



Construction Rules for Morningstar[®] US Dividend Target 50 IndexSM

Morningstar Methodology Paper
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Index Characteristics

Overview

The Morningstar US Dividend Target 50 Index (the “Index”) is an index reflecting the performance of 50 dividend paying U.S. based equities. The securities are selected from a universe comprised of securities trading on one of the three major exchanges in the U.S. and are classified as U.S. securities by Morningstar. The index is reconstituted and rebalanced quarterly and positions are equally weighted. The following index construction rules are intended to represent the options for investment in portfolio of high quality, dividend paying equities.

Inception Dates and Base Market Values

The inception date of the Index is December 31, 2001. Daily price and total return series are available from this date forward. The index base market value at inception is 1,000.

Calculation and Dissemination of Index Values

Price return index values are disseminated electronically at 15-second intervals during regular trading hours, and disseminated over the Börse Stuttgart tape. Daily and monthly price and total return index values are distributed via various data distribution channels and are available on <http://indexes.morningstar.com>.

Trading Holidays

The Morningstar US Dividend Target 50 Index is not calculated when the U.S. Markets are closed.

Index Value Currencies

The closing values of the Morningstar US Dividend Target 50 Index are calculated in United States Dollars using an average of Reuters bid and ask price.

Scheduled Reconstitution Dates

The Index is reconstituted—i.e., the Index membership is reset—four times annually. Adjustments are made at the close of trade on the third Friday of March, June, September, and December. The changes become effective on the next business day.

Scheduled Rebalancing Dates

The weighting of each Security are adjusted—four times annually. Adjustments are made on the Monday following the third Friday of March, June, September, and December. If the Monday is not a business day, then rebalance occurs on the next business day.

Assigning Stocks to the US Dividend Target 50 Index

Overview

At each reconstitution date, the investable universe and index eligibility are defined based on the criteria described in this section. The investable universe and index eligibility criteria are applied in the sequence in which they appear below. Each criterion is applied only to the “survivors” of the criteria applied previously.

Investable Universe

To qualify for inclusion in the investable universe, a security must meet the following criteria:

- 1) It must trade on one of the three major exchanges—the NYSE, NYSE Amex, or NASDAQ exchange.
- 2) The issuing company is classified as a U.S. based on country of incorporation, primary stock market activities, headquarters and primary business activities
- 3) The following security types do not qualify:
 - ▶ American depository receipts and American depository shares
 - ▶ Fixed-dividend shares
 - ▶ Convertible notes, warrants, and rights
 - ▶ Tracking stocks

Index Eligibility

To be included in the Index, a security in the investable universe must satisfy the following conditions:

- ▶ Average daily volume (3 month) in the top third of stocks in the investable universe

Index Selection

At each reconstitution securities in the investable universe are assigned a Weighted Average Fundamental Factor Rank (WAFFR) based on their weighted average rank of the following five fundamental factors (see appendix A for fundamental factor definitions):

Fundamental Factor	Strategy Weight
Expected Dividend or Distribution Yield	33.33%
Cash Flow/Debt	20%
5 Year Normal EPS Growth	13.33%
Return on Equity Latest Quarter	20%
3- Month EPS Estimate Revision (Current Year)	13.33%

The WAFFR for each security is determined on each rebalance date as follows. For each fundamental factor relative rankings for all stocks are calculated where securities with the best possible value will be given a score of 100 while the company that has the worst possible value will be given a score of 0. This score out of 100 is multiplied by the assigned strategy weight (stated above in parentheses) and repeated for each variable that has been assigned a weight. A total score is then tabulated for all stocks in the investable universe. The stock with the highest score will be ranked 1 while the stock with the lowest total score receives the worst rank.

