

# Morningstar's Best Ideas for 2016 and Beyond

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June 11, 2016

## Morningstar Overview and Philosophy

- Provide financial information to individuals, advisors, and institutions
- We believe our competitive edge comes through bottom-up research; we have a huge database of information
- Currently have 300 analysts worldwide, focusing on stocks, mutual funds, ETFs, and fixed income
- We're best known for our fund and stock research, but research on bonds, asset allocation and retirement planning are growing emphases.
- Equity philosophy: Bottom up, with a focus on quality and valuation
- Fund philosophy: Also bottom up, because past returns aren't predictive. Agnostic on index v. active debate

## Ground Rules 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

## Top News

**U.S. Stocks Eke Out Small Gains, Snap 3-Day Slump**

**Oil Settles Under \$32 for the First Time in More Than 12 Years**

**Alcoa Reports 18% Drop in Revenue**

Lululemon Shares Pop on Improved Earnings Outlook

Shire Agrees to Acquire Baxalta in \$32 Billion Deal

OECD Leading Indicators Point to Steadying China Growth

## Upcoming Earnings and Data Releases

**Monday Earnings:** Alcoa

**Tuesday Earnings:** CSX

**Wednesday Data:** Fed Beige Book

**Thursday Earnings:** Intel, JPMorgan

**Thursday Data:** Initial Jobless Claims

**Friday Earnings:** BlackRock, Citigroup, Wells Fargo

**Friday Data:** Retail Sales, Producer Price Index, Empire Manufacturing, Industrial Production, UMich Consumer Sentiment

## Popular Stock Quotes

Apple

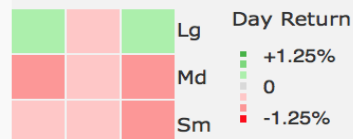
ExxonMobil

Berkshire Hathaway

AT&T

Walt Disney

## Market Barometer



### Value—Growth



Advertisement  
High Yield CDs & Savings Accounts.

## Stock Market Updates

- ▶ Running Commentary
- ▶ Story Stocks
- ▶ Up/Downgrades
- ▶ Gainers/Losers/Most Active

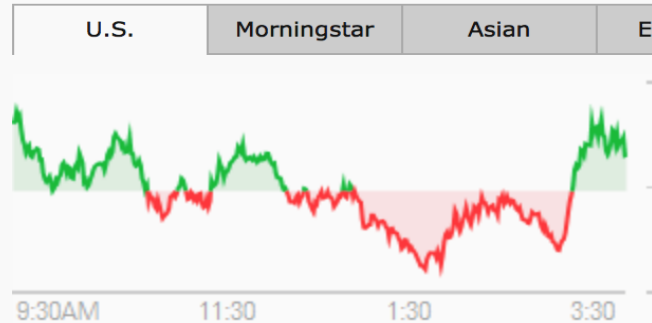
## Market Calendars

- ▶ Earnings Calendar
- ▶ Splits Calendar
- ▶ IPO Calendar
- ▶ Economic Calendar

## Market Valuation

- ▶ See Morningstar's Market Fair Value Chart

## Market Indexes



Index	Value	Change
<u>DJIA</u>	16,398.57	<b>52.12</b>
S&P 500	1,923.67	<b>1.64</b>
NASDAQ	4,637.99	<b>-5.64</b>
Morningstar US Market	4,802.21	<b>-0.15</b>
Morningstar Small Cap	6,717.49	<b>-29.75</b>

Data as of 01-11-2016

The **Fidelity OneQ ETF** closely tracks the Nasdaq Composite Index, one of the most widely watched benchmarks in the world.

# Our Global Coverage Universe = 2% Overvalued as of 6/06/16

Coverage Universe:

All Rated Stocks

52-Week High	4/27/2016	52-Week Low	2/11/2016	All-Time High	12/31/2004	All-Time Low	11/20/2008
1.02		0.86		1.14		0.55	

