

Morningstar's Best Ideas for 2011 and Beyond

AAll Washington D.C. Metro Chapter

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A Step-by-Step Guide to Managing Your Finances

(John Wiley & Sons, 2010)

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Morningstar's Best Ideas for 2011 and Beyond

- Morningstar's philosophy/context for best ideas
- Best ideas for equity/equity funds: Quality, quality, quality
- Equity areas to downplay
- Best ideas for bonds: Control what you can; beware rising rates
- Bond spots to downplay: Quality may not be as safe as it appears
- Best ideas for personal finance: Set up portfolio for future tax efficiency, mind the inflation threat

Morningstar Overview and Philosophy

- We provide unbiased research to individual investors, financial advisors, and institutions.
- We're bottom-up and research-intensive. (117 equity and credit analysts, 95 worldwide fund analysts.)
- Our equity analysis is valuation- and quality-conscious: Like Warren Buffett, we emphasize economic “moats,” or sustainable competitive advantages.
- On the fund research side, we're agnostic on the great indexing versus active debate. (Data are very mixed, even when adjusted for “survivorship bias.”)
- Informed by Ibbotson Associates' research on asset allocation, we believe long-term and strategic asset allocation trumps more active, tactical strategies.

Let's Get Oriented: Market Fair Value

Markets

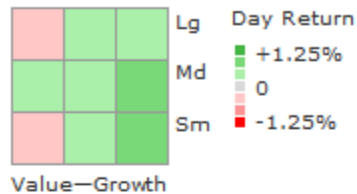
Market Indexes



* Real Time Quote

	Chg	Chg%	Value
Morningstar	5	0.2	3,295
DJIA*	16	0.1	12,078
Nasdaq*	14	0.5	2,768
S&P 500*	2	0.1	1,309

Market Barometer



Morningstar Indexes

Biggest Gainers	Gain %
JDS Uniphase Cor	26.99
Zoltek Companies	22.23
Orexigen Therape	19.05
FEI Company	17.94
Silicon Image, I	16.45
More...	

Sector Delta



Morningstar Indexes

	Day Change %
Services	0.10
• Healthcare	0.29
• Consumer Services	0.38
• Business Services	0.19
• Financial Services	-0.23
More...	

Top Dow Jones News

[Cisco Seen Projecting Better Times Ahead](#)
02-04-11 | 03:03 PM EST

[Judge Sides With Lenders, Forces Chapter 11 On Vegas Project](#)
02-04-11 | 02:32 PM EST

[Energy Department Launching Program To Cut Solar-Power Costs](#)
02-04-11 | 02:36 PM EST

[4th UPDATE: SEC's Schapiro Rings Alarm About Budget Woes](#)
02-04-11 | 02:32 PM EST

Market Fair Value

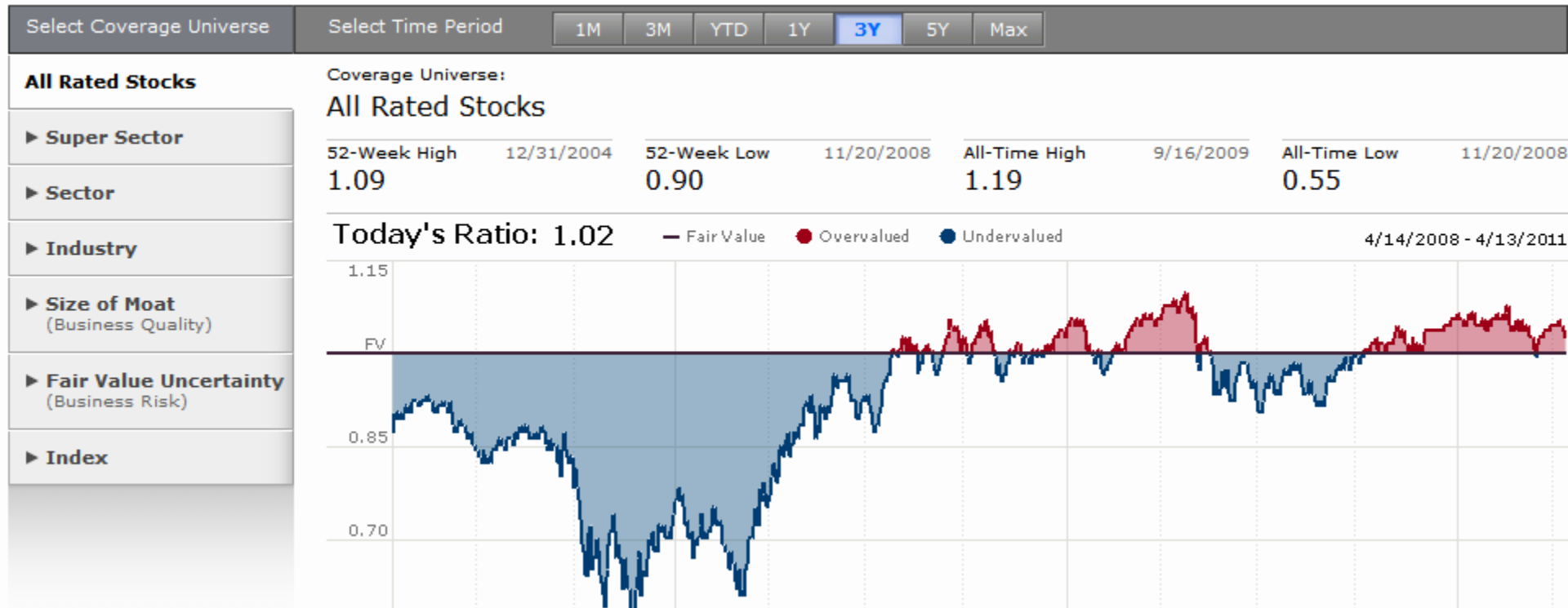
Are stocks over/undervalued?