Once the securities in the investable universe are scored by their respected fundamental factors securities meeting the general eligibility criteria are selected to the index in the following manner:

- ▶ Rank order companies by their WAFFR
- ▶ Any security meeting all of the following criteria is retained in the index:
 - Is a current index constituent
 - Ranks in the top 40% by their WAFFR
 - Has an expected dividend yield greater than 0 where expected dividend yield is equal to the product of the most recent dividend paid and the frequency of payment
- ▶ Additional securities are added to the index in order of WAFFR until the index component count reaches 50 if they have met all of the following conditions:
 - Have an Expected Dividend Yield of 2%
 - Rank amongst the top 30% by WAFFR
 - Do not exceed a cap of 10 stocks per equity sector

Index Calculations

Basic Formula

The value (price) and total return of an index is calculated using a Laspeyres' formula.

$$\text{Index}(t) = \frac{\sum_{i=1}^n (p_i(t) * s_i(t))}{C(t) \sum_{j=1}^n (p_j(0) * s_j(0))} * \text{BaseIndexValue} = (M(t)/B(t)) * \text{BaseIndexValue}$$

The above formulas can be simplified as: $\text{Index}(t) = \frac{M(t)}{D(t)}$

Where:

D(t)	=	divisor at time (t) = B(t)/Base Index Value
N	=	number of stocks in the index
p _i (0)	=	closing price of stock i at the base date
s _i (0)	=	constructed shares of company i at the base
p _i (t)	=	price of stock i at time (t)
s _i (t)	=	constructed shares of company i at time (t)
C(t)	=	adjustment factor for the base date market capitalization
T	=	time the index is calculated
M(t)	=	market capitalization of the index at time (t)
B(t)	=	adjusted base date market capitalization of the index at time (t)

It is important to note that the shares (s_i(t)) for the index constituents are artificial constructs used for calculation purposes. Consequently, the constructed shares only have relation to the actual shares of the company in terms of the current market price/fair value relationship.

Index Calculations (Cont.)

Constructed Shares and Constituent Weighting

The Morningstar US Dividend Target 50 Index is rebalanced on a quarterly basis. The data used to determine new index weights is as of the last business day of the month prior to the effective date of the rebalancing. The Index is weighted by float adjusted fair value market cap. Float adjusted fair value market cap is equal to the product of Total Outstanding Shares, Free Float Factor, and Morningstar Fair Value Price. The Morningstar US Dividend Target 50 Index is an equal weight index.

Morningstar US Dividend Target 50 Weight is determined by:

$$IW_i(q) = \frac{1}{n}$$

And the constructed shares ($s_i(t)$) for each constituent in the index calculation formula are:

$$s_i(t) = \frac{\sum_{j=1}^n (s_j(t-1)p_j(t-1)*IW_j(q))}{p_i(t-1)}$$

Where:

N	=	number of stocks in the index
(q)	=	quarter end time the index weights are calculated
(t)	=	time the index is calculated
$p_i(t)$	=	price of stock i at time (t)
$IW_i(q)$	=	company weight in index i at quarterly rebalancing time q
$fp(q)$	=	Morningstar Fair Value Price of company i at time (t)
$ts(q)$	=	Total outstanding shares of company i at time (q)
$s_i(t-1)$	=	constructed shares of company i at time t minus 1*
$f_i(q)$	=	free float factor of company i at time (q)

* At time of index inception the constructed shares are determined by an arbitrary portfolio value, typically \$10 Billion.

Index Calculations (Cont.)

Divisor Adjustments

To avoid distortions caused by corporate actions that affect the share capital of index constituents, the divisor of the index is adjusted accordingly. The following formulae will be used for divisor adjustments due to corporate action. Note: No divisor adjustment are necessary for stock splits, since market value does not change and the share number and share price are adjusted prior to the opening of trading on the split's ex-date.

$$D(t+1) = D(t) * \frac{\sum_{i=1}^n (p_i(t) * s_i(t)) + [\Delta MV(t+1)]}{\sum_{i=1}^n (p_i(t) * s_i(t))}$$

Where:

D(t) = divisor at time (t)

D(t+1) = divisor at time (t+1)

p_i(t) = stock price of company i at time (t)

s_i(t) = number of shares of company i at time (t)

ΔMV(t+1) = aggregate change in market value resulting from corporate actions

Note: If the current trading price of an issue is unavailable, the previous trading session's closing price is used. However, if the issue is affected by any corporate action that requires an adjustment, then the adjusted price is used.

Most but not all of the following actions will require the calculation of an adjustment factor which will be included in the pre-market-open index calculation described above in the section titled "Index Calculation." Generally, because the index is not market cap weighted changes to the share capital structure of index constituents will not affect the component weights.

