

# Morningstar Wide Moat Focus Index Through a Factor Lens

Factor exposures have provided a modest headwind as stock selection remains the primary driver of favorable returns.

## Morningstar Equity Research

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Andrew Lane

Director of Equity Research, Index Strategies  
+1 312 244-7050

andrew.lane@morningstar.com

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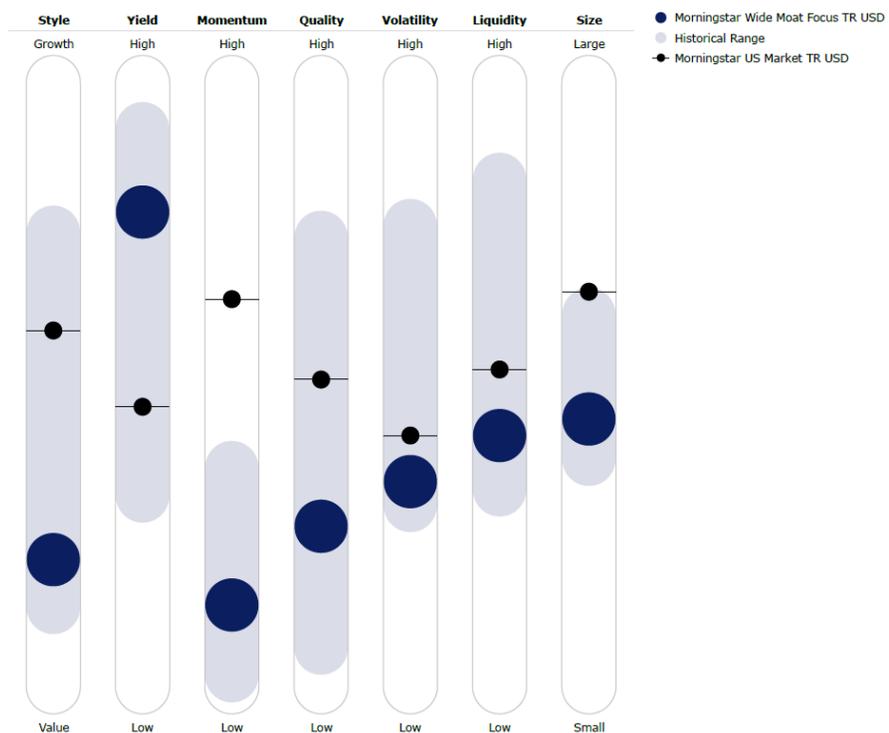
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The Morningstar Wide Moat Focus Index has delivered more than 300 basis points of annual excess returns versus the broader U.S. equity market since its early 2007 live inception date. We often contextualize this track record by looking at the impact of sector weightings and stock selection. In this report, we highlight key factor exposures and analyze their impact on performance.

In aggregate, the index's exposures to traditional factors has proved unfavorable. Two notable exposures stand out in the factor profile below. First, we note a very low exposure to the momentum factor. This has represented a pressing headwind, with momentum having been the best-performing factor, in isolation, since the index's live inception date. Second, and perhaps counterintuitively, the index has exhibited a slightly below-market exposure to the quality factor. For the most part, however, the Wide Moat Focus Index's factor loadings have proved dynamic over time.

Morningstar Wide Moat Focus Index: Factor Profile, Trailing 5 Years



Source: Morningstar Direct. Data from March 1, 2016, to Feb. 28, 2021.

Benchmark: Morningstar US Market Index.

Note: Factor exposures reflect percentile from 1 to 100 based on weighted constituent-level data relative to a 40,000-stock global coverage universe.

### Assessing the Impact of Traditional Factor Exposures on Wide Moat Focus Index Performance

In this report, we analyze the positioning of the Wide Moat Focus Index across seven traditional factors: size, liquidity, yield, value/growth, quality, volatility, and momentum.

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#### Exhibit 1 Global Risk Model: Factor Descriptions

Name	Description
Size	Market capitalization of a company. Higher scores imply smaller companies.
Liquidity	Share turnover of a company. Higher scores imply more liquidity.
Yield	A measure of a firm's total yield (dividend plus buyback). High scores imply high-yielding firms.
Value/Growth	Uses the Morningstar Style Box raw style score for calculating value/growth characteristics. Higher scores imply firms that are more growth and less value oriented
Quality	A quality firm is one with high profitability and low financial leverage. High scores imply high-quality firms.
Volatility	Total return volatility as measured by trailing 12-month volatility of daily returns. Higher scores imply greater return volatility.
Momentum	Total return momentum over the horizon from negative 12 months through negative 2 months. Higher scores imply greater return momentum.

Source: Morningstar.  
Global Risk Model version: Standard.

Please see [Appendix A](#) for more detail on how these factor scores are defined and calculated.

#### The Wide Moat Focus Index's Factor Exposures Have Detracted From Excess Returns

Data from the Morningstar Global Risk Model indicates that factor exposures have provided a modest headwind for excess returns since the Wide Moat Focus Index's live inception date. Across the seven factors analyzed in this report, three have had a material impact on performance. In Exhibit 2, the active exposure column reflects the degree to which the index is overweight or underweight a factor loading relative to its benchmark. A factor premium reflects the degree to which a particular factor has influenced asset returns. The active contribution column indicates the impact of a given factor exposure on the index's annualized excess returns.

**Exhibit 2** Morningstar Wide Moat Focus Index: Risk Factor Attribution

	Portfolio Exposure	Benchmark Exposure	Active Exposure	Factor Premium %	Portfolio Contribution %	Benchmark Contribution %	Active Contribution %
Size	0.12	-0.14	0.26	22.38	0.24	-0.25	0.49
Liquidity	0.28	0.18	0.10	10.05	0.36	0.13	0.22
Yield	0.18	0.07	0.11	10.11	0.07	0.05	0.02
Value-Growth	-0.07	-0.01	-0.06	1.33	-0.02	0.00	-0.02
Quality	-0.10	0.00	-0.10	17.84	-0.05	-0.01	-0.04
Volatility	0.02	-0.07	0.09	-22.71	0.06	0.13	-0.07
Momentum	-0.46	0.00	-0.46	28.76	-0.95	-0.05	-0.90
						<b>Total:</b>	-0.29

Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.

