Morningstar® Preferred Stock List Methodology

Key Benefits

- Provides a good starting point from which to build a direct equity portfolio.
- Quickly surfaces investment ideas using our differentiated economic moat, moat trend, stewardship, and fair value uncertainty ratings, rather than simply the 4- and 5-star rated stocks.
- Offers three different quality and risk environments, depending on adviser or individual investor preference.
- Updated daily to incorporate our research team's most recent thinking.

Three Lists – Least Restrictive to Most Restrictive

- *Cautious* – Suitable for more conservative investors looking for biggest names at the best valuations.
- *Experienced* – A suggested starting point for most client portfolios.
- *Professional* – A wider universe for use by professionals comfortable with building tailored stock portfolios. (However, it excludes stocks that Morningstar does not cover and those we believe are significantly overvalued).

Using Morningstar's Preferred Stock List

The Morningstar Preferred Stock List offers screened subsets of our coverage universe that we believe provide good starting points from which to build a direct equity portfolio.

We think it is important for clients to understand how to use all our proprietary data points in their investment decision-making process, rather than view any one characteristic in isolation. The Morningstar Preferred Stock List accomplishes this by incorporating economic moat, stewardship, and fair value uncertainty ratings, along with our star ratings. The combination forms a more comprehensive process of finding investment ideas, a critical part of the differentiated service you receive from us. For more detail on our ratings and research process, please refer to the Morningstar Equity Research Methodology at the back of this document as well as on all of our individual company research reports.

There are three lists available: *Cautious*, *Experienced*, and *Professional*. These are designed according to the varying stock selection capabilities of advisers.

- The *Cautious* list is suitable for more conservative investors looking for the biggest names at the best valuations. There won't always be enough ideas here to construct a complete diversified portfolio, but those that are present can generally be core portfolio holdings.
- The *Experienced* list is a suggested starting point for most client portfolios, assuming the adviser has a base level of stock-picking ability. Generally, a diversified portfolio can be constructed from this universe. However, because 'no-moat' (lesser quality) and higher uncertainty rated stocks may be included, a greater level of expertise is required of the adviser in portfolio construction.
- The *Professional* list functions like a stock gateway, creating a low-hurdle stock environment for advisers to work within. It simply excludes stocks that Morningstar does not cover and those we ascribe a 1-star rating. In most circumstances, we think it should be rare for advisers to recommend stocks outside of this large universe.

The *Cautious* list usually includes about 30 stocks, *Experienced* about 100 stocks, and *Professional* about 200 stocks, though the size of each can vary significantly depending on market conditions. The lists are driven by absolute valuations, rather than relative, meaning the distribution of investment opportunities will fluctuate with market prices. Rich valuations will reduce the list sizes, while compressed valuations will allow more companies to pass these filters.

For clients with specific needs regarding the size, quality, update frequency, reporting, or other variables of this list, please contact your sales representative about customisation and consultation options.

Preferred Stock List Construction

For each of the lists, we apply some simple filters.

For the *Cautious* list, each stock must:

- Be a constituent of the S&P/ASX 100 and covered by Morningstar.
- Have a 3, 4, or 5-star rating.
- Have a fair value uncertainty rating of low or medium.
- Have a narrow or wide economic moat rating.

For the *Experienced* list, each stock must:

- Be a constituent of the S&P/ASX 200 and covered by Morningstar.
- Have a 2, 3, 4, or 5-star rating.
- Have a fair value uncertainty rating of low, medium, or high.
- Not have both a moat rating of none and a 2-star rating.
- Not have both a moat rating on none and a stewardship rating of poor.

For the *Professional* list, each stock must:

- Be covered by Morningstar.
- Have a 2, 3, 4, or 5-star rating.
- Have a fair value uncertainty rating of low, medium, high, or very high.

Why We Use These Rules

Morningstar Coverage Universe

We start with the 200-plus Australia & New Zealand stock universe covered by our team of more than 15 analysts and strategists using our globally-consistent equity research framework. This is an effective initial screen because we have a large coverage universe and intentionally focus our capacity predominantly on higher-quality companies. If we don't cover a stock, it is usually because it is of a lower quality or too small to meet most client requirements.

Uncertainty Rating

Generally, focusing on low or medium uncertainty stocks instead of high and very high uncertainty leads to lower volatility and more predictable investment outcomes in the long run. This is because companies rated as having lower uncertainty tend to have more stable cash flow and stronger balance sheets when viewed through the economic cycle. There's nothing wrong with having exposure in a diversified portfolio to higher uncertainty situations, but these stocks should usually not form the core of an equity portfolio. Stocks rated with an extreme uncertainty rating are always excluded from these lists.

