

---

# Morningstar's Best Ideas for 2017 and Beyond

## **Christine Benz**

- Director of Personal Finance, Morningstar
- Senior Columnist, Morningstar.com
- Author of *30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances* (2010)

September 10, 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. "Costs matter."

---

## 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

# Asset Class Returns: A 15-Year Review

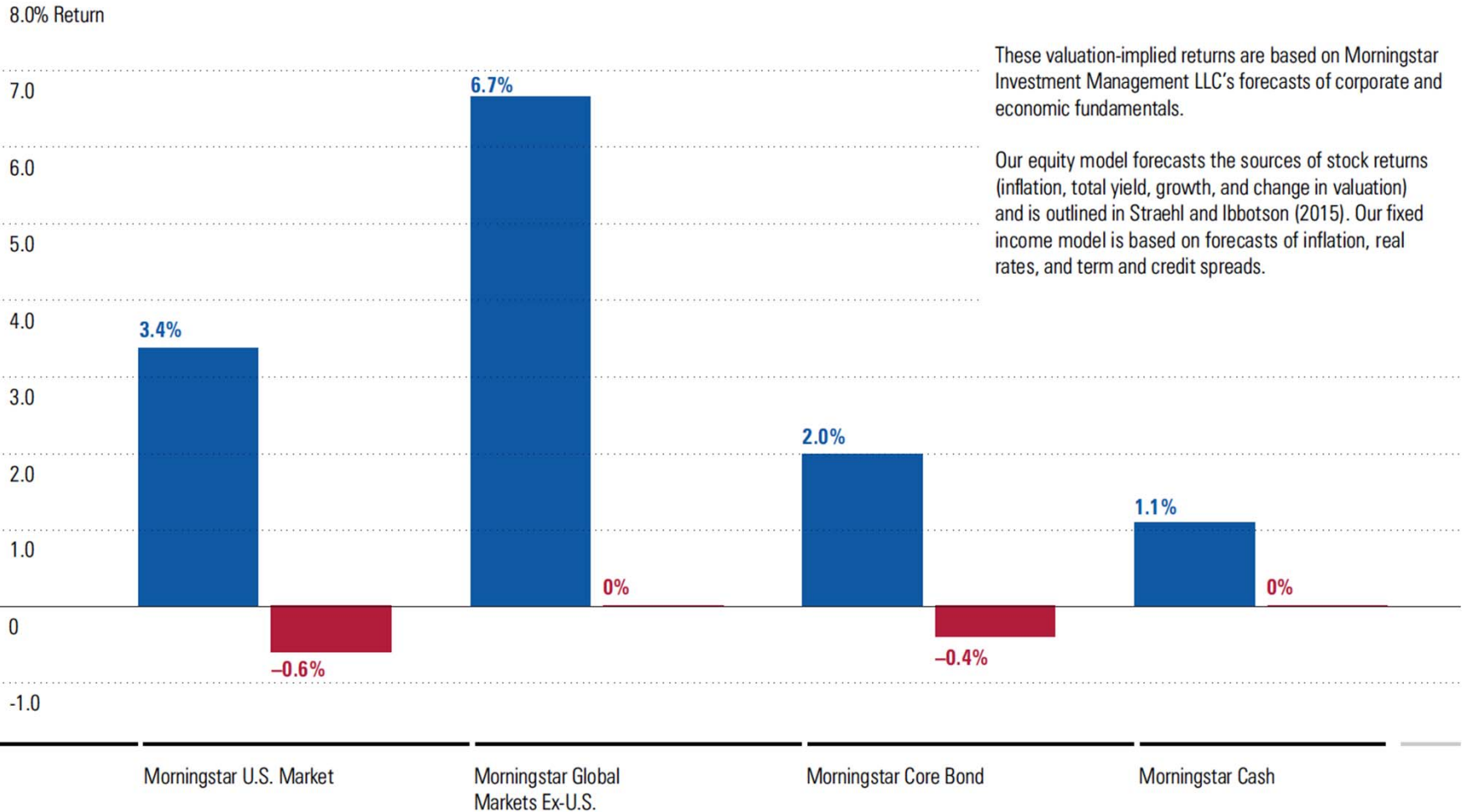
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 YTD	Entire Period
Highest return	10.8%	34.0	53.3	25.9	35.0	36.1	39.4	14.1	83.8	28.4	9.4	19.7	37.9	13.6	1.8	15.1	10.1
