
Morningstar's Best Ideas for 2011 and Beyond

Presentation for AAll Members
Los Angeles Chapter

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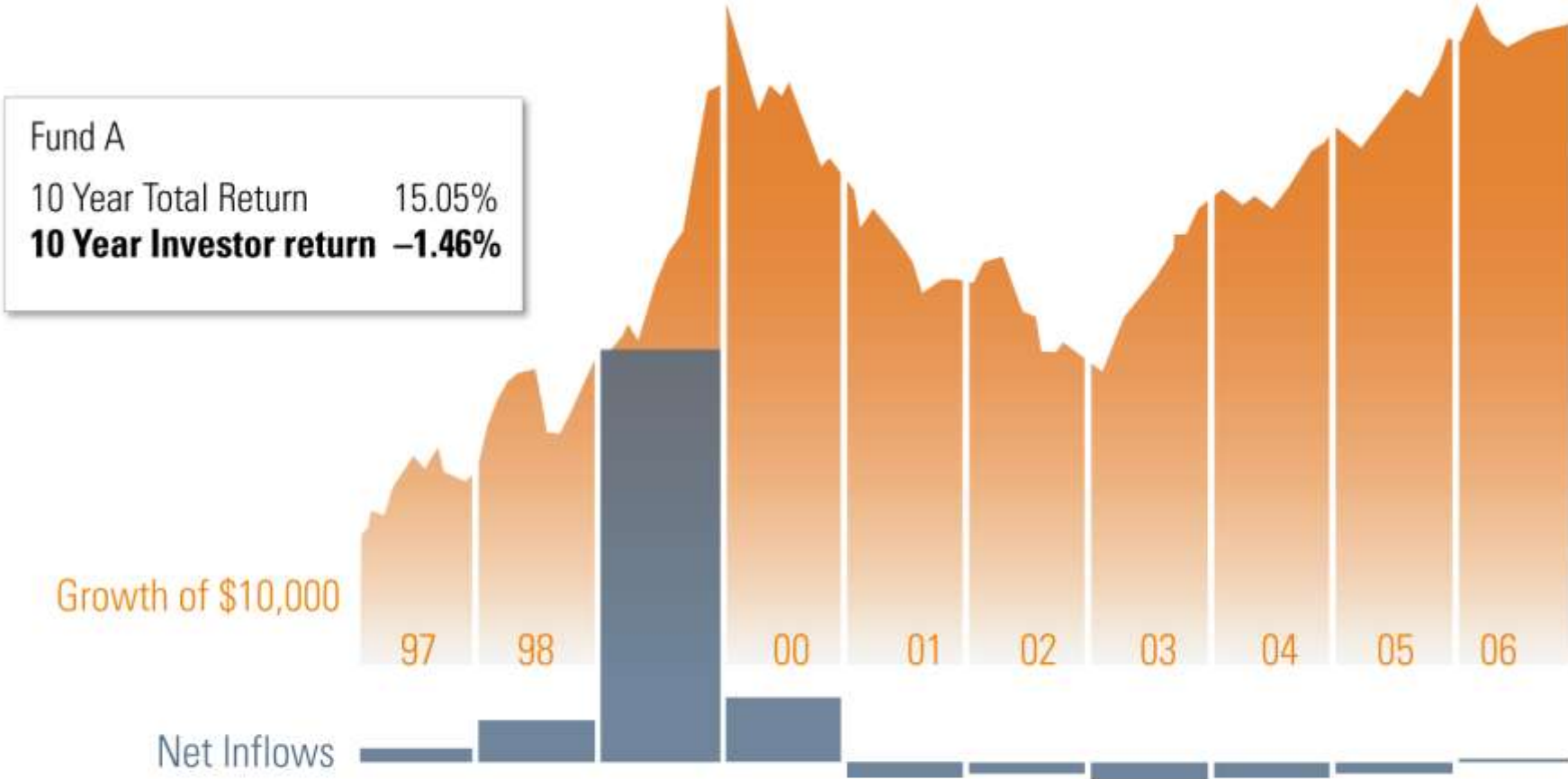
September 17, 2011

Before we get into the good ideas, let's have a look at how avoiding the bad ones is a huge part of the battle.

Investors' tendency to performance-chase is a perfect case in point.