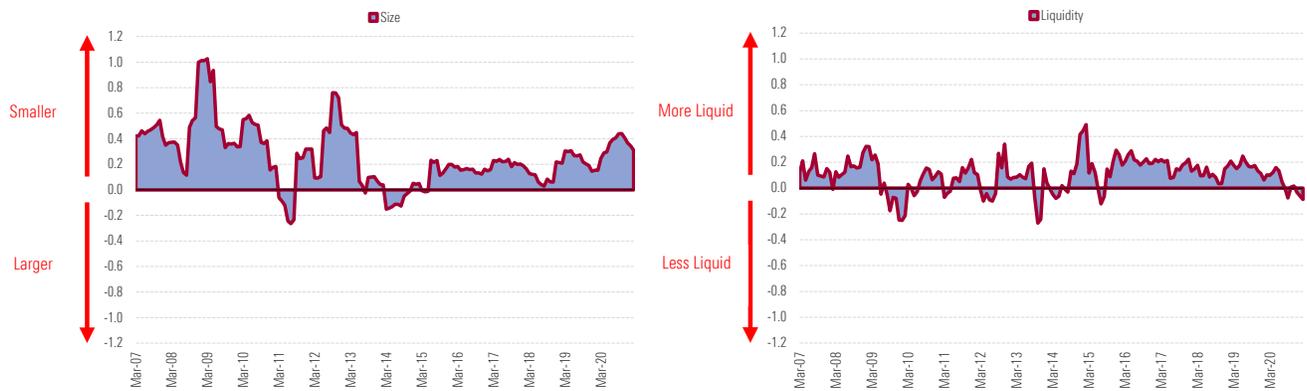
Benchmark: Morningstar US Market Index.

Risk Model: Global Equity Model (USD), Standard.

Note: Factor exposures are calculated relative to an ~11,000-stock estimation universe. See Appendix B for more details on estimation universe construction rules.

The Wide Moat Focus Index's positive active exposure to the size factor reflects the inclusion of smaller companies, on average, relative to its benchmark. To be clear, the Wide Moat Focus Index operates in the large-cap style band. Its holdings simply skew a bit smaller, on average, versus the benchmark's holdings. This positioning has proved favorable with regard to performance. High exposure to the liquidity factor, representing the inclusion of more-liquid, higher-turnover stocks relative to the benchmark, has also benefited performance. The index's active exposure (exposure relative to that of the benchmark) to these two factors is shown in Exhibit 3.

**Exhibit 3** Wide Moat Focus Index Active Exposures: Size and Liquidity

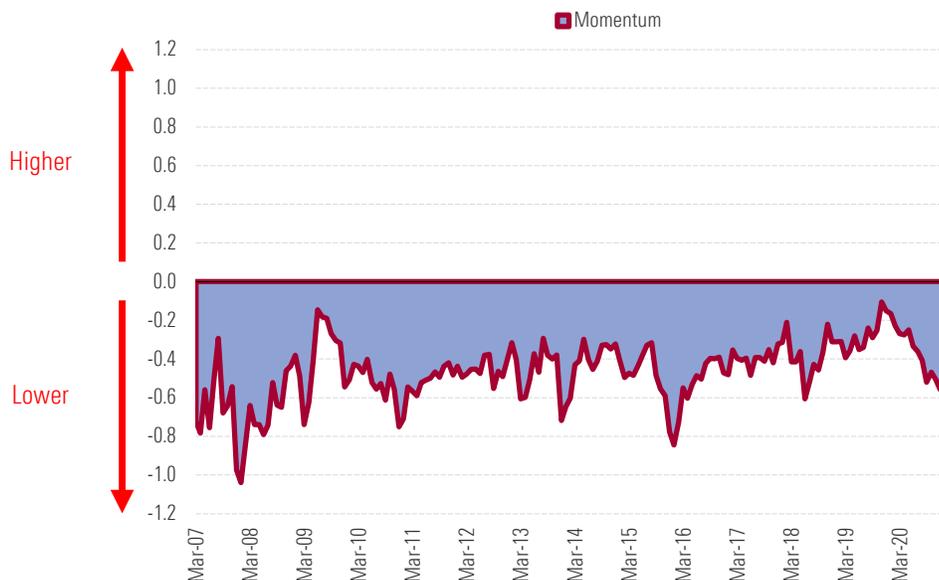


Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.

Benchmark: Morningstar US Market Index.

Risk Model: Global Equity Model (USD), Standard.

The impact of these two favorable exposures is more than offset, however, by the adverse impact of low exposure to the momentum factor. Momentum has exhibited the highest factor premium of the group, meaning that returns associated with one additional unit of momentum exposure have been higher than returns from incremental exposure to any of the other six factors. Accordingly, the index's consistent below-market momentum exposure has materially detracted from excess returns.

**Exhibit 4** Wide Moat Focus Index Active Exposure: Momentum

Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.

Benchmark: Morningstar US Market Index.

Risk Model: Global Equity Model (USD), Standard.

### Factor Analysis Reflects the Impact of Portfolio Construction and Helps Avoid 'Unintended Bets'

Having assessed the impact of Wide Moat Focus Index factor exposures on performance, we now examine how certain factor exposures came to be. For a given portfolio, factor exposures are typically targeted by the prevailing portfolio construction rules. Targeted factor exposures, however, can sometimes lead to unintended factor exposures bets as well.

The Wide Moat Focus Index's smaller size bias relative to the benchmark is best considered an intentional exposure. This stems from the use of an equal-weighting approach versus the market cap-weighted benchmark. The use of an equal-weighted design gives each holding a roughly equivalent opportunity to drive returns rather than allowing performance to be largely dictated by a limited number of very large companies. The Wide Moat Focus Index's historical positioning in the Morningstar Style Box relative to that of its benchmark is included in Appendix C.

We'd characterize the index's negative active exposure to momentum as an unintended byproduct of the index's valuation screen. Although this particular factor exposure has detracted from excess returns, the valuation screen that causes it has also paved the way for highly favorable stock selection results over time. One might consider it a "necessary evil." The use of a valuation screen increases portfolio turnover, as new, undervalued stocks replace incumbent holdings during the quarterly portfolio reconstitution process. When a stock performs well and its market price converges upward with our prevailing fair value estimate, its portfolio weighting is likely to be reduced during the upcoming quarterly reconstitution process if the stock is not removed from the index altogether. This process reduces

exposure to the momentum factor but also helps ensure that constituents are, on average, trading at attractive valuations.

In addition to the implications of the quarterly reconstitution process, lower momentum exposure is also driven by the quarterly rebalancing process that maintains an equal-weighted design. When a stock has performed well and establishes a higher momentum score, its portfolio weighting concurrently rises. However, to restore its equal weighting in the portfolio, the stock would then have its weighting reduced during the upcoming quarterly rebalancing process. This process likely limits overall momentum exposure as well.

