

iShares Dow Jones US Medical Devices IH

Valuation	Last Price	Fair Value	Consider Buy	Consider Sell	Expect Return	Hurdle Rate	Coverage Rate	Volume	Category
Fairly Valued	47.74	62.83	44.65	83.10	21%	20%	100%	59,923	Health

Per share prices in USD

This specialty fund is the only ETF that provides targeted exposure to the medical-device industry.

by Morningstar Analyst

Thesis 06-05-09 | John Gabriel
Suitability

Pricing data through August 10, 2009
Rating updated August 10, 2009

Investors seeking exposure to health care but who are concerned about the uncertain regulatory environment and the potential impact that health-care reform might have on the sector could find iShares Dow Jones U.S. Medical Devices to be a suitable satellite pick. In our view, the medical-device industry should be pretty well insulated from many of the cost-cutting pressures likely to come about as a result of health-care reform. Still, we stress that this fund should be used as a tactical satellite investment, not as a core position in any asset-allocation portfolio. Keep in mind that because of its focus on a single industry, the fund offers limited diversification benefits.

Health-care needs aren't tied to the economic cycle, so demand for medical equipment tends to be steady. Furthermore, an aging population and fast-growing markets abroad have spurred demand for cardiovascular and orthopedic devices as well as patient care and diagnostic instruments. This, coupled with continued product innovation, should ensure that holdings such as Medtronic and Stryker continue to churn out double-digit cash-flow growth and returns on capital.

Fundamental View

According to Morningstar equity analysts, the potential ripples that health-care reform casts across the medical-device industry could be more bark than bite at this point. The single-payer system that has the health-care sector reeling has been an issue that the device manufacturers have de facto already been dealing with.

Approximately two thirds of implants for total knee replacement and 80% of cardiac rhythm management

devices are reimbursed by Medicare through the Part B program. However, manufacturers do not negotiate directly with Medicare. Thus, the single-payer effect is mediated through the provider network: hospitals and ambulatory surgical centers. Device makers negotiate with individual hospital chains or their group purchasing organizations, which often gives the manufacturers a bargaining advantage because there are only a limited number of device makers in the business and typically a more fragmented group of customers.

The weak customer buying power of hospitals is exacerbated by divisions between the administrators tasked with keeping hospitals out of the red and specialist physicians who operate as free agents. Device manufacturers have long exploited this division, and as long as certain specialists continue to generate profits for the hospitals, we expect physicians to win this game of chicken. Doctors and hospitals often face different incentive systems and hold different agendas. Hospitals do not necessarily have any long-term relationships with individual patients--the relationship tends to be transactional and focused on each admission as an opportunity to generate revenue. On the other hand, the physician does have a long-term relationship with the patient and is very concerned about the longer-term implications of any particular procedure or choice of device.

At this point, our equity analysts think that it is highly unlikely that the Centers for Medicare and Medicaid Services would insert itself and directly negotiate with the device manufacturers. This type of centralized approach would likely have physicians up in arms. It is more likely that Medicare would simply reduce its bundled reimbursement to hospitals and leave it up to the hospitals to figure out where to squeeze out the savings.

The regulatory risks are important to understand before investing in this fund; because this is an industry-specific ETF (rather than a sector or broad index fund), regulatory concerns cannot effectively be diversified away. That said, by buying this fund, investors can still achieve

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diversification with respect to their exposure to product liability risks. Keep in mind that this is no small consolation. Those familiar with the long-standing troubles with Boston Scientific's drug-eluting stents over the past few years can surely attest to the importance of diversifying away product liability concerns.

Portfolio Constructions

The fund tracks the Dow Jones U.S. Select Medical Equipment Index, which is made up of 39 domestic medical-device stocks culled from the Dow Jones Wilshire 2500 (which spans the 2,500 largest U.S. stocks by market cap). Because the largest device makers are U.S.-based, the index provides good coverage of the worldwide medical-device trade. The index weights stocks by market cap, subject to certain limits (the five largest companies can't account for more than 65% of assets and a single name can't soak up more than 25% of the fund) and a \$500 million floor. Consequently, the top 10 holdings represent almost 60% of assets. Although the biggest names are well represented in the portfolio, the fund also owns a slug of midsize firms, explaining its less-than-stratospheric \$5.2 billion weighted average market cap. The index rebalances quarterly.

Fees

The fund's net annual expense ratio is 0.48%. While there are broad health-care sector funds available with lower fees, this is the only fund that offers specific exposure to medical-device firms.