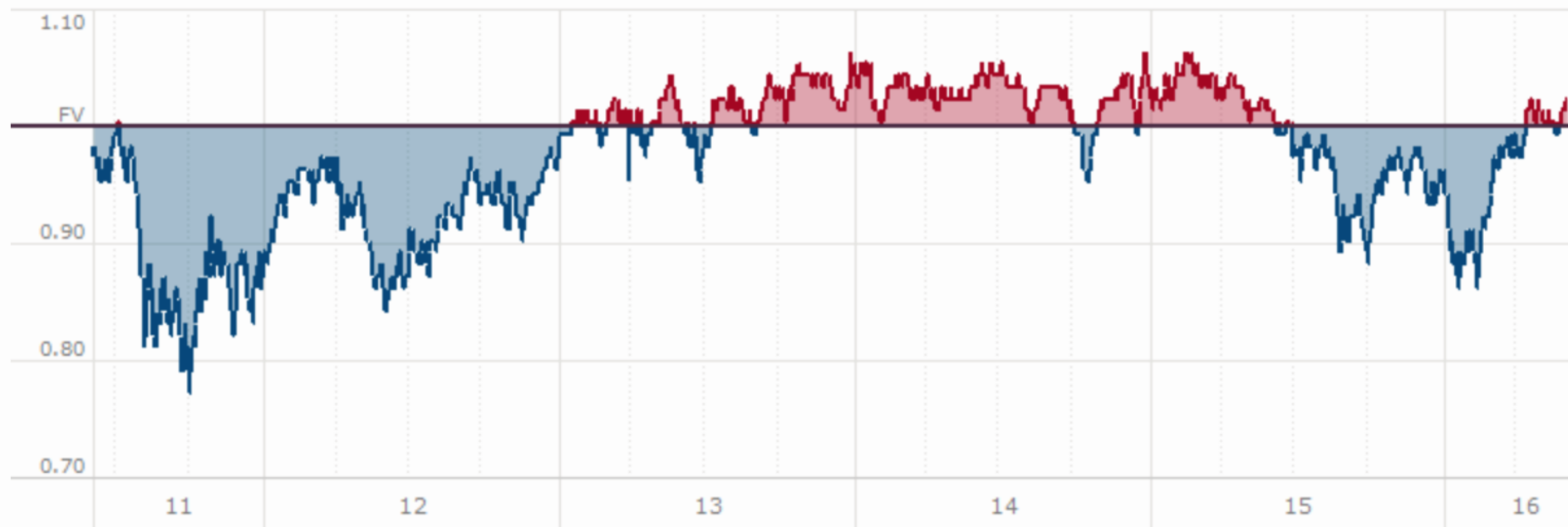
**Today's Ratio: 1.02**

— Fair Value

● Overvalued

● Undervalued

6/6/2011 - 6/6/2016



## But star ratings by investment style box reveals more nuance on that number

- % of stocks within a given style box with 4 or 5 stars
  - Large Value: 40% (cheapest square of style box currently)
  - Large Blend: 24% (second-cheapest square)
  - Mid Growth: 16% (most expensive square)

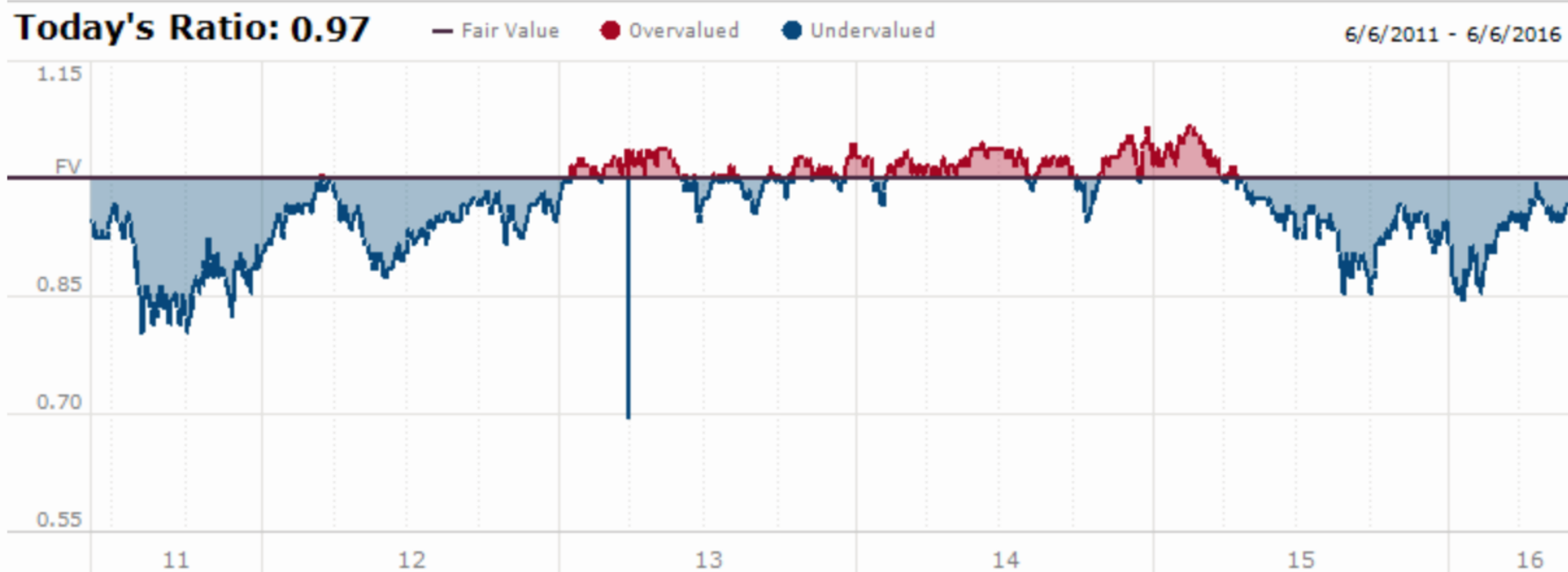
Data as of 6/6/16.

