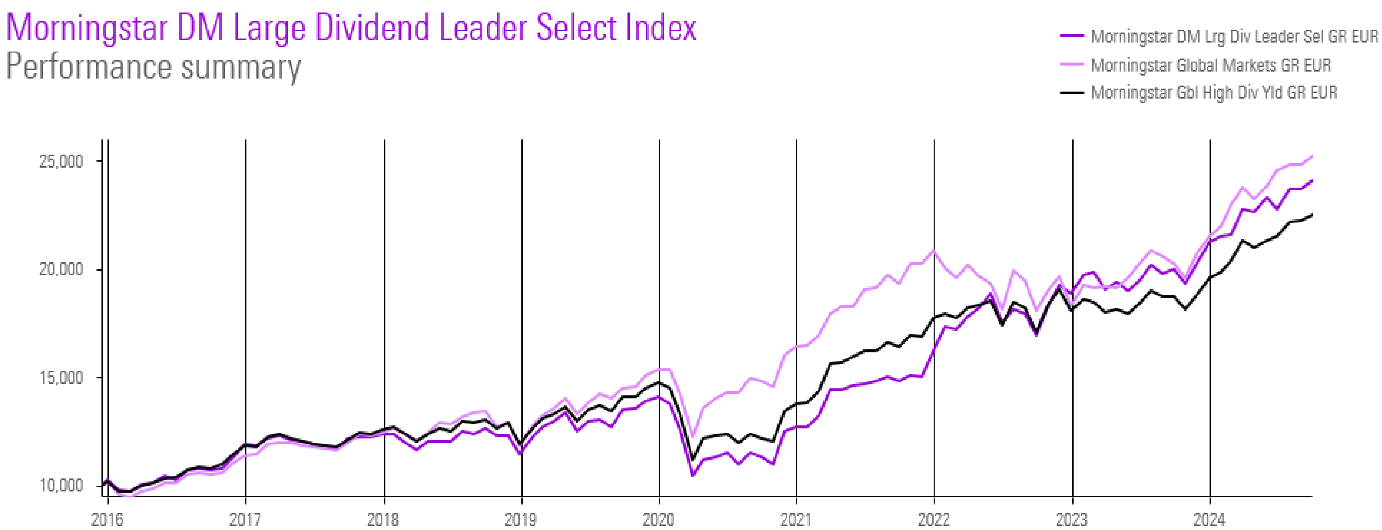
Turnover in the index is still high, typically ranging from 40%-80% per year. That said, this is largely driven by significant changes in the yield rankings. Buffering rules mitigate changes based on minor changes in the yield rankings, and turnover is less costly in this large-cap segment of the market than it would be further down the market-cap ladder. These are highly liquid names that can generally be traded with low market impact.

Changes are also triggered when companies no longer meet the baseline dividend durability criteria. For example, Anglo American cut its dividend in February 2024, due to weakness in its core commodity and diamond business lines. As a result, it failed the dividend-growth screen at the June 2024 reconstitution and was removed from the portfolio.

Performance

Efficient portfolio construction has led to solid long-term performance against the broader high-dividend-paying market segment. From its live inception in December 2015 through September 2024, the Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index outpaced the Morningstar Global Markets High Dividend Yield Index by 87 basis points annualized, as shown in Exhibit 5.

Exhibit 5 Performance



Index Name	Return	Excess Return	Tracking Error	Correlation	Beta	Standard Deviation	Sharpe Ratio	Max Drawdown	Down Capture Ratio	Up Capture Ratio
Morningstar DM Lrg Div Leader Sel GR EUR	10.53	-0.58	10.12	0.83	0.84	16.57	0.73	-36.68	70.86	73.78
Morningstar Global Markets GR EUR	11.11	0.00	0.00	1.00	1.00	17.39	0.79	-34.03	100.00	100.00
Morningstar Gbl High Div Yld GR EUR	9.66	-1.45	5.99	0.94	0.87	16.14	0.72	-35.26	84.10	84.47

Date range: 12/18/2015-9/30/2024. Source: Morningstar Direct.

This performance was even stronger over the trailing five years through September 2024. During that period, the dividend leaders index beat the Morningstar Global Markets High Dividend Yield Index by 2.5 percentage points annualized. This was due to more favorable stock exposure within sectors, particularly within financial services, energy, and healthcare, rather than from sector tilts. For example, the dividend leaders index benefited from having greater exposure to strong-performing high-yielding names, like AbbVie, Rio Tinto, and Gilead Sciences than the broader dividend benchmark.

While performance was strong relative to the high-dividend-paying segment, the dividend leaders index lagged the market over its live history, as the entire high-dividend segment was out of favor over that span. This was partially because strong-performing technology stocks were underrepresented in most dividend portfolios, including Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index.

Where many yield-oriented dividend strategies select or overweight stocks with weak or deteriorating fundamentals, the dividend leaders index's dividend growth and payout screens and dividend dollar weighting have served as effective risk guardrails. The index exhibited comparable volatility to the Morningstar Global Markets Index over its live history, as well as slightly lower sensitivity to market fluctuations, as measured by market beta.

Beyond Yield

High dividend yields may be enticing, but aggressively chasing yield alone can court risk. The highest-yielding stocks may have reached their high yields through declining share prices, resulting from weak or deteriorating fundamentals, or unsustainably high payout ratios. Some of these names may also be involved in controversial lines of business or significant controversies.

The Morningstar Developed Markets Large Cap Dividend Leaders Select Index aims to mitigate these potential risks by focusing on dual dimensions of sustainability: dividend durability and ESG. The resulting portfolio has delivered a significantly higher yield than the market, with comparable risk. This more-holistic approach to portfolio construction is time-tested and may be worth considering as an all-weather income solution.

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

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