

# Construction Rules for the Morningstar® Japan Sustainability Dividend Yield Focus Index<sup>SM</sup>

## Morningstar Indexes

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## Overview

The Morningstar Japan Sustainability Dividend Yield Focus Index<sup>SM</sup> is designed to track high-yielding, qualified-dividend-paying companies that score highly on environmental, social, and governance investment criteria. The indexes are subset of corresponding Morningstar country/region indexes (market indexes) selected for exhibiting superior quality, financial health, and achieving a high Morningstar Sustainability Rating for the portfolio. Morningstar uses the Economic Moat Rating and Quantitative Moat Rating to assess superior quality and uses Distance to Default score to assess their financial health. For more information on Economic/Quantitative Moat Rating and Distance to Default score, please refer to Appendix 2.

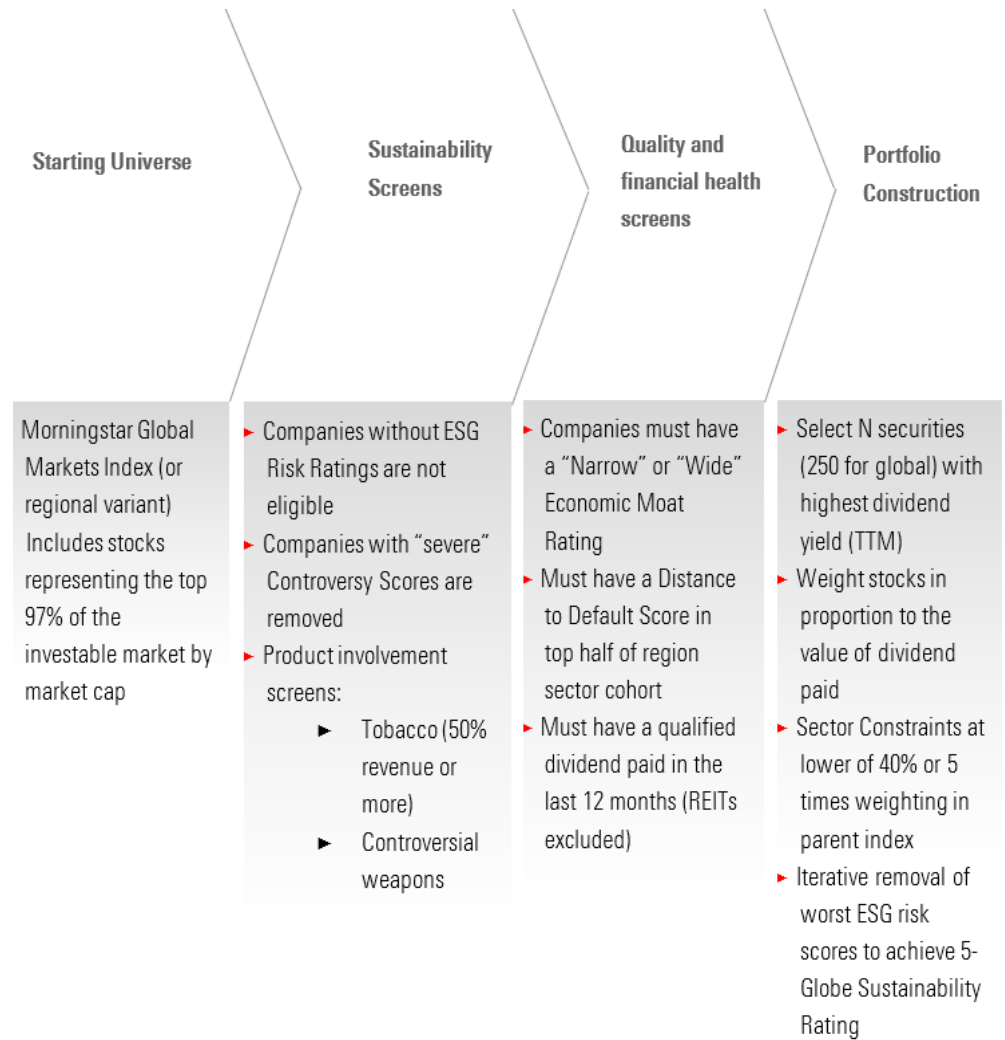
For more information on the Sustainalytics ESG Risk Rating, controversy scores, and Morningstar Portfolio Sustainability Score and Rating, please refer to the [Morningstar Sustainability Rating methodology](#).