Alternatives

There are no other ETFs available that offer targeted exposure to the medical-device industry. Investors can still gain exposure to the industry through a broad health-care sector fund. For instance, iShares Dow Jones US Healthcare, Vanguard Health Care ETF, and Health Care Select Sector SPDR court portfolios with approximately 22%, 21%, and 19% of assets, respectively, exposed to medical-device manufacturers.

Bulls Case

- This is the only pure-play medical-device ETF. If you're bullish on the industry's prospects, this could be your ticket.
- Device and equipment products often impose heavy customer switching costs, as practitioners are loathe to transition to newer products and go through additional training.
- Most of the fund's holdings have at least some semblance of a competitive advantage that preserves cash-flow growth. This reduces uncertainty associated with the fair value estimates that our analysts have placed on the fund's underlying holdings.
- The fund hasn't been much more volatile than the S&P 500, as many of its holdings are established players in an industry characterized by steady demand.

Bears Case

- Investors can't ignore the regulatory and product liability risks that these firms court. Witness the large recalls that have beset Boston Scientific in the last few years.
- Health-care reform policies could hurt the industry's profitability if regulators demand price cuts across the board.

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ETF Notes

04-17-08

iShares Dow Jones U.S. Medical Devices Is on the Cusp of Bargain Territory

iShares Dow Jones U.S. Medical Devices invests in some of the strongest players in the medical device and equipment industry. The top 10 holdings are a good sample of the diverse industry, such as cardiovascular device firm St. Jude Medical STJ, orthopedic device leader Zimmer ZMH, and equipment maker Applied Biosystems ABI. Our analysts expect steady sales growth and returns on capital to continue for most of the ETF's holdings, many of which have trenched out durable competitive advantages, or moats. Given this, and considering the diversity of products that these firms offer, we wouldn't need a wide margin of safety to invest here; a 9% discount to our fair value estimate would do.

On that basis, this fund looks attractive, as it was trading at a 9% discount to what our analysts think its holdings were worth in aggregate as of April 3, 2008. Although that doesn't make the fund a screaming buy, it puts it right on the cusp of bargain territory. Product recalls have weighed on some of the fund's top holdings like Medtronic MDT and Boston Scientific BSX. But our analysts view these events as isolated and temporary and believe these stocks now look cheap, partially explaining this fund's attractive valuation.

04-04-08

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On that basis, this fund looks attractive, as it was trading at an 8% discount to what our analysts think its holdings were worth in aggregate as of April 3, 2008. Although that doesn't make the fund a screaming buy, it puts it right on the cusp of bargain territory. Product recalls have weighed on some of the fund's top holdings like Medtronic MDT and Boston Scientific BSX. But our analysts view these events as isolated and temporary and believe these stocks now look cheap, partially explaining this fund's attractive valuation.

Morningstar's Approach to Evaluating ETFs

Our Key Investing Concepts

- ▶ Company Quality
- ▶ Consider Buying/Consider Selling
- ▶ Coverage Rate
- ▶ Expected Return
- ▶ Fair Value
- ▶ Hurdle Rate
- ▶ Margin of Safety
- ▶ Valuation

Our approach to evaluating ETFs is multi-faceted, reflecting the various ways ETFs can be used.

For instance, given their diversification and low cost, ETFs are good candidates to anchor a portfolio. Alternatively, narrowly focused ETFs like region- or sector-specific funds can be used to plug holes in a portfolio. ETFs can also be worthwhile alternatives to positions in individual securities. Instead of buying a healthcare stock, for example, an investor might opt for a healthcare ETF that owned an assortment of firms.

This versatility informs the way we analyze ETFs. For investors using ETFs to build more efficient portfolios ("Portfolio-Builders"), our analysis coalesces around a fund's role and utility in a portfolio. For those investing opportunistically in certain areas that they think are poised to beat the market ("Market-Beaters"), we focus on the fundamental attractiveness of the securities that an ETF owns.

Portfolio-Builders

Investors trying to construct a low-cost, well-diversified portfolio are likely to focus on a few key attributes when selecting ETFs.

Cost: An ETF's stated expense ratio is crucial in that costs drag on a portfolio's returns. For that reason, we generally recommend investing in ETFs that levy the lowest expense ratios.

Portfolio Construction: There are innumerable ways to build a portfolio using ETFs. Ultimately, the "right" ETF is the one that's best suited to an investor's needs. Therefore, we typically consider an index's breadth (the variety of securities it holds) and depth (the weight of those securities in the portfolio) in evaluating an ETF's usefulness.

Tax Efficiency: ETFs should be more tax-efficient than comparable open-end mutual funds. With that in mind, we typically monitor whether an ETF has kept a lid on taxable capital gains distributions.