	8.5	13.5	47.7	21.6	25.5	26.6	31.8	-3.2	58.2	23.6	5.2	17.5	31.8	6.9	1.7	9.1	8.3
	5.3	11.1	42.4	20.4	15.9	17.0	12.7	-22.2	37.7	21.8	5.0	16.5	22.0	4.9	1.3	6.8	7.9
	5.3	-1.4	29.0	17.6	7.0	15.9	10.3	-26.2	36.1	15.1	2.6	16.0	14.3	4.5	-1.4	5.8	6.3
	2.8	-3.7	27.0	11.5	5.8	13.0	8.6	-33.8	24.8	13.4	0.6	15.8	7.4	3.9	-1.8	4.9	5.8
	-2.5	-6.7	24.7	11.1	4.9	11.8	6.7	-36.1	21.8	12.3	-2.6	12.0	0.6	2.5	-4.5	4.8	5.2
	-15.1	-13.8	22.5	9.5	2.7	4.9	6.0	-36.2	20.9	11.4	-5.3	11.2	-1.8	-0.8	-4.9	4.6	4.5
	-20.6	-20.4	7.9	4.9	1.1	3.6	1.9	-43.0	19.5	8.5	-11.9	3.7	-2.7	-3.9	-13.3	3.2	4.5
Lowest return	-23.1	-23.5	2.7	3.0	0.7	-0.2	-0.7	-53.8	-1.4	7.1	-18.6	2.5	-3.7	-24.4	-26.3	-2.3	2.6