Factor exposure data for the Wide Moat Focus Index is particularly valuable given that we implemented a set of portfolio construction changes to the previously highly concentrated portfolio of just 20 holdings. After the second quarter of 2016, we moved to the current portfolio construction process that involves two subportfolios of 40 stocks each. These subportfolios are reconstituted and rebalanced quarterly but on a staggered basis. Given significant overlap between these two subportfolios, the full index typically holds 45-50 stocks. Turnover and valuation buffers were also added at that time.

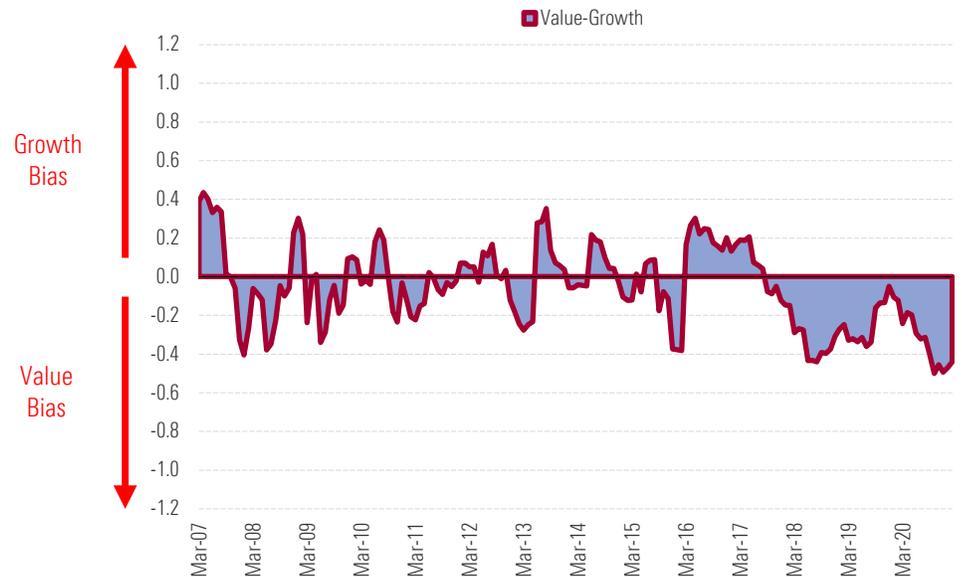
In looking at time series data, these portfolio construction changes did not have a sizable impact on the strategy's factor exposures. One objective was to increase the index's factor loading to momentum. On this front, the index seems to have moved in the desired direction, but only slightly. Regardless, we are pleased to see that this set of portfolio construction changes didn't lead to any unintended consequences as it pertains to factor exposures. Perhaps more importantly, the changes didn't impede favorable stock selection, which has continued to drive excess returns in recent years.

### **Highlighting Two Factor-Related Misconceptions About the Wide Moat Focus Index**

Tangential to the discussion of intended factor bets, we are frequently asked about the Wide Moat Focus Index's exposure to the value/growth and quality factors. Most are surprised to learn that, on average, the index has not exhibited a style bias toward value at the expense of growth and has a quality factor loading below that of the broader market.

### **Despite Its Current Style Bias, the Wide Moat Focus Index Can't Be Considered a 'Value' Strategy**

Given the index's use of a valuation screen, some would suspect we are targeting a style bias toward value at the expense of growth. We stress, however, that the equity research methodology employed by Morningstar equity analysts is style-agnostic when it comes to uncovering undervalued stocks. While the Wide Moat Focus Index utilizes a stock's valuation to determine eligibility, it is by no means a "value investing" strategy. This is evident when looking at the index's historical positioning, as it has oscillated between value and growth over the course of its more than 14-year live track record.

**Exhibit 5** Wide Moat Focus Index Active Exposure: Value/Growth

Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.

Benchmark: Morningstar US Market Index.

Risk Model: Global Equity Model (USD), Standard.

However, while the index has historically operated in the core or blend style band, a notable bias toward value has emerged in recent years. In fact, the portfolio currently exhibits a value bias at the expense of growth nearly as large as it has ever been. A similar value bias emerged in mid-2018, but the index returned to an even balance between value and growth by late 2019.

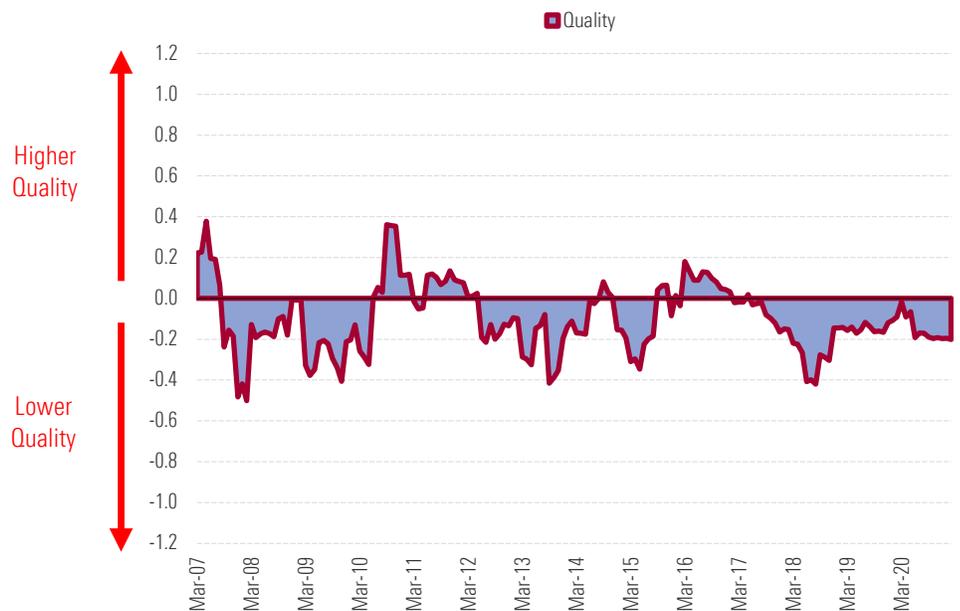
The index's current positioning doesn't necessarily reflect a top-down house view that value is likely to outperform growth. Instead, it reflects the aggregation of valuation conclusions provided by Morningstar equity analysts via bottom-up fundamental analysis across numerous companies. It indicates that, across all U.S. wide-moat-rated stocks covered by the Morningstar equity research team, a greater proportion of value stocks are trading at attractive valuations relative to growth stocks. The cohort of U.S. wide-moat companies typically is roughly 140, a small portion of Morningstar's coverage of more than 1,500 stocks and a very small portion of the broader U.S. equity market.