Market Results

- ⇒ [Running Commentary](#)
- ⇒ [Story Stocks](#)
- ⇒ [Up/Downgrades](#)
- ⇒ [Earnings Calendar](#)

Broad Market: Fairly to Slightly Overvalued Currently

Market Fair Value



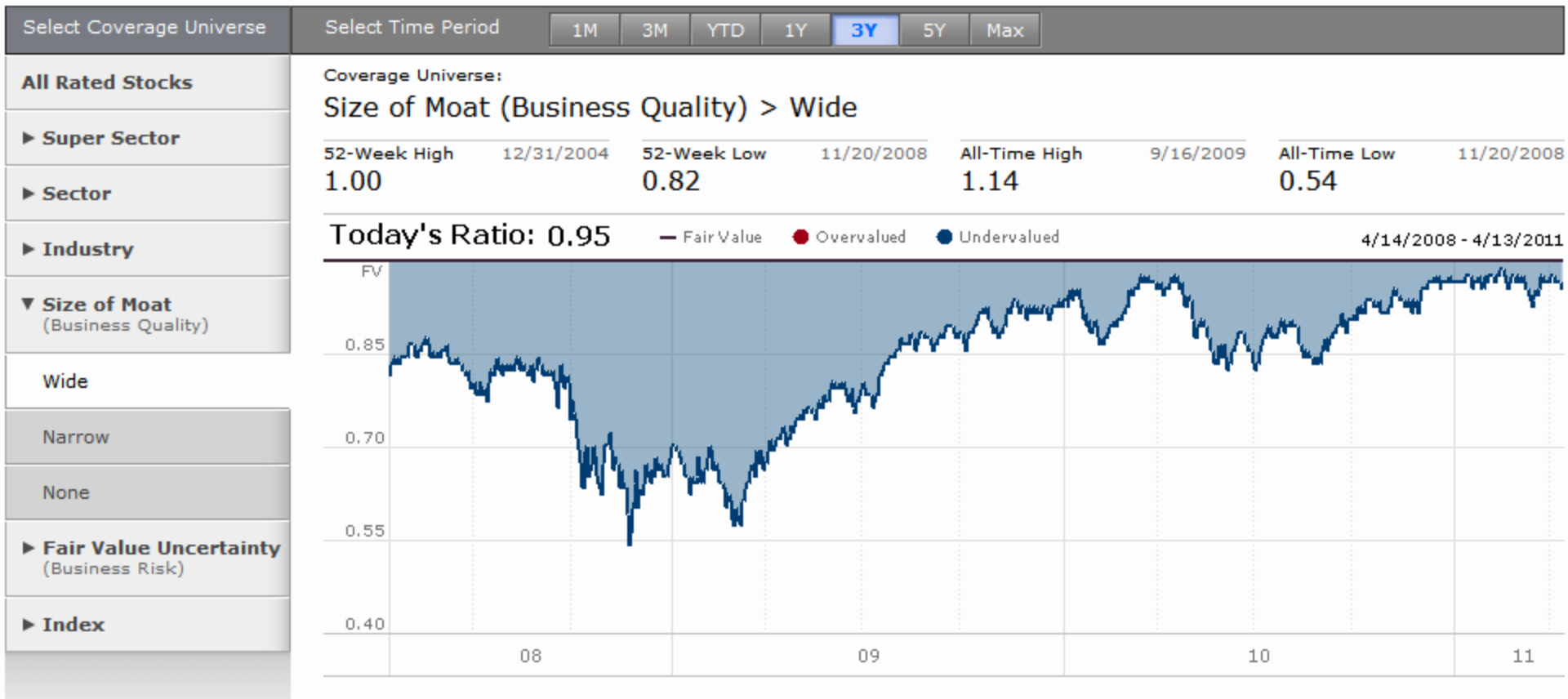
But a view through the Morningstar style box presents a more nuanced picture...

