Morningstar® Sustainability Dividend Yield Focus Index Family℠

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Economic Moat:
The Morningstar Economic Moat Rating describes the sustainability of a company's economic profits. We define economic profits as returns on invested capital over and above our estimate of a firm's cost of capital, or weighted average cost of capital. Only firms with economic moats—something inherent in their business model that rivals cannot easily replicate—can stave off competitive forces for a prolonged period. There are two major requirements for firms to earn either a narrow or wide economic moat rating: The prospect of earning above average returns on capital and some competitive edge that prevents these returns from quickly eroding. When a company does not have an economic moat rating assigned, the Morningstar Quantitative Moat Rating is determined by an algorithm designed to predict the economic moat rating a Morningstar analyst would assign to the stock.

Distance to Default:
Morningstar's market-driven Distance to Default score uses option pricing theory to evaluate the risk that the value of a company's assets will turn out to be less than the sum of its liabilities. Distance to Default ranks companies on the likelihood that they might encounter financial distress. The more likely the value of a company's assets is to fall below the sum of its liabilities and a small capital cushion, the greater the likelihood of financial distress.

Sustainability lies at the heart of successful investing. Whether it relates to a company's ability to maintain cash flows and dividend payments or to its management of environmental, social, and governance-related risks and opportunities, long-term staying power is critical. Dividends, for their part, have played a central role in investing for centuries. Prized for their income stream, they signal balance sheet strength and a commitment to shareholders. Dividend payments and dividend growth account for a substantial portion of long-term equity market return.

Investors have learned, however, that high-yield stocks are far from sure bets. A stock's yield can soar because its share price is depressed and financial distress imminent. Equity-income strategies that rely on historical payouts can fail to spot trouble ahead.

Meanwhile, environmental, social, and governance-based investing is gaining popularity, not just among values-based investors but also those focused on risk and return. Research has shown that companies adhering to high standards on ESG criteria may outperform industry peers over the long haul.

The Morningstar Sustainability Dividend Yield Focus Index family aims to provide a solution for investors looking to generate income from their equity investments while remaining focused on total return as well as high standards on ESG criteria. The indexes favor dividend-paying companies that are competitively advantaged, financially healthy, and exceptional in their management of ESG factors.

Index Eligibility

The indexes derive their constituents from Morningstar equity market indexes representing various markets and regions. For example, the Global Markets Sustainability Dividend Yield Focus Index draws from the Morningstar Global Markets Index. To be eligible, a security must be assigned a Morningstar Economic Moat Rating or a Quantitative Moat Rating, an ESG Score, an ESG Controversy Score, and a Distance to Default Rating (see sidebars). Companies may not derive more than 50% of their revenue from tobacco products, nor may they be involved in the production of controversial weapons (land mines, for example). Companies with the highest ESG Controversy Scores are ineligible for the indexes. Eligible securities must have paid a dividend in the last

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Morningstar Sustainability Dividend Yield Focus Index Family Construction Process

Selection Universe

- Select constituents from the corresponding Morningstar Country/Region Index.

Security Selection

- Adjusting sustainability scores.
- Controversy screen: Eliminate constituents having a controversy rating greater than 4.
- Apply tobacco and controversial-weapons screen.
- Screen for dividend-paying companies.
- REITs are excluded.
- Morningstar quality screens:
  – Wide or Narrow Moat Rating
  – Distance to Default
- Sustainability score screens:
  – Target the Morningstar Five Globe Sustainability Rating by iteratively removing worst sustainability performers.

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- Select N companies by Trailing 12-months dividend yield.

12 months, and that dividend must be considered "qualified income," thus real estate investment trusts are excluded. To ensure index liquidity, new index constituents must have three-month average daily trading volume of at least $1 million.

Screens for Quality, Financial Health, and Yield

Eligible securities are first screened on the basis of their Morningstar Economic Moat Rating and their Distance to Default scores (see sidebar). Companies that are assigned wide or narrow moat ratings must land in the top 50% of their Morningstar Region-Sector cohort by Distance to Default score. To minimize turnover, current index constituents are allowed to remain as long as they score in the top 60% of their Morningstar Region-Sector cohort. Companies that do not have a moat rating or a Morningstar Quantitative Moat Rating must have a Distance to Default score in the top 30% of their Region-Sector cohort, while current constituents fitting that description must land in the top 36% of their peer group. A targeted number of eligible securities passing the screens are selected on the basis of trailing 12-month dividend yield.

Sustainability Optimization

The portfolio of securities passing the screens is assigned a Sustainability Score and compared with its relevant Morningstar fund category. The bottom 25% of eligible securities by Sustainability Score are removed. If necessary, additional securities are removed in increments of 5% index weight until the aggregate portfolio's Sustainability Score reaches the threshold of the top 10% of the most relevant Morningstar fund category.

Index Weighting

To maximize yield, the index is weighted on the basis of trailing 12-month available dividends, which considers dividend per share and number of shares. The number of stocks in each index will vary according to qualifying securities, but targets are listed in the family member table below. Sector weight is adjusted to avoid concentration. Security weight is capped at 5% for indexes with more than 50 securities and 10% for indexes with fewer than 50. Stocks weighing more than 5% cannot collectively exceed 50% of total index weight. Exposure to economic sectors is capped at 40% or 5 times the weight of the sector in the parent index.

Rebalancing and Reconstitution

Morningstar rebalances constituent shares and weights of the indexes semiannually on the Monday following the third Friday of June and December. The market data used is as of the last trading day of May and November. Current constituents are reviewed quarterly and removed if they have the highest ESG Controversy Score or if they meet exclusion criteria related to tobacco or controversial weapons.