Based on factor attribution analysis, the underlying rotation between value and growth, in isolation, has had effectively no impact on excess returns. However, the turnover of individual holdings that drives these portfolio-level changes has meaningfully contributed to the index's impressive stock selection over time. Accordingly, we believe that the index's freedom to move back and forth between the two style orientations has helped augment returns versus other comparable strategies that are, by design, constrained to a specific style box.

### The Wide Moat Focus Index Exhibits a Lower Quality Factor Loading Than the Broader Market

The concept of an economic moat is often conflated with business quality. In this vein, given that the Wide Moat Focus Index includes only companies with wide economic moats, most would expect to see a heavy loading to the quality factor. However, this is not the case, as the index has actually exhibited a below-market exposure to the quality factor. While the bias toward lower-quality companies has been modest, it has proved fairly consistent over time.

**Exhibit 6** Wide Moat Focus Index Active Exposure: Quality



Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.

Benchmark: Morningstar US Market Index.

Risk Model: Global Equity Model (USD), Standard.

In part, we believe this counterintuitive dynamic is due to the fact that our economic moat ratings are forward-looking while quality factor metrics are inherently backward-looking. The Morningstar Global Risk Model calculates the quality factor score of a stock by considering the company's trailing 12-month return on equity and its trailing 12-month debt/capital ratio. However, when assigning economic moats, Morningstar equity analysts consider economic profit forecasts many years into the future. A wide economic moat rating requires the belief that a company, with near certainty, will generate economic profits 10 years into the future and, more likely than not, will generate economic profits 20 years into the future. Companies that have delivered healthy economic profits in the past and have likely scored well on these two quality metrics along the way are by no means certain to do so into the future. In fact, companies that earn outsize economic profits often have the biggest targets on their backs in terms of inspiring new competition.

Apple serves as a relevant case study. We assign only a narrow moat rating to Apple due to the rapid pace of technological change across its industry, combined with the considerable length of our 20-year wide moat assessment period. Apple scores quite well across just about any backward-looking quality metric but is ineligible for the Wide Moat Focus Index absent a wide economic moat.

On the other side of the coin, many companies that might not score well on backward-looking quality metrics can still earn a wide economic moat rating, given our forward-looking judgments about their prospects. Amazon is one such example. Amazon has forgone higher near-term profits in the name of greater long-term gains via its commitment to massive reinvestment. This strategy has weighed on its quality factor score in recent years. However, Morningstar analysts believe it will pay off handsomely, as evidenced by the wide economic moat we assign to the company.

The Wide Moat Focus Index's valuation screen also helps explain its low-quality exposure. Often, wide-moat-rated stocks become attractively priced when the underlying company is navigating some sort of headwind, whether company-specific or industrywide. If the Morningstar equity research team believes the challenge will materially decrease long-term cash flows, a fair value estimate reduction is likely, and sometimes, the economic moat rating will be downgraded to narrow from wide. However, when a stock's moat rating remains wide amid such a situation and the market punishes its valuation by a greater magnitude than that reflected by our analyst's fair value estimate reduction, an attractive entry point will sometimes emerge. This dynamic often leads to new additions to the Wide Moat Focus Index. However, these situations still typically lead to a lower quality factor score. Indeed, a company's trailing 12-month return on equity and its debt/capital metrics can worsen when a company is fighting to overcome a meaningful headwind.

When Morningstar equity analysts reiterate a company's wide moat rating amid this type of situation, they are typically implying that the company's quality metrics might recover, to some degree, over time. When a holding's quality factor score does eventually start to recover in this manner, its market price often recovers as well. The stock might then be replaced in the Wide Moat Focus Index by a new holding with a more attractive valuation that is, in its own right, experiencing a temporary decrease to its quality factor score.

Overall, it is more appropriate to consider the economic moat rating an indicator of future quality than to conflate it with backward-looking quality metrics. This reflects how unique the Morningstar economic moat rating truly is and highlights its importance in determining Wide Moat Focus Index holdings.

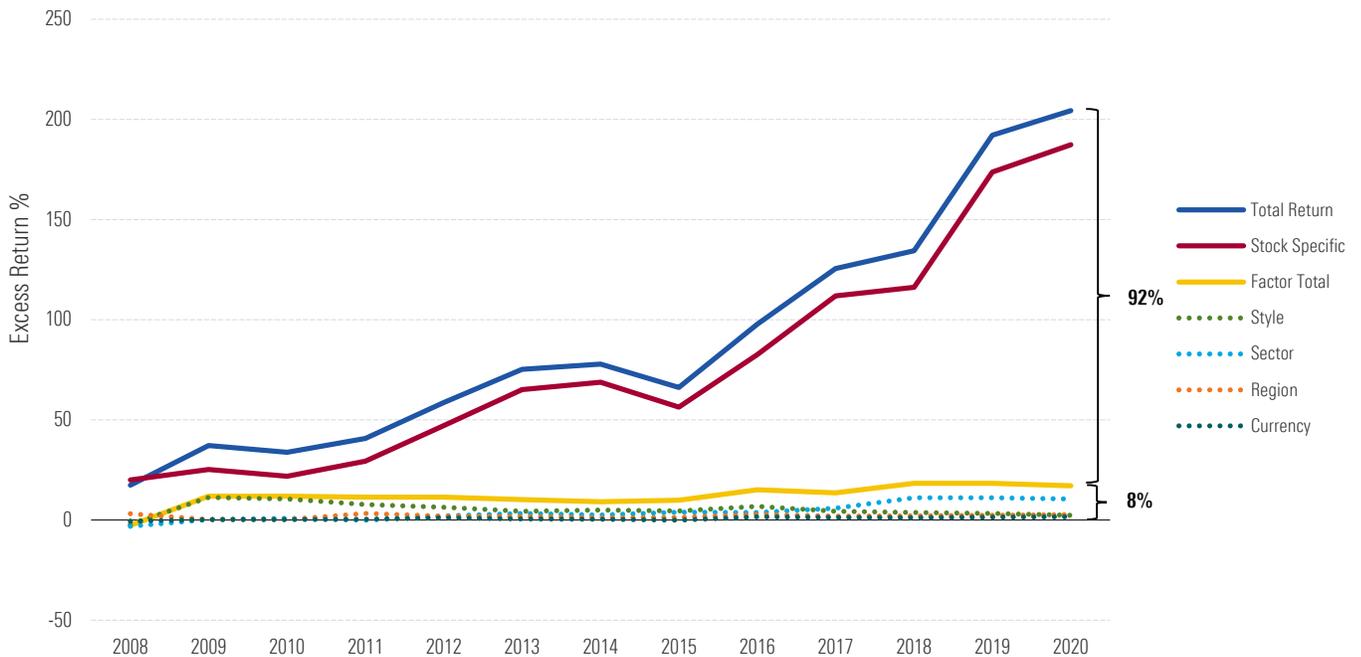
**Stock Selection Remains the Key Performance Driver for the Wide Moat Focus Index**

**Effective Stock-Picking Has Accounted for Nearly All the Index's Historical Excess Returns**

While it's important to monitor a portfolio's factor exposures and assess the performance impact they've had, it's also critical to track the impact of stock selection. The Wide Moat Focus Index's portfolio construction rules are designed to let Morningstar's best U.S. wide-moat stock ideas drive performance. The index is not designed to rely on recurring favorable performance for any individual factor.