## Index Inception Date and Performance Inception Date

The inception date of the indexes is Jan. 22, 2018, and the performance inception dates, when the first back-tested index value was calculated, are provided in the appendix.

## Index Construction

**Exhibit 1** Morningstar Japan Sustainability Dividend Yield Focus Index Construction Process



For additional details, refer to the “Assigning Stocks to the Index” section. N and size-segment for each index are provided in Appendix 3.

## Assigning Stocks to the Indexes

### Selection Universe

At each reconstitution, constituents of the Morningstar Japan Sustainability Dividend Yield Focus Index<sup>SM</sup> are derived from the Morningstar Japan Index (benchmark). For more details on benchmark construction, refer to the [Construction Rules for Morningstar Global Markets Index](#).

### Security Selection

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

- ▶ Security must have current ESG Risk Rating and controversy score.<sup>1</sup>
- ▶ Controversy screen: Security controversy score must be 4 (out of 5) or lower.
- ▶ Product involvement screen: The company must
  - ▶ not have more than 50% tobacco products involvement by revenue.
  - ▶ not have any involvement in production of controversial weapons (as defined by Sustainalytics Global Compact Compliance Service exclusionary lists).
- ▶ Security's dividend must be qualified income; for example, real estate investment trusts are excluded.
- ▶ The company should have paid a dividend in the last 12 months.
- ▶ The index constituents should have a three-month average daily traded volume, or ADTV, of at least \$1 million. However, this applies only to additions, and the ADTV of current constituents may fall below \$1 million.
- ▶ If a company has more than one eligible share class, the most liquid share class as determined by Morningstar is selected.
- ▶ Company quality and financial health:
  - ▶ Company quality is determined based on Morningstar Economic Moat<sup>TM</sup>, where companies are expected to earn above-average profits.
  - ▶ Companies are screened for financial health using Morningstar's Distance to Default measure. Distance to Default is a structural or contingent claim model that takes advantage of both market information and accounting financial information. The firm's equity is viewed as a call option on the value of the firm's assets. If the value of the assets is not sufficient to cover the firm's liabilities (the strike price), default is expected to occur.
  - ▶ For companies that do not have a moat rating assigned by the Morningstar Equity Research team, the Morningstar Quantitative Economic Moat rating is used.
  - ▶ Companies that are assigned a moat rating of narrow or wide must have a Morningstar Distance to Default score in the top 50% within their respective Morningstar region/sector cohorts.
  - ▶ Current constituents that are assigned a moat rating of narrow or wide must have a Morningstar Distance to Default score in the top 60% within their respective Morningstar region-sector cohorts.

<sup>1</sup> ESG and controversy scores are sourced from Sustainalytics

- ▶ Companies that do not have either a Morningstar Economic Moat Rating or a Morningstar Quantitative Economic Moat Rating assigned to them must have a Morningstar Distance to Default score in the top 30% within their respective Morningstar region/sector cohorts.
- ▶ Current constituents that do not have either a Morningstar Economic Moat Rating or a Morningstar Quantitative Economic Moat Rating assigned to them, must have a Morningstar Distance to Default score in the top 36% within their respective Morningstar region/sector cohorts.

A broad overview of Morningstar Economic Moat and Quantitative Moat Ratings, as well as Morningstar Distance to Default is provided in Appendix 2. For details on region cohorts, refer to Appendix 4.

### Index Selection

- ▶ Rank companies by trailing 12-months dividend yield in descending order.
- ▶ Current index constituents are retained in the index if their dividend yield ranks within the top 1.33 multiplied by the target N (25). Additional securities are added to the index in descending order of dividend yield until the count reaches 25.
- ▶ Portfolio construction
  - ▶ Portfolio sustainability: Morningstar calculates the score necessary to achieve a Morningstar Five Globe Sustainability Rating for the Morningstar Global Category<sup>2</sup> where a fund tracking the index would fall.
  - ▶ If the portfolio's sustainability score is insufficient to attain a Five Globe Sustainability Rating, the 25% of securities with the worst ESG Risk Rating scores are removed from the portfolio.
  - ▶ If the portfolio still doesn't meet the sustainability criteria, an additional 5% of securities with worst ESG Risk Rating scores are removed until either the portfolio meets the portfolio sustainability criteria or the bottom 50% of securities are removed.
  - ▶ Buffer rules: Current constituents have relaxed ESG Risk Rating score requirements. Their ESG Risk Rating requirement is 5 percentage points lower than the filter applied to new constituents. For example, if new constituents' ESG Risk Ratings must not rank in the bottom 25% of the universe, current constituents only need to rank above the bottom 20%.

