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Morningstar Wide Moat Focus Methodology Enhancements June 2016

In April, Morningstar announced that the Indexes Group would implement methodology enhancements for the Wide Moat Focus Index effective at the June 2016 Reconstitution.

What enhancements are being made to the Wide Moat Focus Index?

- The number of index constituents will increase from 20 companies to at least 40 companies.
- The Index will shift from a quarterly reconstitution schedule to a semiannual reconstitution. This will unfold on a quarterly staggered schedule.
- The Index will implement a turnover buffer. At the time of reconstitution, current index constituents ranked within the top 150% of target count in the universe with Wide Moat-rated stocks are preferred over new additions.
- The Index will implement sector caps. Exposure to any Morningstar sector shall not exceed 40% of Index weight. In the case that sector exposure of the reference benchmark exceeds 30%, the Index may maintain exposure to that sector of 10 percentage points higher than the benchmark weight. The reference benchmark is the Morningstar US Markets Index.

Why are these enhancements being made?

The main objectives of the methodology enhancements are reducing turnover and increasing capacity. Additionally, the increased number of securities and sector cap provides broader diversification while mitigating unintended sector concentration. The table below summarizes the intended impact of the new methodology.

Parameter	Current Methodology	Updated Methodology	Impact Summary		
			Capacity	Turnover/Holding Period	Sector Exposure
Number of stocks	20	40	√	√	√
Reconstitution Frequency	Quarterly	Semiannual	-	√	-
Staggered Rebalancing	NA	Quarterly	√	-	-
Turnover Buffer	NA	50% buffer width	√	√	-
Sector Cap	NA	Maximum (40%, benchmark weight + 10%)	-	-	√

When will Morningstar implement these enhancements?

The methodology enhancements will be implemented at the June 2016 reconstitution, which occurs after the close of the US stock market on Friday, June 17, 2016, and effective at the open of the US stock market on Monday, June 20, 2016.

What is staggered rebalancing?

In the staggered rebalance approach, Morningstar will divide the index into two sub-portfolios, each containing 40 stocks. One sub-portfolio reconstitutes in December and June; the other sub-portfolio reconstitutes in March and September.

The staggered rebalance process is described below.

1. At initial implementation in June 2016, the sub-portfolios are constructed for the first time and have an identical portfolio composition. The weights of sub-portfolios are set to equal weight (50% each).
2. In September 2016, the first sub-portfolio is reconstituted, while the second is not (drifted leg). As a result, the composition of the sub-portfolios may not remain identical after the reconstitution of the first sub-portfolio.
3. In December 2016, the second sub-portfolio is reconstituted and the first forms the drifted leg. In addition, the sub-portfolio weights are reset to 50% each and distributed among the securities within them in proportion to their weights.
4. In March 2017, the first sub-portfolio is reconstituted again.
5. In June 2017, the second sub-portfolio is reconstituted. In addition, the sub-portfolio weights are reset to 50%.
6. The process is repeated (go to step 2).

Is this a new approach to rebalancing indexes?

Staggered rebalancing is not a new concept and is employed in Morningstar Ultimate Stock-Pickers Index as well as by other index providers, notably in the FTSE RAFI Index.

Why staggered rebalance and not semiannual reconstitution?

With a quarterly reconstitution, stocks are selected frequently, but turnover is higher. In a semi-annual reconstitution approach, turnover is lower, but there is a risk of losing out on buying opportunities by picking stocks on a semi-annual basis. We call this timing risk due to potential missed opportunities for buying Moat-rated companies trading at a discount between reconstitution dates. To keep turnover low (at the semi-annual level) while minimizing timing risk, a staggered rebalancing approach is being implemented where half the portfolio is reconstituted quarterly.

Will the number of stocks always be 40 at each rebalance period?

No, because the two sub-portfolios reconstitute at different times, the total number of stocks may deviate from 40 at a given point of time.

What is the maximum number of securities that could exist in the Index?

The maximum number of securities could reach 80 stocks at any given reconstitution if the sub-portfolios have no common constituents.

Will the historical index levels change?

No, current index levels that have been published will not be adjusted retroactively and only the index levels moving forward from June 20, 2016, will reflect the updated methodology.