# Wide Moats Are the Cheapest of the Three Moat Bands Currently

Coverage Universe:

Size of Moat (Business Quality) > Wide

52-Week High	4/20/2016	52-Week Low	1/21/2016	All-Time High	6/16/2003	All-Time Low	11/20/2008
0.99		0.84		1.07		0.54	



Wide economic moat examples (13% of coverage universe) include Altria, BlackRock, Alphabet (Google), Harley-Davidson, Amazon.com.

# Narrow Moats: Slightly More Expensive

Coverage Universe:

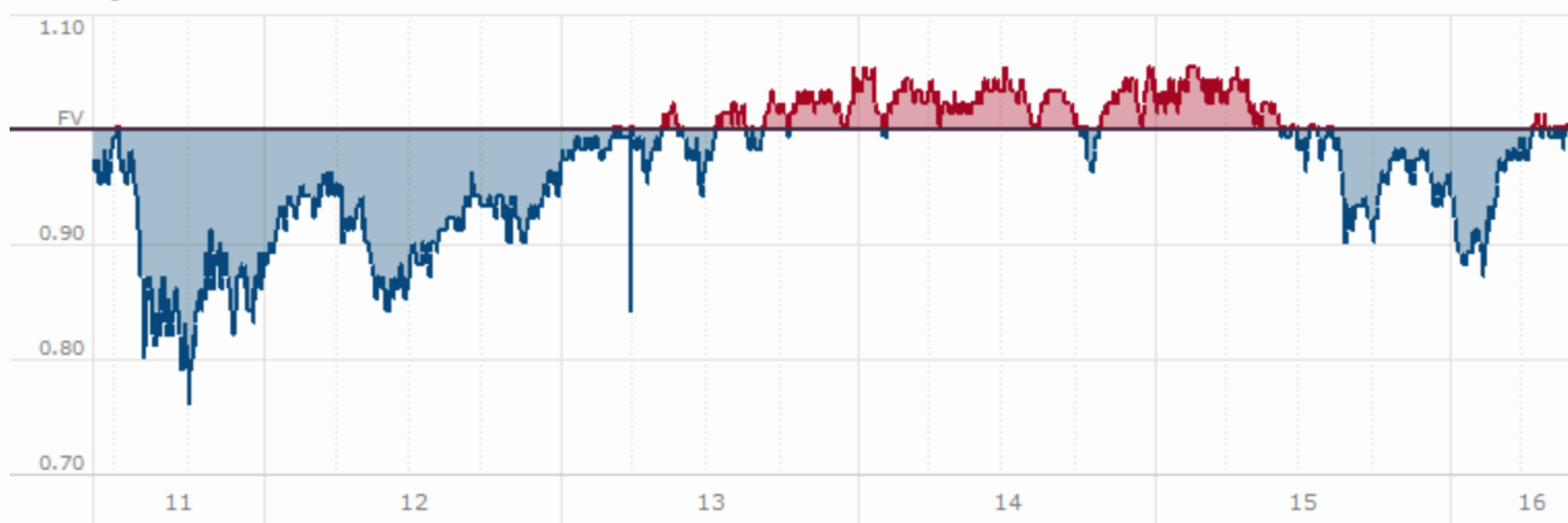
Size of Moat (Business Quality) > Narrow