Performance: An ETF's returns and risk are important, but not a divining rod. We consider an ETF's past performance in gleaming insights into the fund's tendencies--does it lag in rallies and hold its ground during downturns? This can shed light not only on how the fund is likely to perform in the future, but also how it might complement other portfolio holdings.

All told, we favor low-cost, tax-efficient ETFs which are founded on prudent strategies that lend themselves to portfolio construction.

Market-Beaters

Our approach to opportunistic investing with ETFs starts from a central premise: An investment in a stock ETF isn't a wager on the value the market places on a piece of paper; it's a stake in the dozens of businesses the fund owns.

Thus, we think investors seeking to beat the market using ETFs should focus on the intrinsic worth of the businesses concerned. When the market is fairly valuing those firms, then an investor is getting her money's worth. But when the market significantly undervalues those businesses, then an investor stands to reap a market-beating return.

Of course, estimating the value of hundreds of businesses is no mean feat. To that end, Morningstar's equity analysts cover 2,000-plus stocks spanning numerous industries and geographic locales. To estimate a firm's fair value, our analysts conduct extensive fundamental research, examining its competitive profile, the durability of any advantages it might boast, and the economics of the markets in which it operates.

By aggregating these fair value estimates, we can also estimate a stock ETF's intrinsic worth. We can begin to evaluate an ETF's attractiveness by comparing its market price with our fair value estimate.

This process culminates in our ETF "valuation ratings", which denote the attractiveness of a stock ETF based on the valuation of its underlying holdings. For instance, if an ETF is trading meaningfully below our fair value estimate, then we'll assign it an "undervalued" rating. By contrast, if

Morningstar's Approach to Evaluating ETFs (continued)

it's trading at a substantial premium to our fair value estimate, we'll give it an "overvalued" rating.

Following is a guide to some of the important themes in our ETF research.

Company Quality: High-quality firms boast intractable competitive advantages, or "economic moats", that confer economic benefits to shareholders for years and years. Scale in an industry where cost leadership is paramount (ExxonMobil, Wal-Mart), intellectual property protection (Merck, 3M), and brand equity (Coca Cola, Procter & Gamble) are examples. The wider a firm's moat, the more defensible its advantages and, thus, the higher its quality. Since higher-quality firms are worth more, an ETF that's chock full of wide-moat businesses is more valuable than a fund that invests in lower-quality firms in an intensely competitive industry.

Consider Buying/Consider Selling: The "consider buying" price is the market price at which we would recommend investing in an ETF (i.e., when it receives an "undervalued" rating). The "consider buying" price will vary depending on an ETF's risk. Generally speaking, the riskier the ETF, the lower the "consider buying" price relative to the fair value estimate. The opposite is true for less-risky ETFs. The "consider selling" price is the counterpart to the "consider buying" price, marking the price at which we would recommend selling an ETF.

Coverage Rate: This is the percentage of an ETF portfolio's assets that our analysts cover. Generally speaking, we only estimate an ETF's fair value when we cover stocks representing 70% or more of the fund's assets.

Expected Return: An ETF's expected return measures the pre-tax, pre-fee annualized return an investor would stand to realize if the ETF's price converged to our time-adjusted fair value estimate over a three-year time horizon.

Fair Value: A stock ETF's fair value estimate is our estimate of what the portfolio is worth in aggregate. We derive an ETF's fair value estimate by aggregating the fair value estimates that our analysts place on the fund's constituent stock holdings. The more valuable an ETF's holdings, the

higher those stocks' fair value estimates and, in turn, the higher the ETF's aggregate fair value estimate.

Hurdle Rate: An ETF's hurdle rate is the sum of its portfolio's weighted-average cost of equity (COE), its annual expense ratio and, in certain cases, an incremental risk premium. The COE expresses a firm's intrinsic risk as a percentage (e.g., 10%). It represents the minimum return an investor would accept in exchange for purchasing the stock.

Margin of Safety: The gap between the "consider buying" price and the fair value estimate, the margin of safety affords protection should our fair value estimate end up being off the mark. It's a margin of error that varies depending on an ETF's risk; the riskier the ETF concerned, the wider the margin of safety we'd demand, and vice versa.

Valuation: An ETF's valuation rating can take three forms--"undervalued", "fairly valued", and "overvalued". ETFs trading at a meaningful discount to our fair value estimate receive an "undervalued" rating while those trading at a substantial premium get an "overvalued" rating. ETFs hovering near our fair value estimate are rated "fairly valued".