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The Perils of Performance-Chasing: Meet Once-Trendy “Fund A”



Annual Return (%)	12.7	34.9	120.1	-17.1	-27.8	-17.7	43.8	20.9	24.4	8.8
Net Assets (\$mil)	5.3	9.9	72.4	118.9	69.1	45.6	52.2	51.9	57.1	63.2

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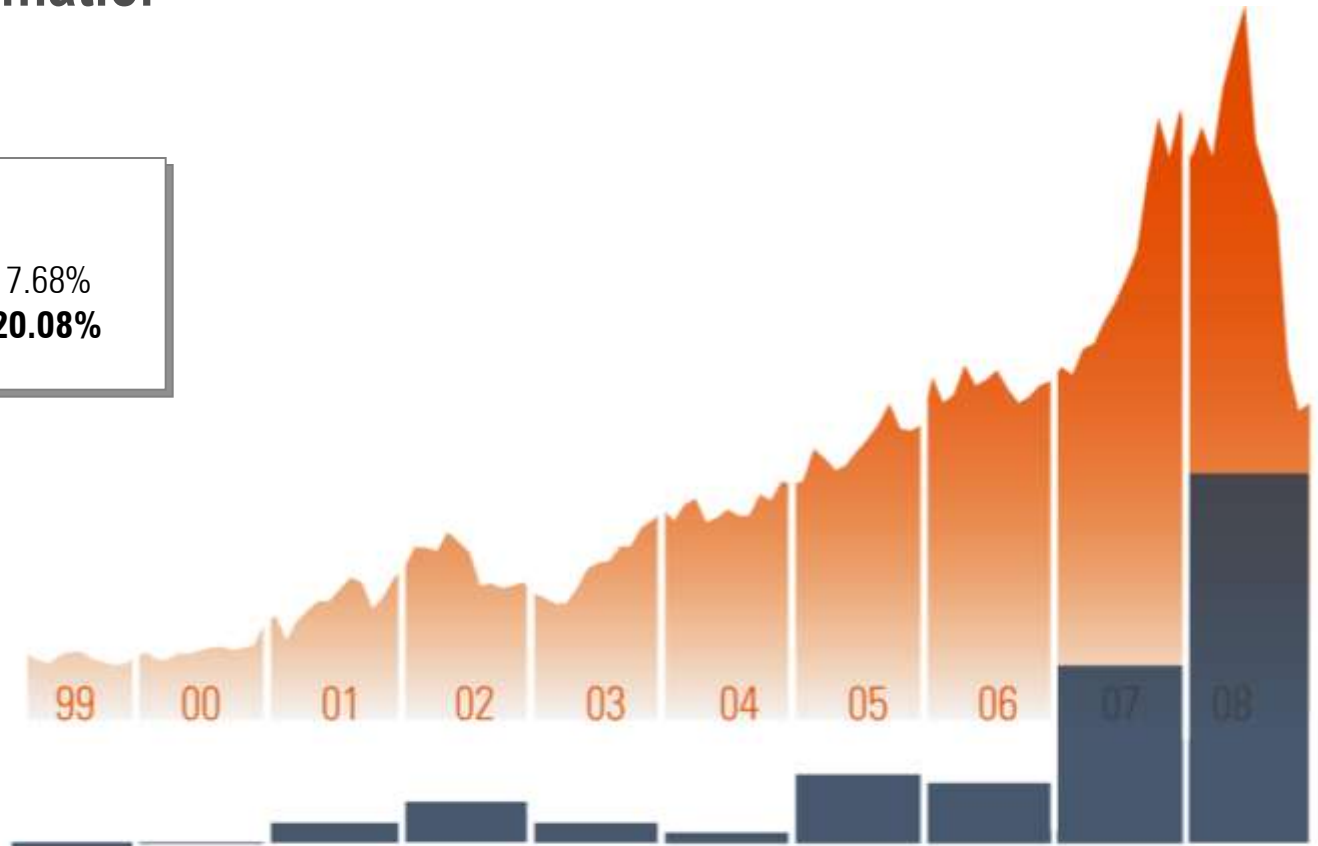
Even More Dramatic!