A broad overview of Morningstar Economic Moat and Quantitative Moat ratings, as well as Morningstar Distance to Default is provided in Appendix 2. For details on region cohorts, refer to Appendix 4. The Morningstar Global Category used for finding the maximum score to achieve the Five Globe Sustainability Rating will be the same as that of the exchange-traded fund or mutual fund tracking the index. If not available at the time of reconstitution, the Morningstar Global Category will be assumed to be as given in Appendix 6.

<sup>2</sup> The indexes used regional Morningstar categories for the back-test period, as the Morningstar Sustainability Ratings were previously set at this level. These assignments can be found in Appendix 5.

### Number of Stocks

The Morningstar Japan Sustainability Dividend Yield Focus Index targets 25 stocks based on a transparent ranking system subject to selection and eligibility criteria at reconstitution. However, if securities fall short of the selection and eligibility criteria or securities are added or deleted as a result of corporate action after reconstitution, the index can have more or fewer than 25 securities. During reconstitution, if the number of securities is less than the target, the weights of the constituents will be determined based on the index weighting scheme. The schedule for reconstitution and corporate actions is available in the "Index Maintenance and Calculation" section.

### Index Weighting

The index is trailing 12-months dividend-dollar-weighted, with 5-5-50 capping. For more details, refer to the [Morningstar Indexes Calculation Methodology rulebook](#). 5-5-50<sup>3</sup> capping will not be enforced for a portfolio with the number of constituents less than or equal to 25 and only individual constituent weight will be capped at 10%.

### Sector Capping

To contain the excessive concentration in sectors and to avoid deviating far from parent index weights, sector weights in the indexes are capped at a minimum of 40% or 5 multiplied by the weight of the sector in the parent index.

Capped Weight = Min (40%, Weight of the sector in the parent index \* 5)

### Index Maintenance and Calculation

#### Scheduled Maintenance

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

The index also undergoes quarterly reviews in March and September on the Monday following the third Friday. If Monday is a holiday, it is effective on the immediate following business day. During quarterly reviews, controversy screens are applied and existing constituents failing this screen are deleted from the index. Weight constraints are, however, not enforced.

Refer to Appendix 1 for details on reconstitution and rebalancing.

### Corporate Action

The treatment of corporate actions can be found in the [Morningstar Indexes Corporate Actions Methodology rulebook](#).

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<sup>3</sup> If the index has less than 50 stocks, maximum security weight limit is 10%

### **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 Index Methodology Change Process](#).

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 affect index daily highs or lows, they are 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: Glossary

Terms	Description
<b>Reconstitution</b>	During each reconstitution, the steps mentioned in the index construction process are performed, resulting in membership reset.
<b>Rebalance</b>	During each rebalancing, the weights are reset and adjusted for updated free-float and shares outstanding data.

### Appendix 2: Morningstar Economic Moat, Morningstar Quantitative Moat, and Morningstar Distance to Default Score

#### Morningstar Economic Moat Rating

In a free-market economy, capital seeks the areas of highest return. Whenever a company develops a profitable product or service, it doesn't take long before competitive forces drive down its economic profits. Only companies with an economic moat—a structural competitive advantage that allows a firm to earn above-average returns on capital over a long period of time—are able to hold competitors at bay.

To help investors identify companies that possess a moat, Morningstar's Equity Research Analysts assign one of three Economic Moat Ratings: none, narrow, or wide. There are two major requirements for firms to earn either a narrow or wide rating: 1) The prospect of earning above-average returns on capital; and 2) Some competitive edge that prevents these returns from quickly deteriorating.

For more information on the moat rating process performed by Morningstar Equity Research, refer to the [Morningstar Equity Research Methodology](#).

#### Morningstar Quantitative Moat Ratings

The Quantitative Economic Moat Rating is analogous to Morningstar's Economic Moat Rating in that both are meant to describe the strength of a firm's competitive position. It is calculated using an algorithm designed to predict the economic moat rating a Morningstar analyst would assign to the stock. The quantitative rating is expressed as none, narrow, or wide. If the input data required for the algorithm is not available, a quantitative rating will not be assigned.

For further details on Morningstar's Quantitative Moat Rating, please refer to the [Morningstar's Quantitative Equity & Credit Ratings methodology](#).

#### Morningstar Quantitative Distance to Default Score

Distance to Default is a structural or contingent claim model that takes advantage of both market information and accounting financial information. The firm's liabilities are viewed as a call option on the value of the firm's assets. If the value of the assets is not sufficient to cover the firm's liabilities (the strike price), default is expected to occur.