- Small stocks
- Large stocks
- International-developed stocks
- Emerging-markets stocks
- Intermediate-term government bonds
- Intermediate-term corporate bonds
- High-yield bonds
- Commodities
- Moderate portfolio

# High Valuations Imply Muted Returns for Most Asset Classes

Morningstar Investment Management LLC (10-Year Valuation-Implied Returns)

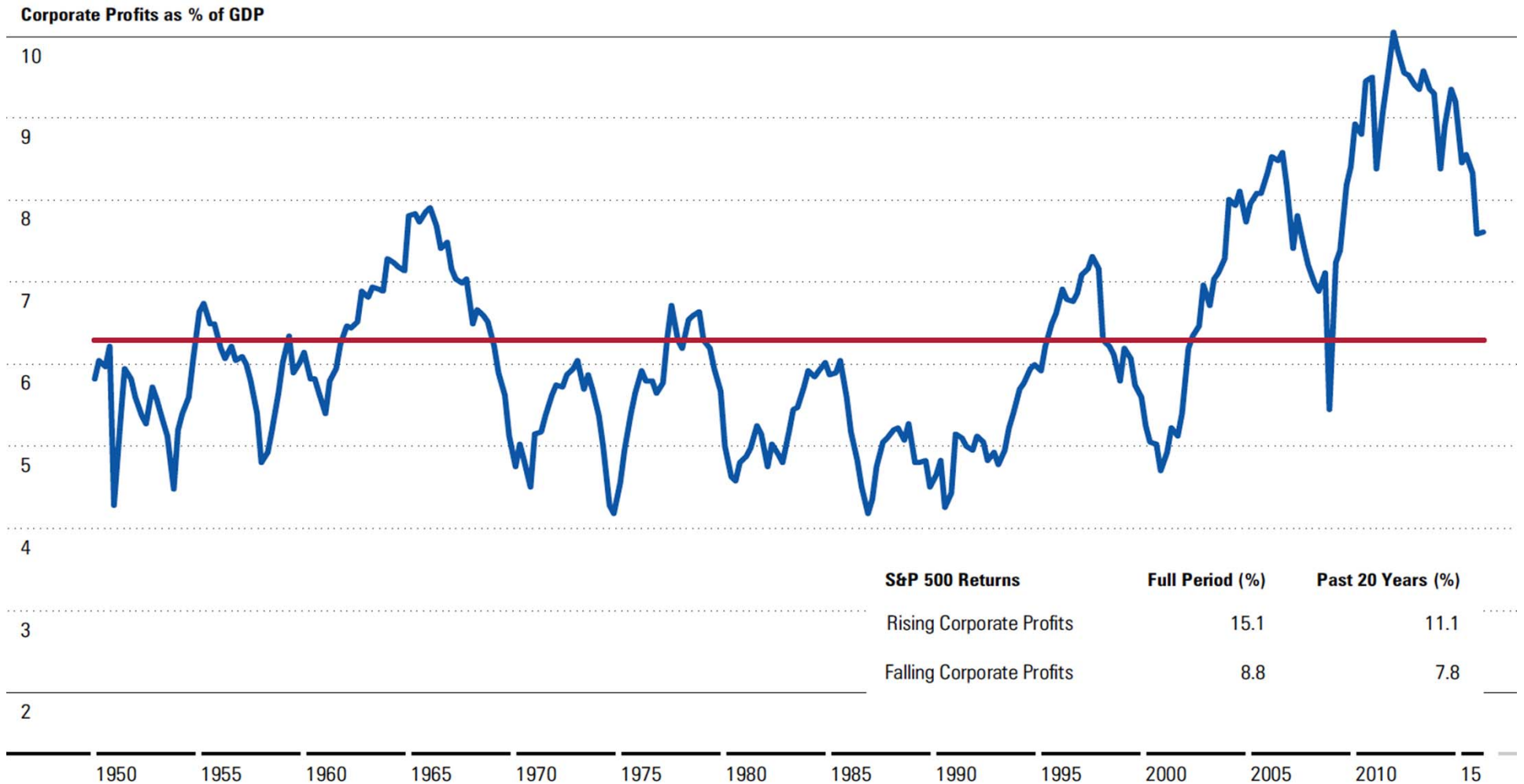
● 10-Year Expected Returns (Nominal Geometric USD) ● QoQ Change



These valuation-implied returns are based on Morningstar Investment Management LLC's forecasts of corporate and economic fundamentals.

Our equity model forecasts the sources of stock returns (inflation, total yield, growth, and change in valuation) and is outlined in Straehl and Ibbotson (2015). Our fixed income model is based on forecasts of inflation, real rates, and term and credit spreads.

# Slowing Corporate Profitability Another Potential Headwind



---

## External Experts Corroborate That Pessimism

### Expected Returns for U.S. Stocks

- Jack Bogle: 2%
- Research Affiliates: 3%
- GMO: -1%
- Vanguard Group: 6%-8%
- AQR: 6%
- JP Morgan: 7%



# What Does M\*'s Bottom-Up Research Say?

## 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

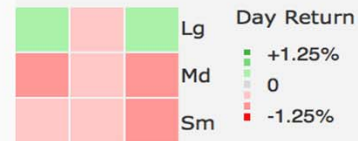
ExxonMobil

Berkshire Hathaway

AT&T

Walt Disney

## Market Barometer



Advertisement  
High Yield CDs & Savings Accounts.

