

Morningstar® Developed Markets Wide Moat Focus IndexSM

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The Morningstar® Developed Markets Wide Moat Focus IndexSM is designed to provide exposure to stocks that Morningstar equity research analysts assign wide moat ratings and that trade at a discount to their fair value estimates. The index contains 50 stocks that receive equal weights, but the number of holdings may fluctuate based on market conditions and the reconstitution process discussed later in this piece.

What Is an Economic Moat?

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 are able to hold competitors at bay and generate economic profits over an extended period of time.

To help investors identify companies that possess an economic moat, Morningstar's equity research team assigns 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 eroding. A firm must possess a competitive advantage inherent to its business in order to possess a moat.

The five sources of economic moats are intangible assets, switching costs, network effect, cost advantage, and efficient scale.

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The Morningstar Developed Markets Wide Moat Focus Index selects the wide-moat stocks trading at a discount to Morningstar's estimate of the fair value of the company's stock price. Index constituents therefore represent the most compelling values among the wide-moat companies, according to Morningstar equity analysts. The index holds 50 or more stocks and reconstitutes semiannually on a quarterly staggered schedule. Therefore, half of the index reconstitutes quarterly. This allows for more frequent hunting for undervalued stocks than does traditional semiannual reconstitution. But it reduces trading by approximately half vis-à-vis quarterly reconstitution.

Methodology

The Morningstar Developed Markets Wide Moat Focus Index is a subset of the Morningstar Developed Markets Index, a broad market index representing 97% of developed markets' equity market capitalization. To qualify for the Morningstar Developed Markets Wide Moat Focus Index, all Developed Markets Index

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constituents must meet the following criteria:

- ▶ Company is assigned a wide moat rating by a Morningstar equity analyst.
- ▶ Company is assigned a fair value estimate by a Morningstar equity analyst.
- ▶ Company cannot be under review at time of stock assignment.
- ▶ Company must have 12 months of price history.

Stocks that meet all of the above criteria are eligible for the index.

At each reconstitution, the 50 wide-moat-rated stocks representing the lowest current price/fair value are selected from the list of securities eligible for the subportfolio that is reconstituting that quarter. Constituents are equal-weighted within their subportfolio. Because of the staggered reconstitution schedule, the overall number of index constituents varies. Similarly, securities will not be equal-weighted in the overall index.

Risk Controls

Index constituents are equally-weighted within their subportfolio, affording all stocks an opportunity to contribute to returns and assuring that performance

is not overwhelmed by a small group. As additional risk controls, stocks are screened out if they exhibit extreme negative momentum (that is, falling precipitously in price).

For the momentum screen, eligible stocks are ranked by the percentage change in price from 12 months ago, and the securities in the bottom 20% are screened out. Exposure to economic sectors and single countries are capped at either 40% of portfolio assets or 10 percentage points greater than the sector or country weight in the Morningstar Developed Markets Index. To minimize portfolio turnover, index constituents remain if they fall within the top 100 most undervalued wide-moat rated securities. Furthermore, new additions to the index must have a three-month average daily trading value, or ADTV, of more than USD 5 million.

Rebalancing and Reconstitution

The index is divided into two subportfolios, each one containing 50 stocks. One subportfolio reconstitutes in December and June, the other in March and September. At each reconstitution, the 50 securities representing the lowest current market price/fair value are selected from the list of securities eligible for the subportfolio. The two subportfolios are brought back to equal weight in the overall index portfolio every December and June.

Morningstar Index Construction Methodology



¹ **Fair Value Estimates** Morningstar equity analysts use a proprietary discounted cash-flow model to develop estimates of fair value—a company's true worth. The ratio of current market price/fair value represents a stock's premium or discount. Over the long term, we believe share prices converge to fair values.