Large Value 0.89	Large Blend 0.92	Large Growth 0.90
Mid Value 1.01	Mid Blend 1.03	Mid Growth 1.12
Small Value N/A	Small Blend N/A	Small Growth N/A

N/A= Coverage insufficient to assign fair value.

Moat Ratings Provide Another View of Market Valuation

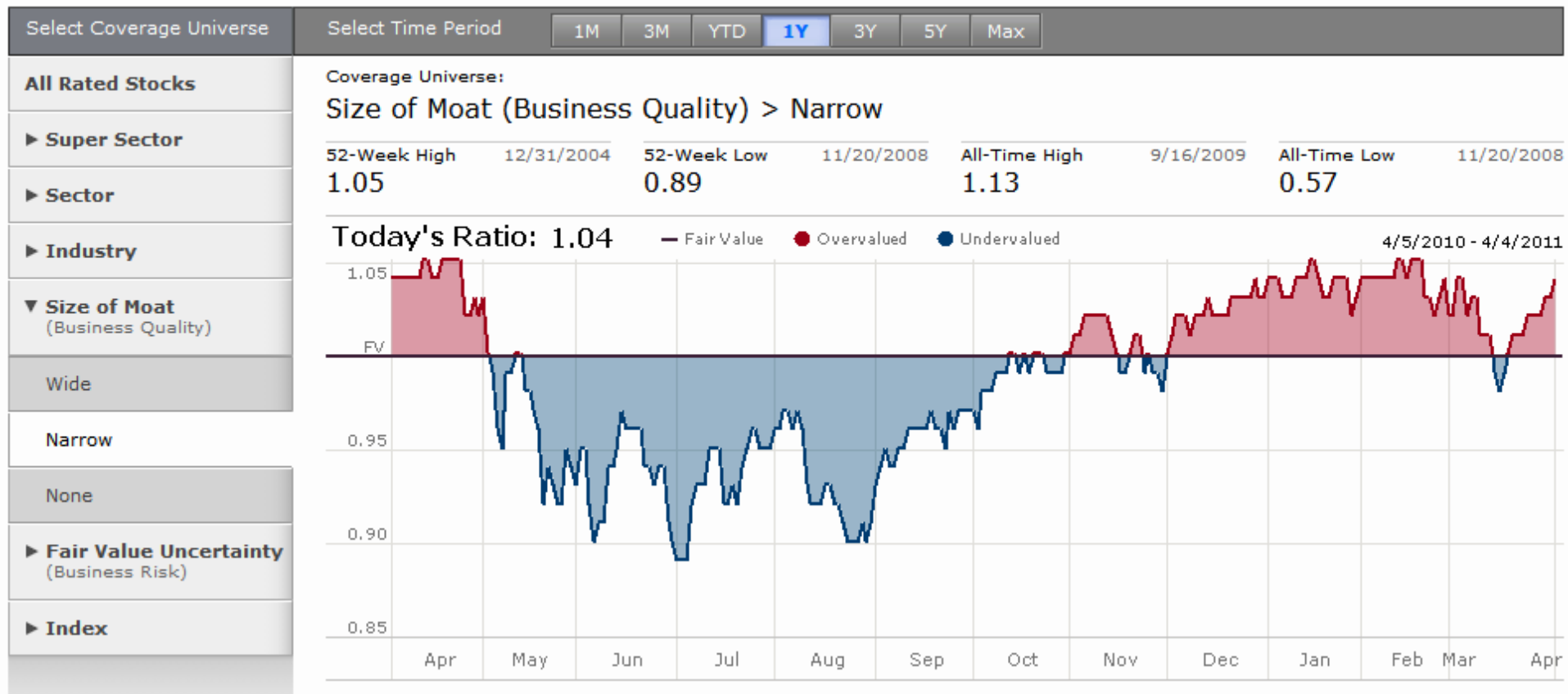
Market Fair Value



Wide economic moat examples include Altria, BlackRock, Google, Harley-Davidson, Wal-Mart.