52-Week High	6/1/2015	52-Week Low	2/11/2016	All-Time High	12/31/2004	All-Time Low	11/20/2008
1.02		0.87		1.11		0.57	

**Today's Ratio: 1.01**

— Fair Value    ● Overvalued    ● Undervalued

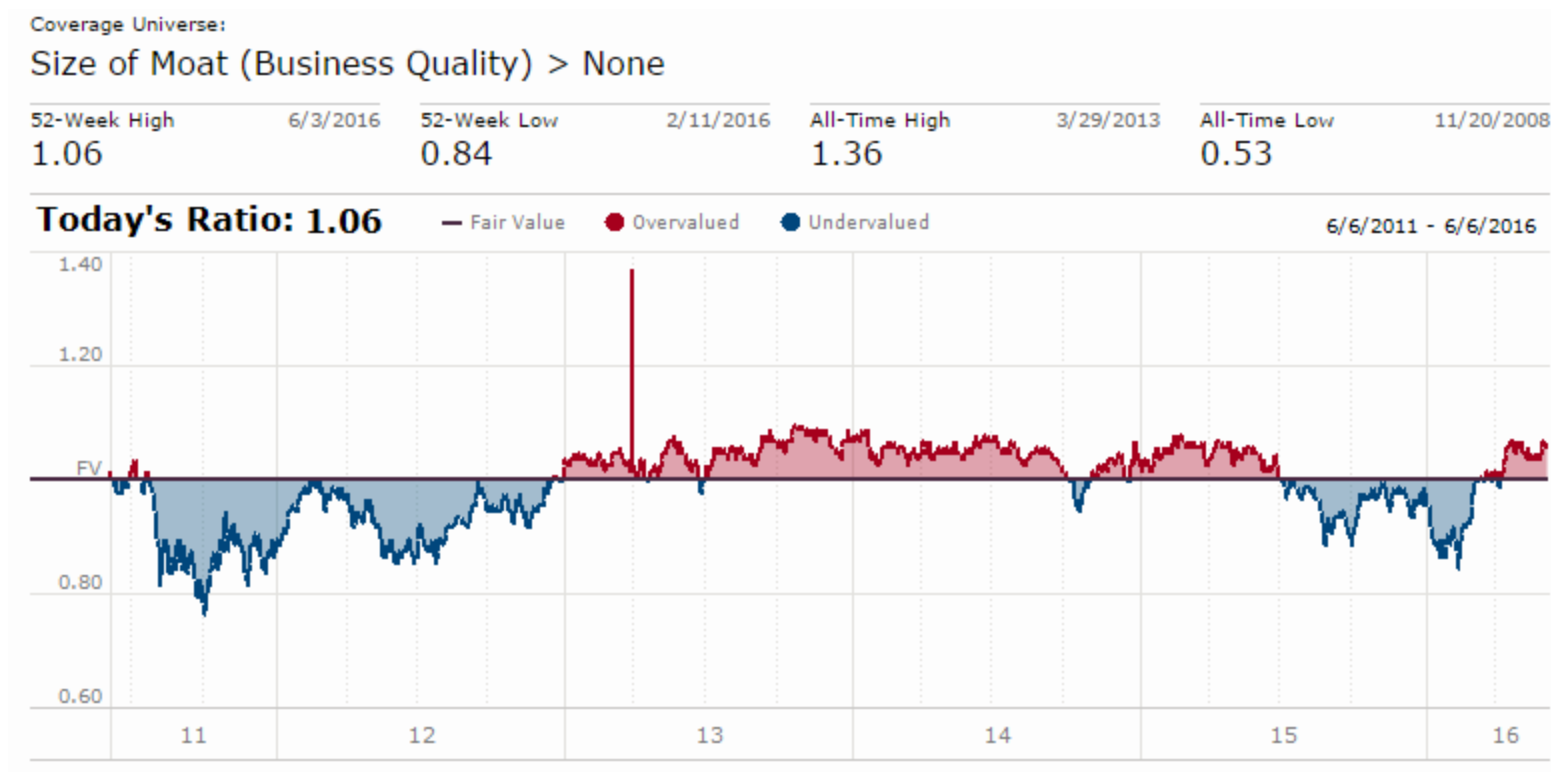
6/6/2011 - 6/6/2016



Narrow economic moat examples include Citigroup, Coach, Whole Foods. Within our coverage universe, 44% of companies have narrow moats.