Fund B

10 Year Total Return 17.68%
10 Year Investor Return -20.08%

Growth of \$10,000

Net Inflows



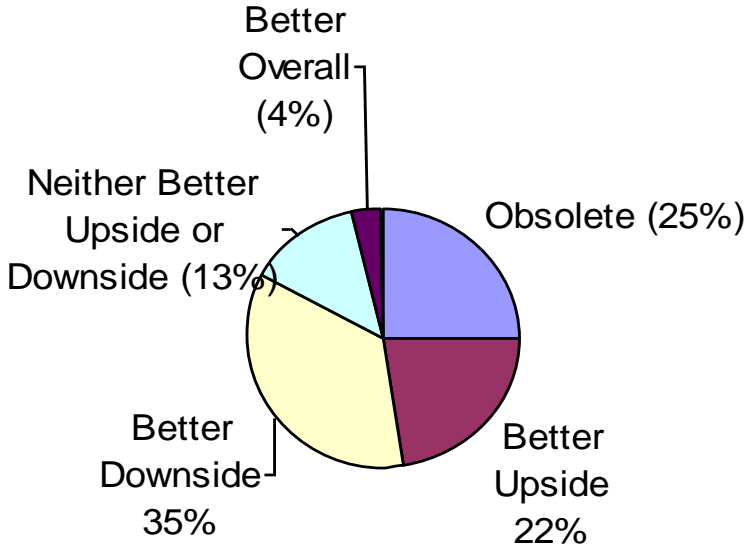
Annual Return (%)	5.6	45.0	38.2	-27.9	65.0	11.0	21.5	11.2	76.4	-55.7
Net Assets (\$mil)	69.0	78.9	249.6	385.0	773.6	924.6	1636.1	2276.4	5460.5	4160.7

Despite all the recent buzz, tactical asset allocation doesn't appear to be "a best idea," either. (Certainly not for the whole of your portfolio.)

The performance of professional tactical asset allocators tells the tale.



Performance of "Tactical" Mutual Funds Versus Vanguard Balanced Index (1992-present)



Morningstar's Philosophy and Context for Best Ideas

Investors can successfully employ an element of opportunism in their portfolios, provided they:

- Are operating with a sensible long-term asset-allocation mix.
- Regularly rebalance (“tactical lite”).
- Focus on what they can control (bottom-up security selection) rather than what they can't (macro factors).
- Swim against the tide when initiating new positions in their portfolios.

Let's Get Oriented: Market Fair Value

Markets

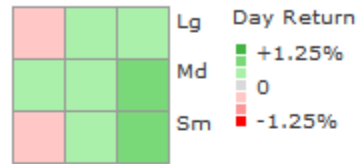
Market Indexes



* 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 = Undervalued Currently

Coverage Universe:

All Rated Stocks

52-Week High	2/18/2011	52-Week Low	9/5/2011	All-Time High	2/20/2006	All-Time Low	11/20/2008
1.07		0.76		1.19		0.55	

Today's Ratio: 0.86

— Fair Value ● Overvalued ● Undervalued

9/16/2010 - 9/16/2011



A view through the Morningstar style box reveals where the values are (and where they're not).

Large Value 0.76	Large Blend 0.83	Large Growth 0.84
Mid-Cap Value 0.91	Mid-Cap Blend 0.92	Mid-Cap Growth 0.97
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



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.)

Narrow Moats: A Similar Story



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

Wide Moats Are The Cheapest of the Three Moat Bands



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

So what are the best ideas for equity investors?

- Quality and large caps look (relatively) cheap right now; if you're rebalancing or putting money to work, 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), ExxonMobil (XOM), General Electric (GE), Lowe's (LOW), Pfizer (PFE), Roche Holding (RHHBY), Vulcan Materials (VMC).

The Sector Lens: Another View

Economically Sensitive

Communications Svc.
P/FV: 0.85

Energy P/FV: 0.83

Industrials: 0.83

Technology: 0.91

Cyclical

Basic Materials: 0.86

Consumer Cyclical
P/FV: 0.88

Financial Services
P/FV: 0.78

Real Estate 1.01

Defensive

Consumer Defensive
P/FV: 0.98

Utilities P/FV: 1.00

Health P/FV: 0.84

Sector Valuation graph available on Stocks cover page.

Best Ideas for Sector Investors

Energy

- Vanguard Energy ETF (VDE): Price/fair value = 0.79
- Vanguard Energy (VGENX): Actively managed fund
- ExxonMobil (XOM), Kinder Morgan Mgmt (KMR), Schlumberger (SLB)

Financials

- iShares S&P Global Financials (IXG): Price/fair value = N/A
- Davis Financial (RPFGX): Actively managed fund
- Bank of New York Mellon (BK), BlackRock (BLK), Western Union (WU).

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., BLDRS Developed Markets 100 ADR Index P/FV = 0.78)
- 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 = 0.91)

Best ideas for bonds: Be careful about reaching for yield, and mind the long-term possibility of higher interest rates.

- 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).
- Don't forget about inflation-protected bonds: A hiccup in rates could gobble up yield on nominal bonds. Harbor Real Return (HARRX) or Vanguard Inflation-Protected Securities.

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: We dodged a bullet in 2010, but prep 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!

- Consider your own inflationary picture: If your main costs are food and energy, then put inflation front and center.
- 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.
- Commodities and especially stocks are also reasonable ways to hedge.

Questions?
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