In practice, this is what we've observed. Stock selection has explained 92% of the index's cumulative excess returns since its live inception, with factor exposures tied to style, sector, region, and currency accounting for the balance.

**Exhibit 7** Wide Moat Focus Index: Risk Factor Attribution, Cumulative Excess Returns vs. Benchmark %



Source: Morningstar Direct. Data from Jan. 1, 2008, to Dec. 31, 2020.  
 Benchmark: Morningstar US Market Index.  
 Risk Model: Global Equity Model (USD).

In looking at the time series, the Wide Moat Focus Index enjoyed a notable performance tailwind from its active factor exposures in 2009 amid the market's recovery from the financial crisis. However, the impact of active factor exposures on performance has been immaterial over the many years since then. Since 2009, stock selection has almost exclusively driven excess returns.

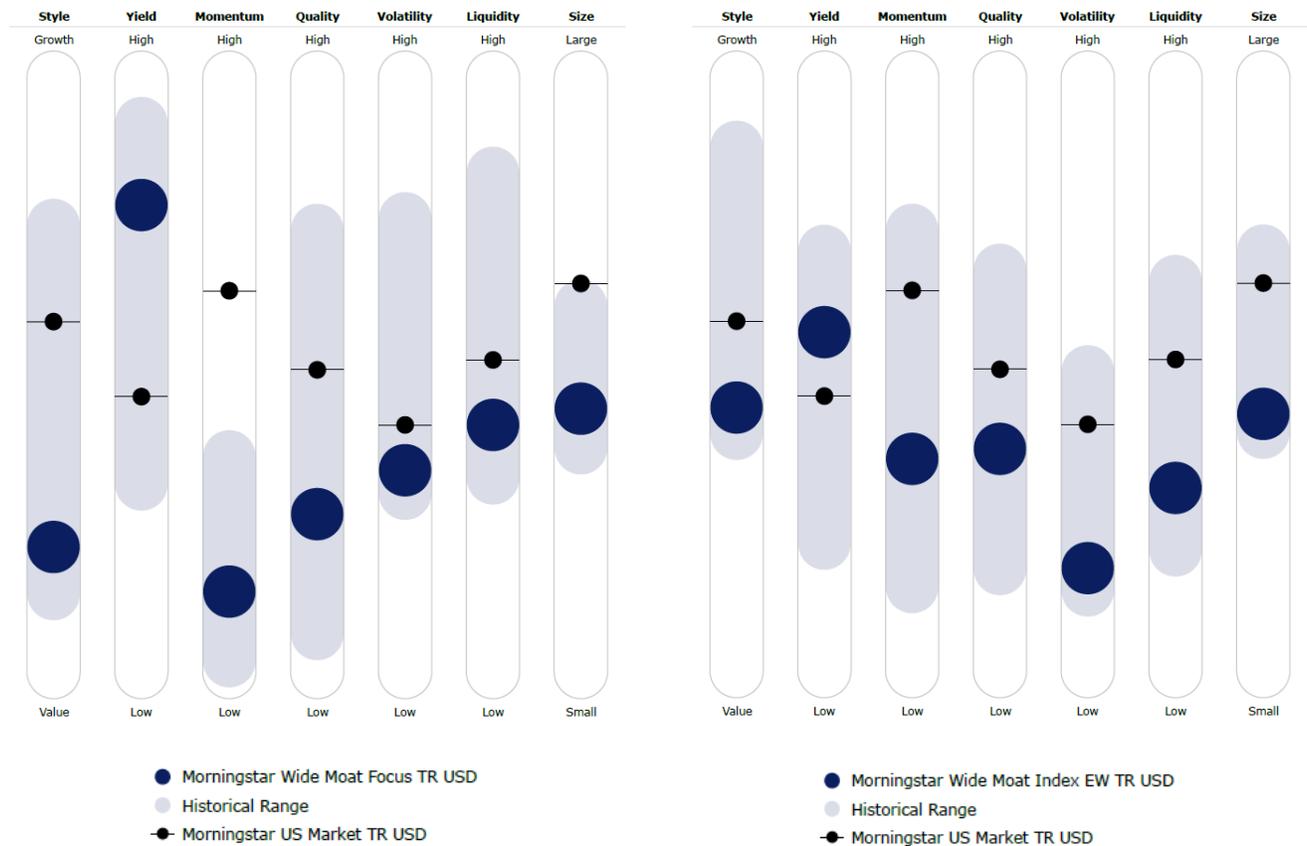
**Factor Profile Comparison: Wide Moat Focus Index vs. Wide Moat Index**

**The Wide Moat Focus Index's Valuation Screen Has Only a Modest Impact on Factor Exposures**

In addition to the Wide Moat Focus Index, Morningstar also offers the Wide Moat Index. The Wide Moat Index is very similar in that it includes only U.S. wide-moat-rated stocks on an equal-weighted basis. It is also reconstituted and rebalanced quarterly. The primary difference is that the Wide Moat Focus Index employs a valuation screen—hence the word *focus*—and the Wide Moat Index does not. The Wide Moat Focus Index typically holds 45-50 stocks out of the roughly 140 U.S. wide-moat-rated stocks covered by Morningstar equity analysts. The Wide Moat Index simply holds all of these U.S. wide-moat-rated stocks.

The existence of the Wide Moat Index allows us to analyze how the Wide Moat Focus Index's valuation screen has affected its factor exposures. These factor profiles are included in Exhibit 8, with the Wide Moat Focus Index on the left and the Wide Moat Index on the right.

**Exhibit 8** Wide Moat Focus Index (Left) vs. Wide Moat Index (Right): Factor Profile Comparison



Source: Morningstar Direct. Data from Feb. 1, 2016, to Jan. 31, 2021.  
 Benchmark: Morningstar US Market Index.

At first glance, there are no glaring deviations between the Wide Moat Focus Index and the Wide Moat Index after the valuation screen is implemented. With regard to current positioning, both indexes are overweight and underweight the same factors relative to the broader market.

