

Morningstar® US Dividend Valuation IndexSM

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Contact Us

indexes@morningstar.com
 U.S. +1 312 384-3735
 Europe +44 203 107 2969
 Asia +65 6340 1288

Distance to Default

Morningstar's market-driven Distance to Default score uses option pricing theory to evaluate the risk that the value of a company's assets will turn out to be less than the sum of its liabilities. Distance to Default ranks companies on the likelihood that they might encounter financial distress. The more likely the value of a company's assets is to fall below the sum of its liabilities and a small capital cushion, the greater the likelihood of financial distress.

Morningstar's Approach to Valuation

Morningstar believes that a company's intrinsic worth results from the future cash flows it can generate. Morningstar analysts assign fair value estimates using a three-stage discounted cash flow model. Economic moat, or sustainable competitive advantage, is a critical input. Companies with wide or narrow economic moats are viewed as capable of sustaining excess profits. Estimates are adjusted by the Morningstar Uncertainty Rating, which represents the range of likely potential intrinsic values. As uncertainty increases, the margin of safety widens, meaning a deeper discount to fair value is demanded.

Dividends have played a central role in investing for centuries. Prized for their income stream, they signal balance sheet strength and a commitment to shareholders. Dividend payments and dividend growth account for a substantial portion of long-term equity market return.

But dividend investing also carries risks. Income-hungry investors can bid up the shares of dividend-paying stocks, leading to overvaluation. On the flipside, stocks with depressed share prices can lure investors in with a high yield—only to experience dividend cuts and financial distress. Thus, a selective approach is warranted.

The Morningstar US Dividend Valuation Index offers exposure to companies offering significant payouts that are also attractively valued and financially healthy. Valuation is gauged not through backward-looking financial metrics, but through the insights of Morningstar's Equity Research Team. Financial health is measured by the dynamic Distance to Default indicator.

Index Eligibility

The Morningstar US Dividend Valuation Index derives its constituents from the Morningstar US Market Index, which targets 97% of the U.S. equity market's float-adjusted market capitalization. To be eligible for the dividend index, a security must have paid a dividend in the trailing 12-month period. Dividends must be "qualified income"; thus, real estate investment trusts are excluded. Securities must also be assigned a fair value estimate by Morningstar's Equity Research Team. Analyst coverage of roughly 700 U.S. stocks represents 85% of equity market capitalization.

Index Selection

Eligible companies are screened on the basis of dividend yield, financial health, and valuation. The index selects securities in the top 50% of the universe by trailing 12-month dividend yield. Companies must also possess a Distance to Default score (see sidebar) in the top half of their peer group. Because leverage is inherent to their business model, financial services stocks are judged against their sector; all other companies are measured against the broad equity universe. Securities whose share prices land in the 30% most overvalued in the overall eligible universe are excluded (see sidebar on Morningstar's approach to valuation). The number of constituents is variable, depending on eligibility and selection criteria.

Index Weighting

Securities are weighted according to the available-dividend model. Dividend per share is multiplied by the number of shares that can be purchased (float). This retains the primary benefits of market-cap weighting (low turnover and scalable investment capacity), while also maximizing yield. As a risk control measure, individual security weight is capped at 5% at the time of reconstitution.

Rebalancing and Reconstitution

The index is reconstituted (membership reset) and rebalanced (weights reset) semiannually in March and September on the Monday following the third Friday of the month. If Monday is a holiday, reconstitution/rebalancing is effective on the following business day. Market data used is as of the last trading day of February and August.

Morningstar US Dividend Valuation Index Construction Process

