



Exchange Traded Funds (ETFs) Research Methodology

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Introduction

Morningstar's aim is to help investors determine an Exchange Traded Funds (ETFs) overall investment merit to help them construct diversified portfolios and achieve their goals. The Morningstar Recommendation can be used within an investment decision making process by individuals, advisers, and institutional investors. Morningstar's qualitative research seeks to identify which Exchange Traded Funds are suitable for investors, financial advisers, and those that are not. Importantly the Morningstar recommendation is not a short-term tactical view on certain markets.

Overview – Key Benefits

Our recommendation gives investors a clear statement of Morningstar's qualitative assessment of an ETFs investment merits or lack thereof. The Morningstar ETF Research Report, issued with a Morningstar Recommendation, gives a transparent, in-depth discussion of the rationale for the recommendation and also gives meaningful insight into current and future drivers of the ETF and its likely performance biases in varying market conditions. The qualitative recommendation can help advisers better focus their research across the universe, while the research reports are designed to help investors and advisers better understand the inner workings, to help them select the right ETFs for their individual needs and risk profiles. The goal is to ensure that investors and their advisers understand how an ETF can be used in a broader portfolio context. Morningstar does not seek or accept any compensation for issuing a report or recommendation, so investors can be sure the opinions are independent and objective.

Morningstar's Qualitative Research

The need for investors and their advisers to have access to objective, unbiased research borne of a completely transparent process has never been greater. Morningstar's qualitative research provides forward looking insight and analysis into how an ETF might behave under different market conditions, helping investors to maintain realistic performance expectations and manage their portfolios more wisely. Morningstar delivers its qualitative assessments in both an Morningstar ETF Research Report and in one of five Morningstar Recommendations.

Morningstar's principles of qualitative research

Independence.

Morningstar does not charge ETF providers to be rated, nor do they commission research, providing investors and their advisers with truly independent, objective information. Morningstar's decision to report on an ETF is driven by investor interest and analyst discretion.

Investors First.

Morningstar's analysts focus wholly on helping investors make better decisions.

Relevant Coverage.

Analysts determine coverage based on asset size, investment merit, and client demand to ensure they cover the funds that matter most to investors.

Comprehensive Scale.

Morningstar's Ratings scale has been developed to allow analysts to not only cover good ETFs, but also identify mediocre and poor ETFs through negative ratings. This approach provides far greater insight in helping investors when they often need it the most.

Local and global expertise.

Morningstar has a network of ETF analysts located across the firms Chicago, London, and Sydney offices. Analysts work together to share global insights, analysis, and investment research covering 4000 ETFs globally.

The key goals of Morningstar's qualitative research are to:

- ▶ Issue a judgment on the ETFs overall investment merit with an eye on selecting those capable of achieving investment outcomes.
- ▶ Help investors understand how an ETF fits into an investment portfolio
- ▶ Provide forward-looking insight and analysis into how an ETF might behave in different market conditions
- ▶ Compare ETFs to peers, including similar index managed fund counterparts on fundamental criteria, such as expenses, liquidity, and tracking error.
- ▶ Monitor the qualitative assessment over time—assessing when a structural/index change has affected the fund's investment merit

Morningstar assesses ETFs on the basis of how we believe they will perform in the future over an economic cycle, in both an absolute sense and against peers. Our model rewards ETF providers which are open and transparent, have a well-structured product offering, and importantly affordable fee structures. The key Issues our qualitative research assesses include, the firm's ability to manage the ETF against the stated index, fee structure, liquidity mechanisms, and the underlying valuation. The portfolio composition and the suitability of the index are considered as key outcomes of the investment process.