However, in looking at positioning of the two indexes relative to one another, there are some notable deviations. First, the Wide Moat Focus Index has typically exhibited greater exposure to value at the expense of growth from a style perspective. While we believe growth stocks and value stocks alike can certainly be mispriced, it does seem intuitive that the search for attractive valuations will typically lead to a greater proportion of value-oriented stocks. Of course, this is not always how the two indexes are positioned, as the historical range for each extends into both style territories.

Their relative momentum exposure also stands out, with the Wide Moat Focus Index exhibiting a lighter loading to the momentum factor. This stems from the Wide Moat Focus Index's more frequent turnover in search of attractive valuations. However, the Wide Moat Index's below-market momentum exposure indicates that U.S. wide-moat stocks, in general, don't exhibit strong momentum characteristics. We'd also note a higher loading to the volatility factor for the Wide Moat Index. Again, this is to be expected due to the notion that undervalued stocks might have become more attractively priced thanks to some sort of headwind that has weighed on share prices.

Finally, while the Wide Moat Index exhibits a below-market exposure to quality, the Wide Moat Focus Index's valuation screen further reduces this exposure.

In conclusion, aggregated factor exposures have represented a negative impact on the relative performance of the Wide Moat Focus Index. Despite this impact being only modest, it is still important to monitor these factor exposures. Doing so helps ensure that the index is not making impactful unintended bets. It also helps contextualize index performance over a given period. Finally, factor analysis helps inform how the index might best be employed in the context of a broader portfolio. ■■■

## Appendix A: Traditional Style Factor Definitions

### Size

The size factor is the normalized value of the logarithm of a firm's market capitalization:

$$size_{i,t} = -\ln(MV_{i,t})$$

The factor is unbounded, and higher scores indicate smaller market capitalization. A score of 0 indicates an average level of market capitalization.

### Liquidity

The liquidity factor is the normalized value of the stock's raw share turnover. The raw share turnover score is calculated as the logarithm of the average trading volume divided by shares outstanding over the past 30 days. It is essentially a churn rate for a stock and represents how frequently the shares get traded.

$$share\ turnover_{i,t} = \ln\left(\frac{1}{T} \sum_{t=1}^T \frac{V_{i,t}}{SO_{i,t}}\right), \text{ where } T = 30$$

The factor is unbounded, and higher scores indicate higher liquidity. A score of 0 indicates an average level of liquidity.

### Yield

The yield factor is expressed as a total yield, which is the sum of the trailing 12-month buyback and dividend yield of a company. Higher values indicate larger, positive yield exposure:

$$Total\ Yield = Buyback\ Yield_{ttm} + Dividend\ Yield_{ttm}$$

The factor is unbounded, and higher scores indicate higher yield. A score of 0 indicates an average level of quality.

### Value/Growth (Standard Model)

Value/growth reflects the aggregate expectations of market participants for the future growth and required rate of return for a stock. For this version used in the Standard Factor model, we use the raw style score from the style box as the input for calculating the value/growth exposure of stocks. The raw style score is calculated as the difference between a stock's growth score and value score:

$$Raw\ Style\ Score = Growth\ Score - Value\ Score.$$

The value score is the weighted average of a stock's prospective earnings (E), book value (BV), revenue (R), cash flow (CF), and dividend (D), all scaled by the current price of the stock:

$$Value\ Score = \left[ w_E \times \frac{E}{P_t} + w_{BV} \times \frac{BV}{P_t} + w_R \times \frac{R}{P_t} + w_{CF} \times \frac{CF}{P_t} + w_D \times \frac{D}{P_t} \right].$$

The growth score of a stock is the weighted average of the growth rates in a company's earnings (E), book value (BV), revenue (R), and cash flow (CF):

$$Growth\ Score = [w_E \times E_{growth} + w_{BV} \times BV_{growth} + w_R \times R_{growth} + w_{CF} \times CF_{growth}].$$

The factor is unbounded, and higher scores indicate higher liquidity. A score of 0 indicates an average level of liquidity.

### Quality

We define a quality score of a stock as the equally weighted z-score of a company's profitability (trailing 12-month return on equity) and the z-score of its financial leverage (trailing 12-month debt/capital). The z-score is with respect to all the stocks in the global universe.

$$Quality = \frac{1}{2} \left[ ROE_z + \left( 1 - \frac{Total\ Debt_t}{Total\ Capital_t} \right)_z \right].$$

*ROE* is the trailing 12-month return on equity and the subscript z indicates a z-score.

The factor is unbounded, and higher scores indicate higher quality. A score of 0 indicates an average level of quality.

### Volatility (Standard Model)

The volatility score for the Standard model is defined as the trailing 12-month volatility of daily returns of a stock.

$$Volatility = \sqrt{\frac{\sum_{t=1}^N (r_t - \bar{r}_t)^2}{N - 1}}$$

The factor is unbounded, and higher scores indicate higher volatility. A score of 0 indicates an average level of volatility.

### Momentum

The momentum factor is the normalized value of the stock price's raw momentum score. The raw momentum score is calculated as the cumulative return of a stock from 365 calendar days ago to 30 days ago. This is the classical 12-1 momentum formulation except using daily return data as opposed to monthly. To compute, U.S. dollar currency returns are used.

$$momentum_{i,t} = \sum_{t=365}^{t-30} \left( \ln(1 + r_{i,t}) - \ln(1 + r_{f,t}) \right)$$

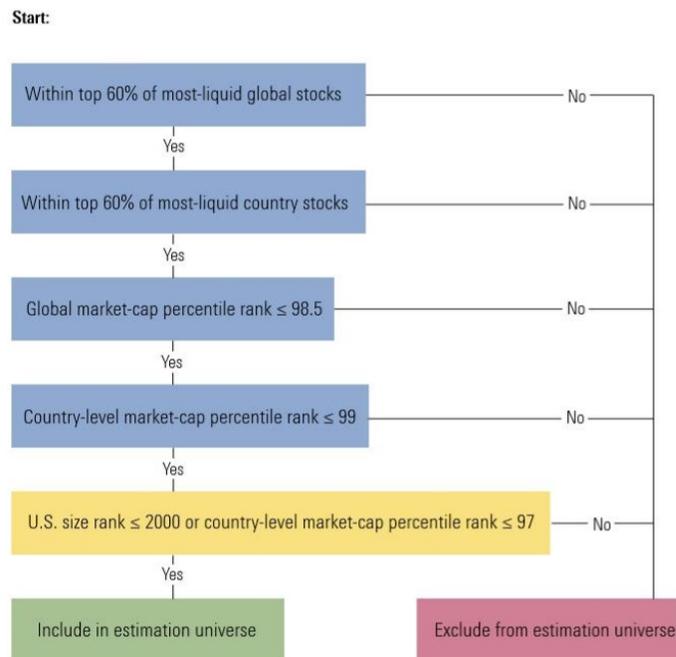
The factor is unbounded, and higher scores indicate higher returns over the past year as well as a propensity for higher returns in the future. A score of 0 indicates an average level of momentum.