Corporate Action Adjustments

Spin-Offs

Issues spun off by index holdings (parent company) are not added to the index but will be considered for inclusion at the next reconstitution. The weight of the parent company is reduced by a factor of the spin-off conversion ratio, that is the weight is a product of the original shares * new price. A divisor adjustment is made to account for the reduction in market value.

Mergers and Acquisitions

If an index constituent acquires or merges with another company in the index, the original entities are replaced by the security of the successor entity. The weight of the new entity is equal to the market value sum of the original index constituents. A divisor adjustment is not necessary because the index market value remains unchanged.

If an index constituent acquires or merges with company that is currently not a component of the index, then the original entity is replaced by the security of the successor entity; however, in this case the weight of the new entity is equal to the market value of the original index constituent. A divisor adjustment is not necessary because the index market value remains unchanged.

If an index constituent is the target of an acquisition or merger by a company that is not an index component, the original index constituent is deleted from the index. A divisor adjustment is made to reflect the decrease in market value.

Stock Dividends / Splits

Stock splits and dividends do not require a divisor adjustment because the market value of the entity remains unchanged.

Share Repurchase / Offering

If an index constituent issues or repurchases shares, the new share capital structure is considered at the next rebalancing. No divisor adjustment is necessary.

Delisting, Bankruptcy, and Financial Distress

If an index constituent is delisted by its principal exchange, enters bankruptcy proceedings, or is under extreme financial distress, the security is removed from the Morningstar US Dividend Target 50 Index. Exceptions are made on a case-by-case basis. For example, a security might not be removed immediately when a bankruptcy filing is not a result of operating or financial difficulties. Upon deletion, a divisor adjustment is made to reflect the decrease in market value.

Change of Principal Exchange

A security is removed from the index if its principal exchange ceases to be the NYSE, NYSE Amex, or NASDAQ exchange. A divisor adjustment is made to reflect the decrease in market value.

Change of Domicile

If a company ceases to meet the company domicile eligibility rule, the company is removed from the index. A divisor adjustment is made to reflect the decrease in market value.

Loss of Liquidity

If a constituent accumulates 10 consecutive nontrading days between reconstitution dates, it is removed from the indexes. Two business days' prior notice of its removal is provided. A divisor adjustment is made to reflect the decrease in market value.

Data Corrections and Precision

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 the 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.

Computational and Reporting Precision

All calculated and adjusted data are stored in real numbers. For reporting purposes, Index values are rounded to two decimal places and divisors are rounded to appropriate decimal places.

Undocumented Events

Any matter arising from undocumented events will be resolved at the discretion of the Morningstar Index Committee.

Appendix A: Morningstar Variable Descriptions

Average Daily Trading Volume

The average daily trading volume is a measure of the liquidity of a company's stock. It is calculated by taking a security's daily trading volume for the past quarter and calculating the arithmetic average.

Cash Flow-to-Debt

Cash Flow-to-Debt is a measure of a company's excess earnings available to debt holders. Cash Flow is a measure of earnings after expenses and taxes. Cash flows are essential to the solvency of a corporation. Debt is the sum of the short-term and long-term debt securities of a company. Higher values are best.

Dividend Payout

Dividend Payout is a measure of the yearly dividends per share distributed by a company.

Expected Dividend Yield

Expected Dividend Yield is a measure of the dividends that a company is expected to pay each year. It is calculated by dividing the annual dividends per share by the current price per share where the annual dividends per share are equal to the product of the most recent dividend paid time the payment frequency.

EPS Estimate Revision

3-month EPS estimate revision measures the percentage change over the past 3 months in the median broker earnings estimate for a company's current fiscal year. For example, an estimate revision of 15% means that current year earnings estimates have been raised by 15% over the past 3 months. High values are considered best for ranking purposes.

Return on Equity

Return on Equity is a measure of the income generated by the equity contributed by shareholders. It is calculated by dividing the Net Income by Shareholder's Equity. Higher values are best.

5-Year Normal EPS Growth

Earnings-Per-Share (EPS) is a measure of a company's earnings spread over the shares of a company's outstanding equity. The 5-Year Normal EPS Growth is a historical metric that reflects the EPS growth over a five year period. Higher values are best.