Valuation Recommendation

We believe investors should focus their portfolios on stocks that are undervalued by having a bias toward stocks with 3, 4, or 5 star ratings. Even stocks with a 3-star rating should generate positive total returns, by approximately their cost of equity less the dividend yield, over time, assuming our fair value estimates are reasonably accurate. In some cases, we see merit in continuing to own a stock with a 2-star rating, assuming the business is of high quality (a narrow or wide economic moat and low or medium uncertainty), as long as there aren't more attractive opportunities available.

For example, when yield-oriented stocks have been bid up and there aren't alternatives available for an income strategy, a high-quality stock that is only slightly overvalued should still produce positive total returns over time, albeit less so than those with a 3, 4, or 5-star rating. However, barring significant specific financial circumstances, we see little merit in owning a stock with a 1-star rating. This rating indicates our analyst believes the market has priced in an unrealistically optimistic outlook, implying that future share price returns are likely to be undesirable.

Economic Moat

Economic moats are a key element to our research framework and, not surprisingly, a key part of our preferred stock methodology. All else equal, investors should focus their portfolios, particularly core holdings, on companies with economic moats. We see these companies as more likely than not to withstand ever-present competition, thus generating more consistent total returns over time, assuming they're purchased at reasonable prices relative to our valuations. As such, we prefer to have a shorter leash on stocks that are less competitively advantaged (designated with a moat rating of none) and trading above our fair value estimate (designated with a 1- or 2-star rating).

Stewardship

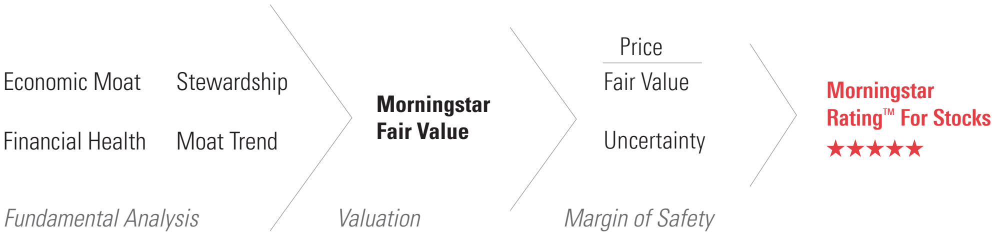
We assess stewardship based on a company's effectiveness in allocating capital toward attractive return-generating projects, particularly investments that enhance a firm's competitive advantages or sustainably enhance total shareholder returns. We're particularly positive on companies that are investing in building, or strengthening, their economic moat and significantly less supportive of those that are destroying, or weakening, their competitive advantages, such as by acquiring low-quality businesses or otherwise growing for growth's sake. For stocks that we rate as having both a moat rating of none and a stewardship rating of poor, the downside can be particularly difficult to assess, leaving investors at risk of capital destruction. At the right price, there can be opportunities in these firms, but the discount to fair value often needs to be exceptional and, even then, these stocks should rarely be considered core investments.

The Morningstar Preferred Stock List provides guidance to a general audience and must be considered in the context of an individual's investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors. There are several important steps beyond using the lists that must be performed effectively to build a direct equity portfolio, such as number of holdings, position weighting, turnover, benchmark, and so forth. These elements are not considered here and are the responsibility of the end user. Investors may also consider investing in our separately managed accounts to leverage our research and portfolio expertise.

Morningstar® Equity Research Methodology

We believe 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. Four key components drive the Morningstar rating: our assessment of the firm's economic moat, our estimate of the stock's fair value, our uncertainty around that fair value estimate and the current market price. This process ultimately culminates in our single-point star rating. Underlying this rating is a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's equity analysts. In this document, we provide a detailed overview of how the Morningstar Rating for stocks is derived, and also outline the analytical work that feeds into our coverage of stocks.