### Appendix 3: Indexes in the Morningstar Sustainability Dividend Yield Focus Index Family

Index	Size-Segment	Performance Inception Date	Target Number of Constituents (N)
Morningstar US Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	50
Morningstar Global Markets Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	250
Morningstar Global Markets ex-US Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	200
Morningstar Developed Markets Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	150
Morningstar Developed Markets ex-US Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	125
Morningstar Developed Europe Sustainability Dividend Yield Focus Index	Large-Mid	Dec 18, 2009	50
Morningstar DM Asia Pacific ex-Japan Sustainability Dividend Yield Focus Index	Large-Mid-Small	Dec 18, 2009	25
Morningstar Emerging Markets Sustainability Dividend Yield Focus Index	Large-Mid	Dec 16, 2011	75
Morningstar Nordic Sustainability Dividend Yield Focus Index	Large-Mid-Small	Dec 18, 2009	25
Morningstar Japan Sustainability Dividend Yield Focus Index	Large-Mid-Small	Dec 18, 2009	25
Morningstar United Kingdom Sustainability Dividend Yield Focus Index	Large-Mid-Small	Dec 18, 2009	25
Morningstar Canada Sustainability Dividend Yield Focus Index	Large-Mid-Small	Dec 18, 2009	25

### Appendix 4: Region Cohorts Used in Distance to Default Score Percentile Calculation

- ▶ **United States**
- ▶ **Japan**
- ▶ **Developed markets excluding United States and Japan**
- ▶ **Emerging markets**

For more details on region definitions and member countries, please refer to the [Construction Rules for Morningstar Global Markets Index](#).

### Appendix 5: Morningstar Category Assignment for Back Tests

Index	Morningstar Category for Back Test
Morningstar US Sustainability Dividend Yield Focus Index	Large Value
Morningstar Global Markets Sustainability Dividend Yield Focus Index	US Fund World Stock
Morningstar Global Markets ex-US Sustainability Dividend Yield Focus Index	Foreign Large Value
Morningstar Developed Markets Sustainability Dividend Yield Focus Index	US Fund World Stock
Morningstar Developed Markets ex-US Sustainability Dividend Yield Focus Index	Foreign Large Value
Morningstar Developed Europe Sustainability Dividend Yield Focus Index	Europe Asia Africa (EAA) Fund Europe Equity Income
Morningstar DM Asia Pacific ex-Japan Sustainability Dividend Yield Focus Index	Pacific/Asia ex Japan stock
Morningstar Emerging Markets Sustainability Dividend Yield Focus Index	Diversified Emerging Markets
Morningstar Nordic Sustainability Dividend Yield Focus Index	EAA Fund Nordic Equity
Morningstar Japan Sustainability Dividend Yield Focus Index	Japan Large-Cap Value Equity
Morningstar United Kingdom Sustainability Dividend Yield Focus Index	UK Equity Income
Morningstar Canada Sustainability Dividend Yield Focus Index	Canadian Dividend and income equity



**Appendix 6: Morningstar Global Category Assignment for Ongoing Index Construction**

Index	Morningstar Global Category for Ongoing Index Construction
Morningstar US Sustainability Dividend Yield Focus Index	US Equity Large-Cap Value
Morningstar Global Markets Sustainability Dividend Yield Focus Index	Global Equity Large Cap
Morningstar Global Markets ex-US Sustainability Dividend Yield Focus Index	Global Equity Large Cap
Morningstar Developed Markets Sustainability Dividend Yield Focus Index	Global Equity Large Cap
Morningstar Developed Markets ex-US Sustainability Dividend Yield Focus Index	Global Equity Large Cap
Morningstar Developed Europe Sustainability Dividend Yield Focus Index	Europe Equity Large Cap
Morningstar DM Asia Pacific ex-Japan Sustainability Dividend Yield Focus Index	Asia ex-Japan Equity
Morningstar Emerging Markets Sustainability Dividend Yield Focus Index	Global Emerging Markets Equity
Morningstar Nordic Sustainability Dividend Yield Focus Index	Europe Equity Large Cap
Morningstar Japan Sustainability Dividend Yield Focus Index	Japan Equity
Morningstar United Kingdom Sustainability Dividend Yield Focus Index	UK Equity Large Cap
Morningstar Canada Sustainability Dividend Yield Focus Index	Canadian Equity Large Cap

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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.

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**For More Information**

For any queries, reach out to us via our [communication page](#).



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