### Appendix B: Global Risk Model Estimation Universe Construction

For all securities, we calculate the liquidity and percentile rank of market capitalization at world and country levels at daily frequency. Liquidity is the median dollar trading volume over the past 91 trailing days. We define the percentile rank of market capitalization as  $\{\text{total market capitalization of companies whose market capitalization is greater than or equal to the company in question}\} / \{\text{market capitalization of all companies}\} * 100$ , where the stock with the largest market capitalization gets the smallest percentile rank.

We include the stock of a company into the estimation universe if it satisfies the following requirements:

#### Exhibit 1B Global Risk Model: Estimation Universe Construction Logic



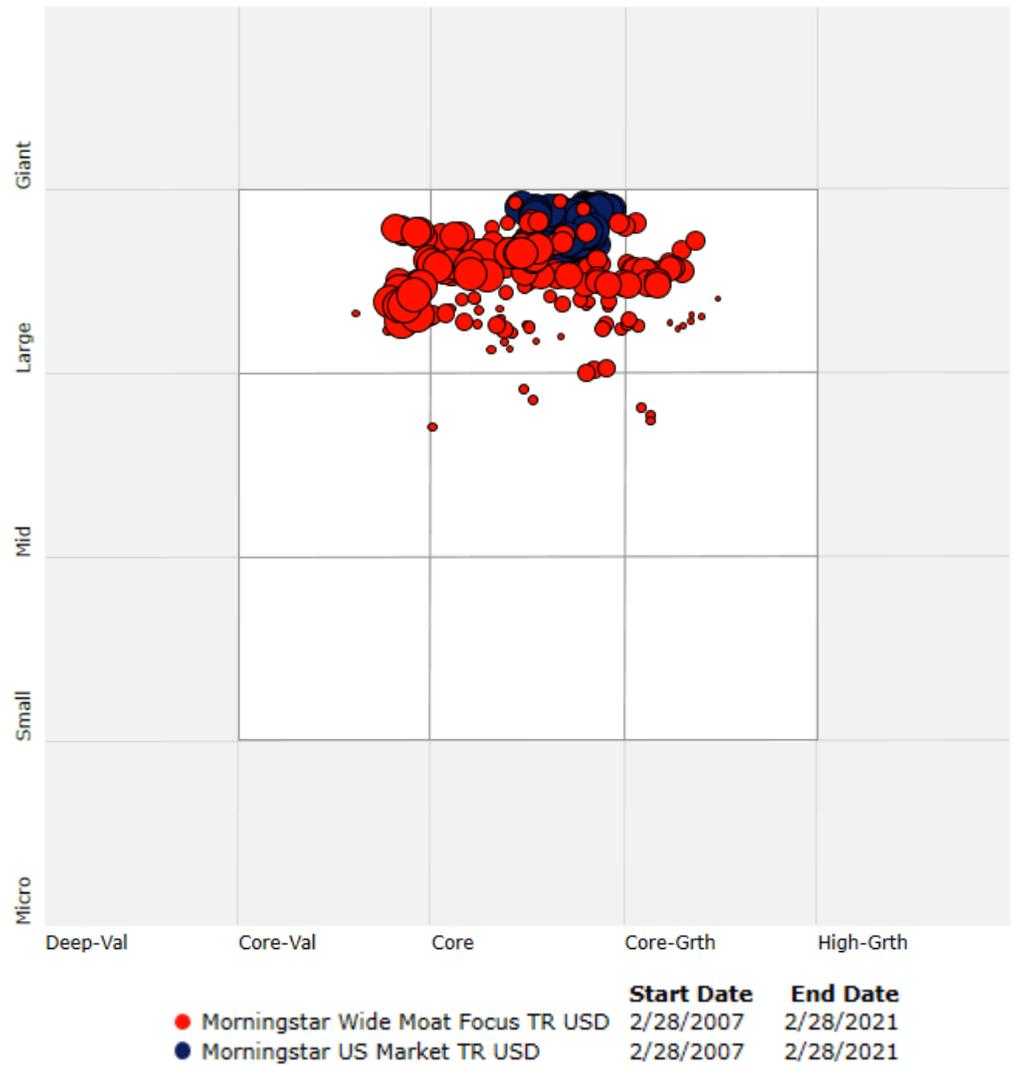
Source: Morningstar.

For the U.S. stocks, if the number of stocks that satisfies the four criteria is less than 2,000, we add the most liquid U.S. stocks back into the universe to achieve this total. These U.S. stocks must have a U.S.-size rank  $\leq 2000$  and have a percentile rank of U.S. market capitalization  $\leq 99$ . The size rank is a rank based on the sum of a stock's market capitalization rank, where the stock with largest market capitalization gets a rank of 1, and its liquidity rank, where the stock with highest liquidity gets a rank of 1. The stock with the lowest sum is given a size rank of 1.

We include shares having a foreign ownership limit, like China A stocks, and we do not use free float-adjusted market cap.