Narrow Moats = Fairly Valued/Overvalued in Aggregate

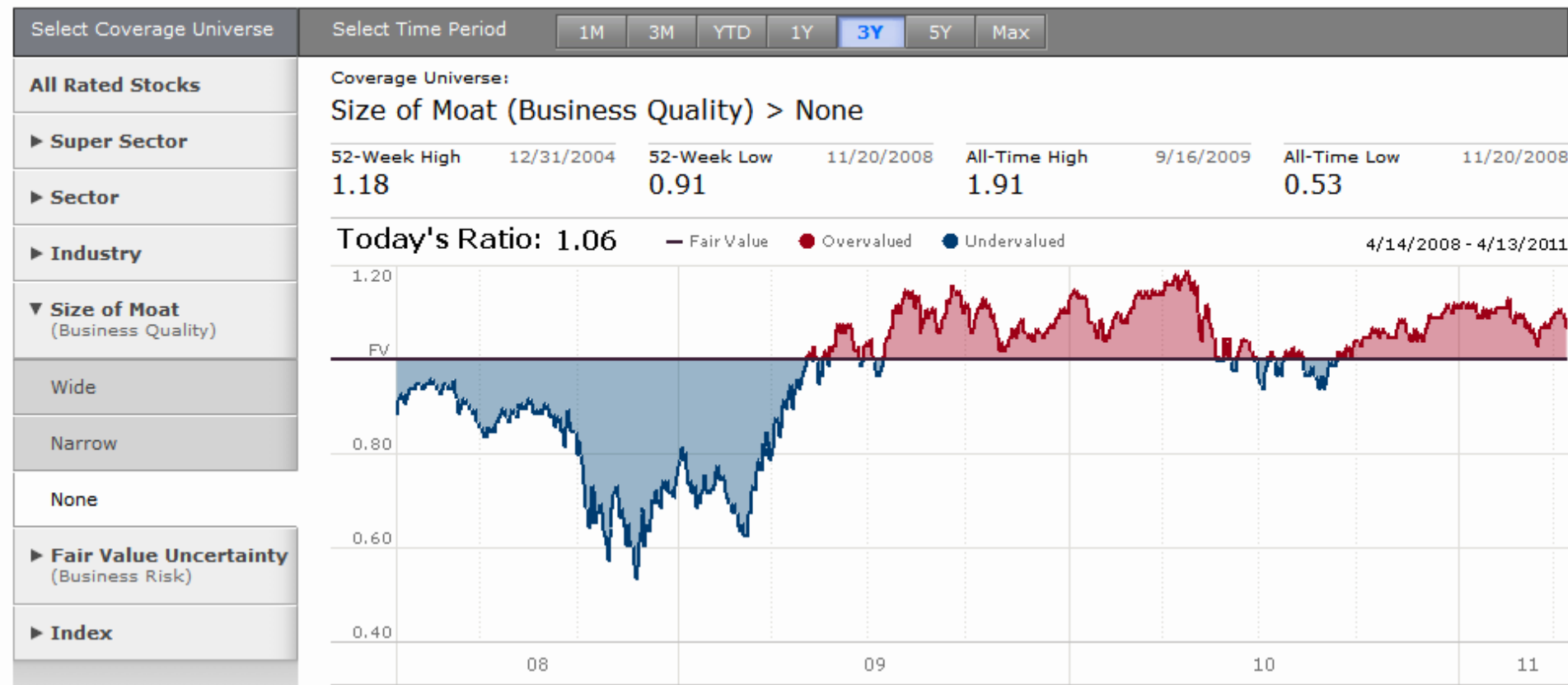
Market Fair Value



Narrow economic moat examples include Allstate, Charles Schwab, Coach, General Mills, Whole Foods.

No Moats Looking Overvalued Currently, Following Stellar 2009-2010 Performance

Market Fair Value



Examples of companies with *no* economic moats include Abercrombie & Fitch, E*Trade Financial, Eastman Kodak, Brinker International. (Most of the companies under coverage have no moats.)

So what are the best ideas for equity investors?