# No Moats Most Expensive of All



Examples of companies with *no* economic moats include Allstate, Dick's Sporting Goods, Honda Motor, Panera Bread, Southwest Airlines. (43% of stocks in our coverage universe do not have moats.)

## The Sector Lens: Another View of Valuations

### Economically Sensitive (1.06)

Communications Svc.  
P/FV: 1.02

Energy P/FV: 1.28

Industrials: 1.02

Technology: 1.03

### Cyclical (0.95)

Basic Materials: 1.17

Consumer Cyclical  
P/FV: 0.93

Financial Services  
P/FV: 0.87

Real Estate 1.01

### Defensive (1.05)

Consumer Defensive  
P/FV: 1.08

Utilities P/FV: 1.07

Health P/FV: 0.98

Data as of 6/6/16.

*Sector Valuation graph available on Stocks cover page.*

## Takeaways for U.S. Equity Investors

- Stocks dropped below fair value earlier this year, but our coverage universe is now fairly valued.
- Value stocks, not surprisingly, look cheaper to our analysts than do growth stocks
- Undervaluation in small-, mid-, and large-cap value stocks
- Large value currently the cheapest style box; mid-growth the most expensive
- High-quality names (wide-moat) are cheaper than lesser-quality companies (no and narrow moat)
- But many traditional defensive names (wide moats, low uncertainty ratings) aren't cheap today; quality-conscious investors need to be selective

## Best Ideas for Quality-Conscious Equity Investors

4 or 5 stars (low market valuations relative to our estimates of fair value), wide moats, and low uncertainty ratings (10 as of 6/6/16)

Allergan AGN (5 stars)

Magellan Midstream Partners MMP

Nestle NSRGY

Pfizer PFE

Roche Holdings RHHBY (5 stars)

Amgen AMGN

Merck MRK

Novartis NVS Pfizer PFE

Procter & Gamble PG

Spectra Energy LP SEP

## Best Ideas for Investors with Longer Time Horizons, Higher Risk Capacities

4 or 5 stars, wide moats, and *high* uncertainty ratings (7 as of 6/6/16)

Banco Santander Chile

Blackstone Group BX

Harley Davidson HOG

Jones Lang LaSalle JLL

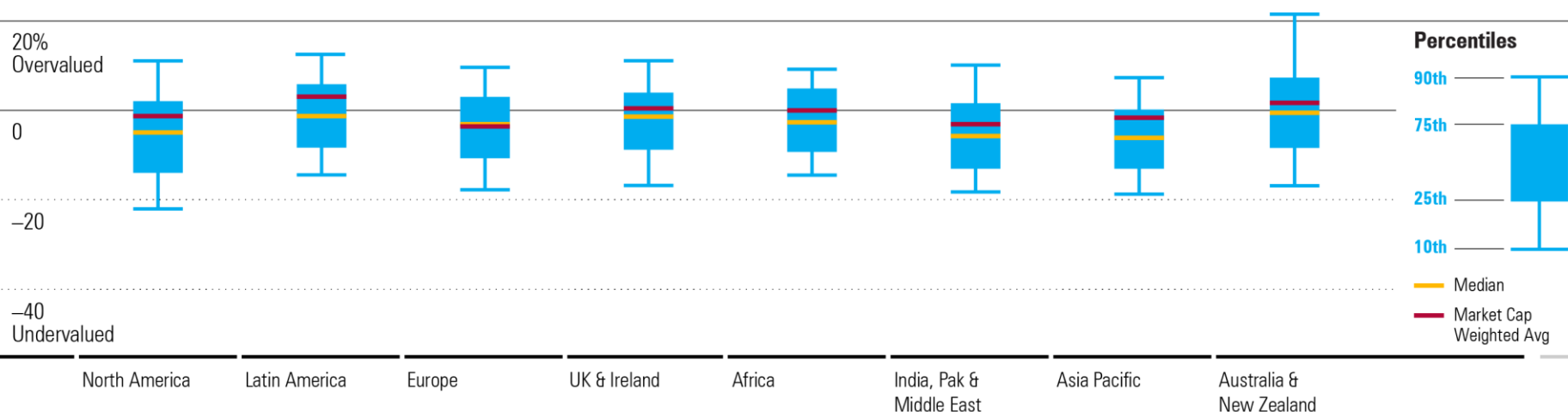
Polaris Industries PII

The Swatch Group SWGAY

## Best Ideas for U.S. Equity-Fund Investors: Large Caps

- Large-value stocks still looks (relatively) cheap right now; if you're rebalancing or putting money to work, tip your portfolio toward them.
- Top large-cap funds with an emphasis on valuation:
  - AMG Yacktman YACKX
  - Dodge & Cox Stock DODGX
  - Diamond Hill Large Cap DHLAX
  - Oakmark OAKMX and Oakmark Select OAKLX
  - Vanguard Dividend Growth VDIGX