Process, Portfolio

We assess how effectively ETFs achieve their stated investment objective, largely tracking an underlying index. Morningstar analysts determine: how ETFs are constructed and managed for investors, what are the key drivers, and how they are different from competitors. Part of this includes ensuring that implementation is logical and consistent with the stated investment objective. In assessing ETFs, analysts determine whether the construction and management of the portfolio reflects the characteristics of the underlying index. We also consider the appropriateness of the portfolio in achieving diversification for investors. To gain insights into the nature of the portfolio both currently and in the past we analyse key portfolio characteristics through our holdings-based analysis.

Performance

Morningstar considers the performance of ETFs from two perspectives. The first is an assessment of share price performance over time relative to the stated index. The second valuation consideration is the share price relative to the underlying Net Asset Value (NAV) figure. The NAV, which is the value of the underlying holdings, should over time fluctuate in line with market movements. An ETF may trade at a premium or discount to its NAV and is something we monitor closely.

Our qualitative recommendation is not a fundamental buy/sell decision based on the ETFs valuation.

People

Consideration is paid to the individuals involved in delivering the ETF to investors. The quality, experience, and usefulness of the implementation team, market makers, and key participants impact on Morningstar's qualitative opinion.

Parent

Morningstar believes the quality of the investment firm can have a meaningful impact on an ETFs long term success and existence. When appraising a parent company, analysts reflect on the company's structure, availability of resources, and ability to implement ETF strategies successfully. Another important consideration is the product suite provided by the parent, and whether or not it is suitable for particular markets and certain investors.

Price

In helping investors achieve their investment outcomes Morningstar pays particular attention to the fees ETF providers charge clients. The fee structure on ETFs can have a significant impact on investor returns and subsequently on our analyst's opinion.

Risks

As part of our qualitative appraisal we outline the prevailing risks associated with specific ETFs. These may include, but are not limited to: Liquidity, Diversification, Cost, and Business.

Analysts assign a Morningstar Recommendation to ETFs using a five-point scale ranging from Highly Recommended to Avoid. Analysts evaluate ETFs on a relative basis, against a universe of offerings in a similar peer group. The ratings scale is unique from other firms because it includes negative ratings which allow analysts to assess and rate poor ETFs, as well as good ones. Investors will be able to screen and filter their fund choices using the qualitative ratings. The ratings are as follows:

Highly recommended

These represent Morningstar analysts' highest conviction picks. Morningstar awards this rating to ETFs that it believes are of the highest quality and have strong investment merit. To earn this rating, an ETF must be significantly better than its peers in most key respects.

Recommended

ETFs in this category are those Morningstar analysts believe are above average and have key advantages over competitors. While these are worthy funds, analysts don't see them as the very best.

Investment Grade

These ETFs are not standouts, but nor are they deeply flawed. Morningstar analysts do not have a high degree of conviction, and they don't stand out relative to peers but should get the job done.

Inferior

These ETFs are thought to be deficient relative to their peers in many key respects. Morningstar analysts believe these ETFs lack a strong investment case, or are inherently too risky or are managed/implemented poorly.

Avoid

Morningstar analysts believe that there is a severe structural defect at the parent organisation or the ETF, which make these offerings extremely poor investments.

Morningstar Recommendations are decided by consideration and open debate within Morningstar's fund and ETF research team. The aim of the recommendation process is to clearly distinguish the ETFs which in Morningstar's view are the standouts, those which should be avoided, and those in between. To determine the Morningstar Recommendation, the lead analyst proposes an initial recommendation which is discussed extensively within the team, and an overall view is formed. Morningstar Recommendations are discussed when appropriate with Morningstar's global ETF analyst teams. The Morningstar Recommendation is the final outcome of a collaborative process based on a site visit, fundamental assessment, quantitative and holdings-based analysis of the portfolio, and an assessment of the key issues outlined. Morningstar's qualitative ETF research reports are periodically reviewed and updated to reflect relevant changes, developments or issues that may of developed. As part of Morningstar's ongoing commitment we also provide frequent discussion, episodic articles and ongoing commentary of issues relating to ETFs, ensuring that clients remain abreast of all relevant investment issues.

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