- Quality and large caps look (relatively) cheap right now; if you're rebalancing, tip your portfolio toward them.
- Top “wide moat” fund and exchange-traded fund picks: Jensen Portfolio (JENSX), Dreyfus Appreciation (DGAGX), Vanguard Dividend Growth (VDIGX), Sequoia (SEQUX), Vanguard Dividend Appreciation (VIG), T. Rowe Price Equity-Income (PRFDX), Vanguard Wellington (VWELX).
- Top stock picks (4- or 5-star plus wide moat): Abbott Labs (ABT), Applied Materials (AMAT), General Electric (GE), Lowe's (LOW), Pfizer (PFE), Roche Holding (RHHBY), Vulcan Materials (VMC), Zimmer (ZMH).

The Sector Lens: Another View

Cyclicals

Basic Materials P/FV:
1.07

Consumer Cyclical
P/FV: 1.03

Financials P/FV: 0.94

Real Estate P/FV:
1.16

Econ. Sensitive

Communication
Services P/FV: 0.97

Energy P/FV: 1.05

Industrials P/FV: 1.01

Technology: 1.11

Defensive

Consumer Defensive
P/FV: 1.03

Health: 1.01

Utilities P/FV: 1.04

Sector Valuation graph available on Stocks cover page.

Using our ETF Valuation Quickrank, a handful of *industries* look relatively inexpensive, even factoring in their risks.

- **Health care**, especially pharmaceuticals.
- Price/fair value for Health Select SPDR (XLV) = 0.87
- Price/fair value Pharmaceutical HOLDERS (PPH) = 0.81

- **Large-Cap Financials**
- Price/fair value for iShares Dow Jones U.S. Financial Svcs. = 0.83

- Notably overvalued per Morningstar's equity analyst team: Real estate and parts of the technology sector.

And how about international?

- In general, foreign stocks' valuations are right in line with our analysts' estimates of fair value.
- As in the U.S., quality and large caps from developed markets look (relatively) cheap right now. (e.g., price/fair value for SPDR DJ Global Titans = 0.88)
- Morningstar favorite funds that fit with that theme: Dodge & Cox International (DODFX), Harbor International (HIINX), Vanguard International Value (VTRIX).
- Looking somewhat pricey (though less than they once were): Emerging markets (price/fair value for First Trust ISE Chindia =1.18)

Best ideas for bonds: Don't get too fancy, and mind the prospect of higher interest rates.

- Following a big runup in risky bond types over the past two years, the easy money may have already been made.
- A bump up in interest rates could lead to losses in bond funds.
- Tactics to consider:
 - Delegate to an active manager with flexible strategy. (Favorite funds: Harbor Bond (HABDX), Harbor Unconstrained Bond (HAUBX), Metropolitan West Total Return (MWTRX), Dodge & Cox Income (DODIX).
 - Consider floating-rate funds (Fidelity Floating Rate High Income FFRHX).
 - Avoid long-term bonds and bond funds.
 - Devote a slice of bond portfolio to dividend-paying stocks.

Avoid/downplay potential trouble spots

- Lighten up on Treasuries and other government-backed bonds (and by extension, total market bond index funds); they tend to be most vulnerable to changes in interest rates.
- Also beware of junk bonds: Spreads have narrowed considerably. (Rule of thumb: Buy when spreads are 8 percentage points, sell when they're 4 percentage points. Spreads are currently ~4 percentage points.)
- Be wary of gunning for income alone. ("More money has been lost chasing yield than has been lost at the point of a gun.")

Best ideas for personal finance: Anticipate the potential for rising tax rates.

- Go Roth: IRA conversion is a great opportunity; also consider Roth 401(k) contributions if eligible.
- Manage for tax efficiency: ETFs, traditional index funds, tax-managed funds, individual stocks.
- Check to see if munis offer better after-tax return than comparable taxable bond funds. (Favorite firm for munis: Fidelity.) Use tax-equivalent yield function of Morningstar's Bond Calculator.
- Don't go crazy with dividend-paying stocks in your taxable accounts. (What happens when tax treatment changes?)

Best ideas for personal finance: Don't forget about inflation!

- Inflation picked up in the waning days of 2010.
- Inflation is a particularly big threat for retirees, who have a large share of their portfolios in fixed-rate investments and are no longer working/eligible for COLA.
- TIPS can help hedge against inflation (favorite fund: Vanguard Inflation-Protected Securities VIPSX) but space out your purchases. (The inflation hedges are looking inflated.)
- Commodities and especially stocks are also reasonable ways to hedge, as long as you're aware they won't precisely track commodities prices.
- Stocks have the best long-run potential to outpace inflation.

Questions?
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