# Foreign Stocks: They Must Be Cheap, Right?



## Top 10 Lowest-Valued Countries (Market Cap Weighted)

Country	Over/Undervalued by (%)	Uncertainty Rating	Number of Companies
Iraq	-17.7	Very High	23
Spain	-12.8	High	111
Switzerland	-11.5	High	180
Saudi Arabia	-10.4	High	147
Egypt	-9.8	Very High	150
Qatar	-8.1	High	37
Hong Kong	-7.0	High	1,038
United Arab Emirates	-6.8	High	55
Peru	-5.9	High	24
Bangladesh	-5.7	Very High	271

## Top 10 Highest-Valued Countries (Market Cap Weighted)

Country	Over/Undervalued by (%)	Uncertainty Rating	Number of Companies
Argentina	9.2	High	48
Russia	7.0	High	115
Mexico	6.8	High	76
New Zealand	6.0	Medium	84
Netherlands	5.4	Medium	81
Portugal	4.9	High	21
Chile	3.8	Medium	75
Denmark	3.3	High	112
Indonesia	3.0	High	366
Malaysia	2.6	High	503

## Foreign Stock Takeaways

- Although U.S. market has outperformed, N. American stocks don't appear to be significantly more expensive than many overseas markets currently
- Foreign-currency depreciation explains a lot of the poor returns experienced by U.S. investors in unhedged foreign investments
- Some of the larger names in foreign markets look somewhat expensive (median stocks look more attractive than cap-weighted averages)
- Emerging markets may be attractive, but investors may want to look beyond capitalization-weighted indexes (see median v. cap-weighted valuations in Latin America, Asia-Pacific)



## Best Ideas for International Fund Investors

- Morningstar favorite core, value-leaning international funds include:
  - Harbor International HIINX
  - American Funds EuroPacific Growth AEPGX
  - Vanguard International Value VTRIX
- Morningstar's favorite emerging markets funds include:
  - American Funds New World NEWFX
  - DFA Emerging Markets DFEMX
  - Harding Loevner Emerging Markets HLEMX
  - T. Rowe Price Emerging Markets Stock PRMSX

## What Should Be on Bond Investors' Radar?

- Recognize vulnerability of longer-term bonds in the face of rising interest rates
- Run through a duration stress test: Duration minus SEC yield = approximate loss in a one-year period in which interest rates rose by one percentage point
- Match duration to your time horizon
- Use credit-sensitive bonds to augment, not supplant, high-quality bonds

## Best Ideas for Bond Investors

- Keep quality high, delegate to an active manager with a flexible strategy
- Morningstar's favorite funds for time horizons of five years or more:
  - Harbor Bond HABDX
  - Metropolitan West Total Return MWTRX
  - Dodge & Cox Income DODIX
  - Vanguard Total Bond Market Index VBMFX
- Favorite short-term funds:
  - Fidelity Short-Term Bond FSHBX

## Best Ideas for Personal Finance: Mind Tax Efficiency

- Go Roth: IRA conversion is a great opportunity for those with long time horizons or affluent retirees; also consider Roth 401(k) contributions/conversions if eligible
- Consider “backdoor Roth” contributions/conversions, but be careful if you own Traditional IRA assets
- Manage for tax efficiency: ETFs, traditional index funds, tax-managed funds, individual stocks
- Mind asset location: Hold tax-inefficient assets like REITs, high-yield bonds, and TIPS inside of a tax-sheltered account
- Check to see if munis offer better after-tax return than comparable taxable bond funds. (Favorite firm for munis: Fidelity.)

## Best ideas for Personal Finance: Don't Forget about Inflation!

- Add inflation protection when inflation isn't splashed on the front page of your newspaper
- 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 TIPS funds: Vanguard Inflation-Protected Securities VIPSX, Vanguard Short-Term Inflation-Protected Securities VTIPX, Harbor Real Return HARRX
- Commodities and especially stocks are also reasonable ways to hedge. Also: Bank-loan funds, precious metals equities, commodities

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**Questions?**  
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