### Appendix C: Size/Style Positioning

**Exhibit 1C** Wide Moat Focus Index: Size/Style Positioning

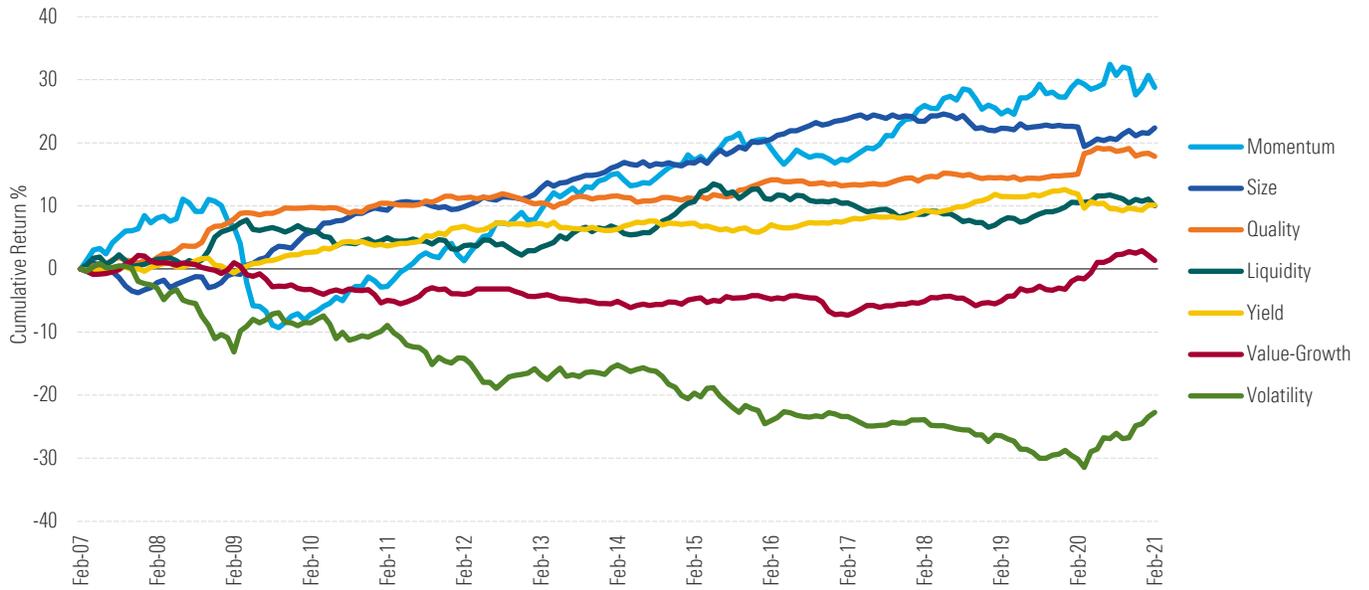


Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.  
 Benchmark: Morningstar US Market Index.

**Appendix D: Size/Style Positioning**

The risk factor premiums shown in Exhibit 1D reflect average returns for one unit of extra exposure to a given factor after the impact of all other risk factors has been accounted for. This data is not related to the Wide Moat Focus Index in any way. It reflects only the historical performance of the factors themselves.

**Exhibit 1D** Wide Moat Focus Index: Risk Factor Premiums



Source: Morningstar Direct. Data from March 1, 2007, to Feb. 28, 2021.  
 Benchmark: Morningstar US Market Index.  
 Risk Model: Global Equity Model (USD).

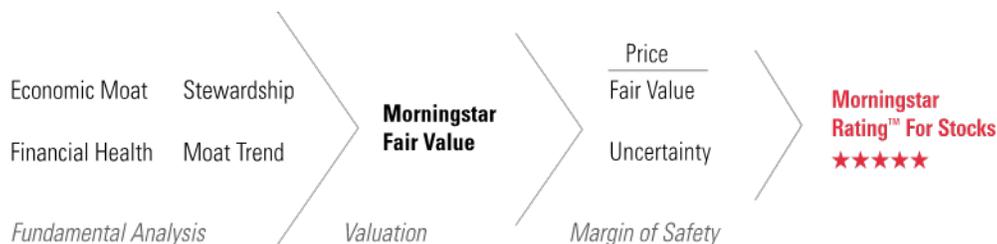
## Research Methodology for Valuing Companies

### Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (for example, mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market-price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

### Morningstar Research Methodology



Source: Morningstar.

Four key components drive the Morningstar rating: 1) our assessment of the firm's economic moat, 2) our estimate of the stock's fair value, 3) our uncertainty around that fair value estimate and 4) the current market price. This process ultimately culminates in our single-point star rating.

### Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

### Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity

period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

#### **Stage I: Explicit Forecast**

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes, or EBI, and the net new investment, or NNI, to derive our annual free cash flow forecast.

#### **Stage II: Fade**

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested, or RONIC—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

#### **Stage III: Perpetuity**

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term market-value weights.

#### **Uncertainty Around That Fair Value Estimate**

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

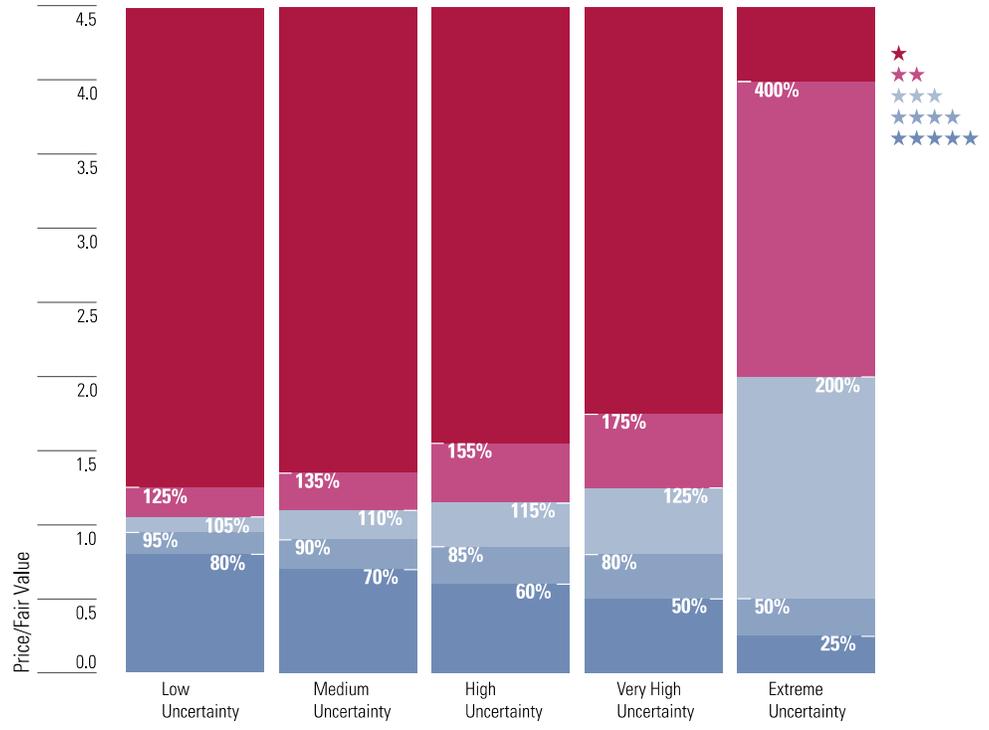
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- ▶ Low—margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.
- ▶ Medium—margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- ▶ High—margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- ▶ Very High—margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- ▶ Extreme—margin of safety for 5-star rating is a 75% discount and for 1-star rating is 300% premium.

Morningstar Equity Research Star Rating Methodology



**Market Price**

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more details about our methodology, please go to <https://shareholders.morningstar.com>.

**Morningstar Star Rating for Stocks**

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow, and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

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+1 312 696-6869

equitysupport@morningstar.com



22 West Washington Street  
Chicago, IL 60602 USA

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