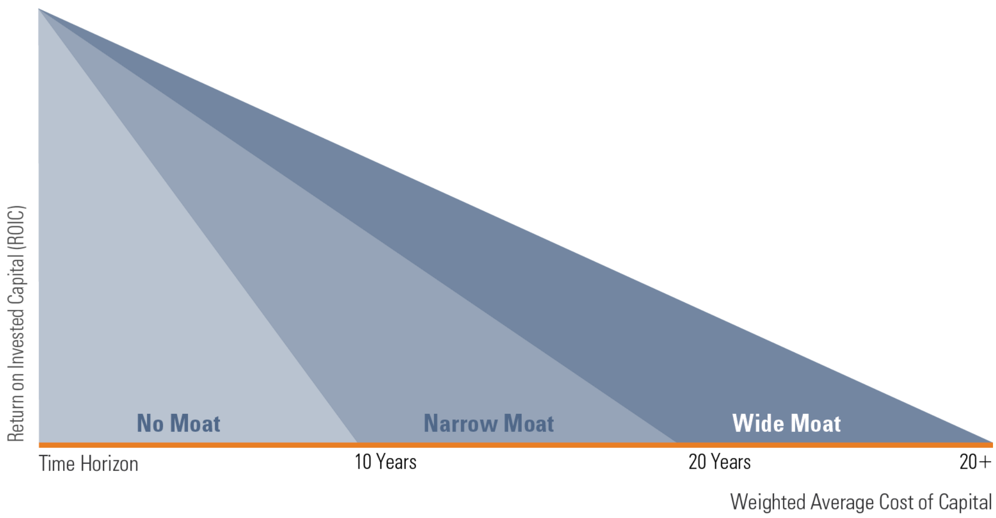
Morningstar Research Methodology



Morningstar's Economic Moat™ Rating

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 excess profits as returns on invested capital, or ROICS, above our estimate of a firm's cost of capital, or WACC (weighted average cost of capital). Without a moat, profits are more susceptible to competition. 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. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Measuring a Moat



Determining Fair Value

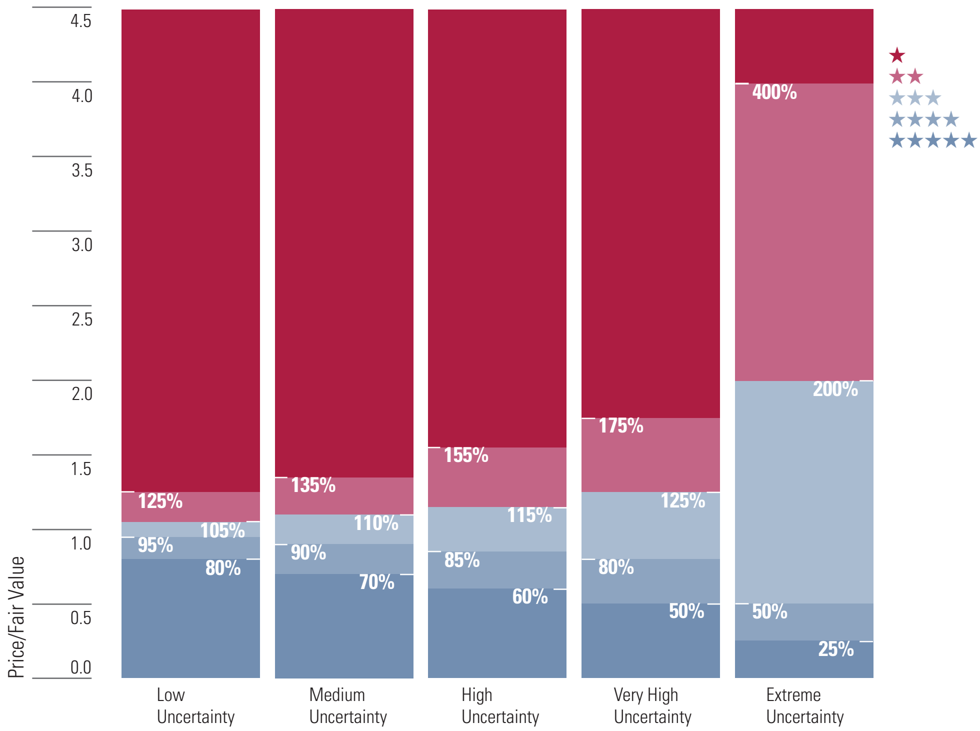
At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' independent primary research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally 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.

The Uncertainty Rating

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 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.

Our uncertainty ratings are low, medium, high, very high, and extreme. With each uncertainty rating is a corresponding set of price/fair value ratios that we use to assign star ratings, as shown in the graph.

Morningstar Equity Research Star Rating Methodology



Generating the Morningstar Star Rating

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 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. Furthermore, we would expect our fair value estimates to generally rise over time, due to the time value of money. Specifically, over the course of a year, barring major changes to analyst assumptions, we would expect our fair value estimates to increase at the level of our estimate of a firm's cost of equity (net of shareholder returns attributed to dividends). So, for a stock that pays no dividends with a $100 fair value estimate today and an estimated 10% cost of equity, we would expect our fair value estimate to rise to $110 in 12 months, all else equal.

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

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.

★★★★★: 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. This rating encourages investors to consider an overweight position in the security relative to the appropriate benchmark.

★★★★: Appreciation beyond a fair risk-adjusted return is likely, in our opinion. This rating encourages investors to own the firm's shares, possibly overweight relative to the appropriate benchmark after fully considering more attractively priced alternatives, such as 5-star rated stocks.

★★★: Indicates that we believe investors are likely to receive a fair risk-adjusted return (approximately cost of equity). Concentrated portfolios might consider exiting these positions if more attractively priced alternatives are available.

★★: We believe investors are likely to receive a less than fair risk-adjusted return and should consider directing their capital elsewhere. Securities with this rating should generally be underweight, assuming less expensive alternatives are available for the portfolio strategy being employed.

★: 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. This rating encourages investors to strongly consider exiting portfolio positions in the security in nearly all strategies.