## Stock Market Updates

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

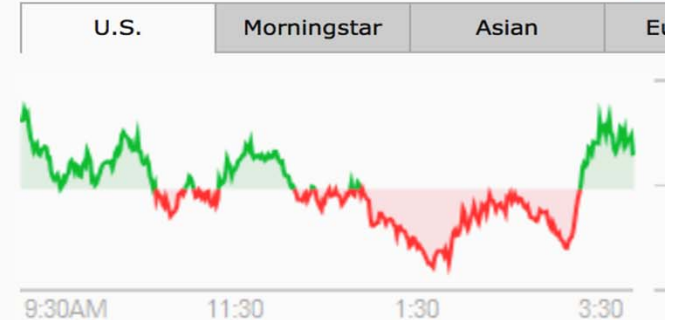
## Market Calendars

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

## Market Valuation

- ▶ See Morningstar's Market Fair Value Chart

## Market Indexes



Index	Value	Change
<b>DJIA</b>	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 = 3% Overvalued as of 9/10/16

Select Time Period

1M

3M

YTD

1Y

3Y

5Y

Max

Coverage Universe:

All Rated Stocks

52-Week High

9/7/2016

52-Week Low

2/11/2016

All-Time High

12/31/2004

All-Time Low

11/20/2008

1.04

0.86

1.14

0.55

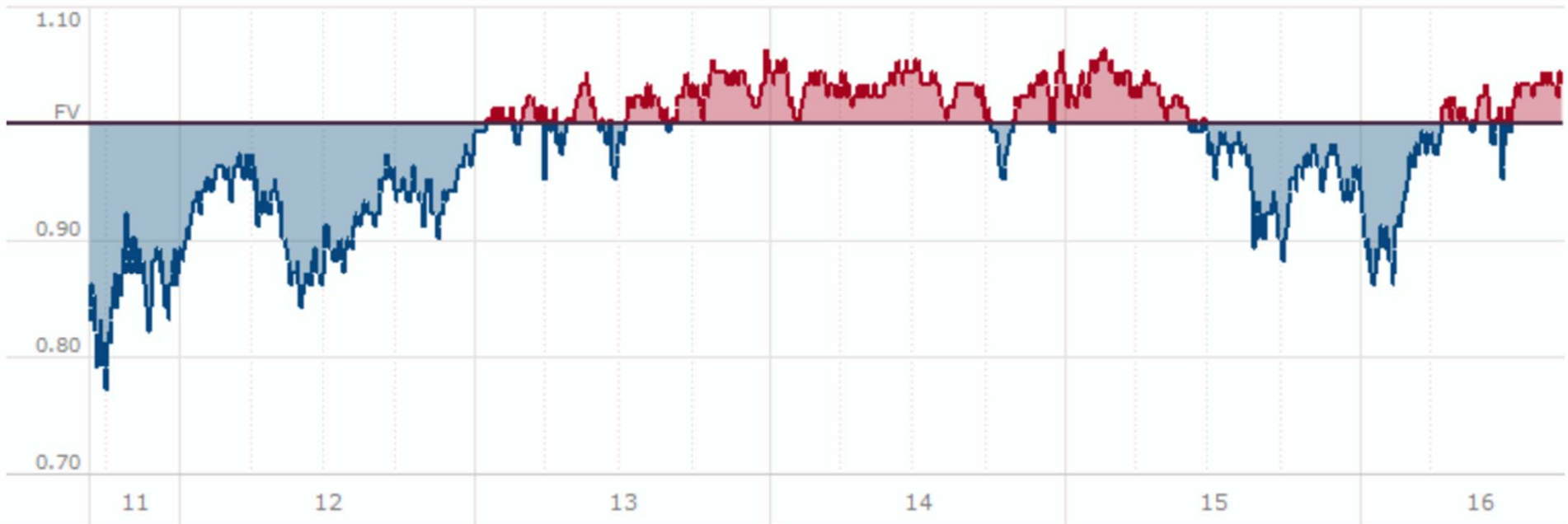
Today's Ratio: 1.03

— Fair Value

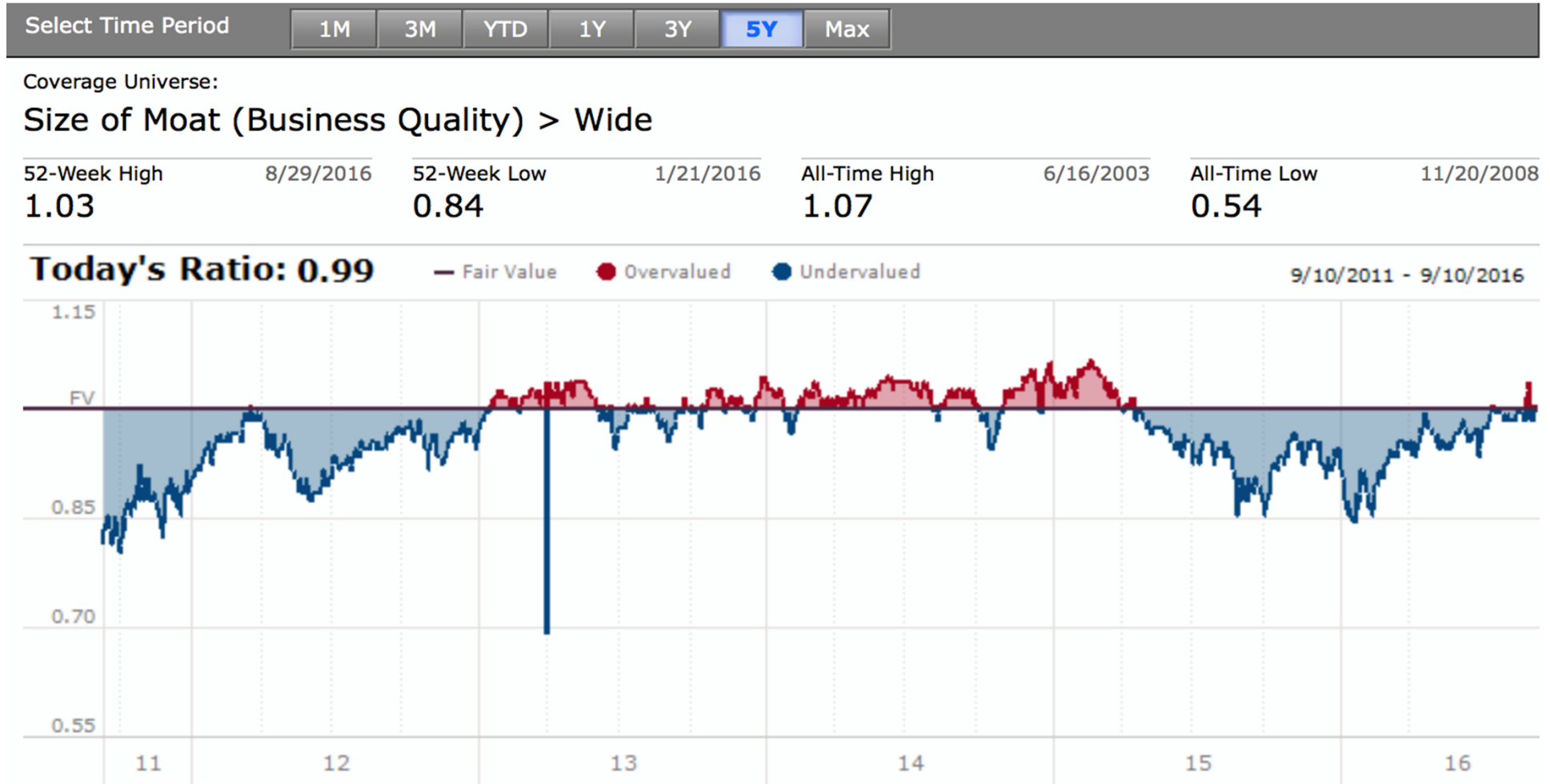
● Overvalued

● Undervalued

9/10/2011 - 9/10/2016

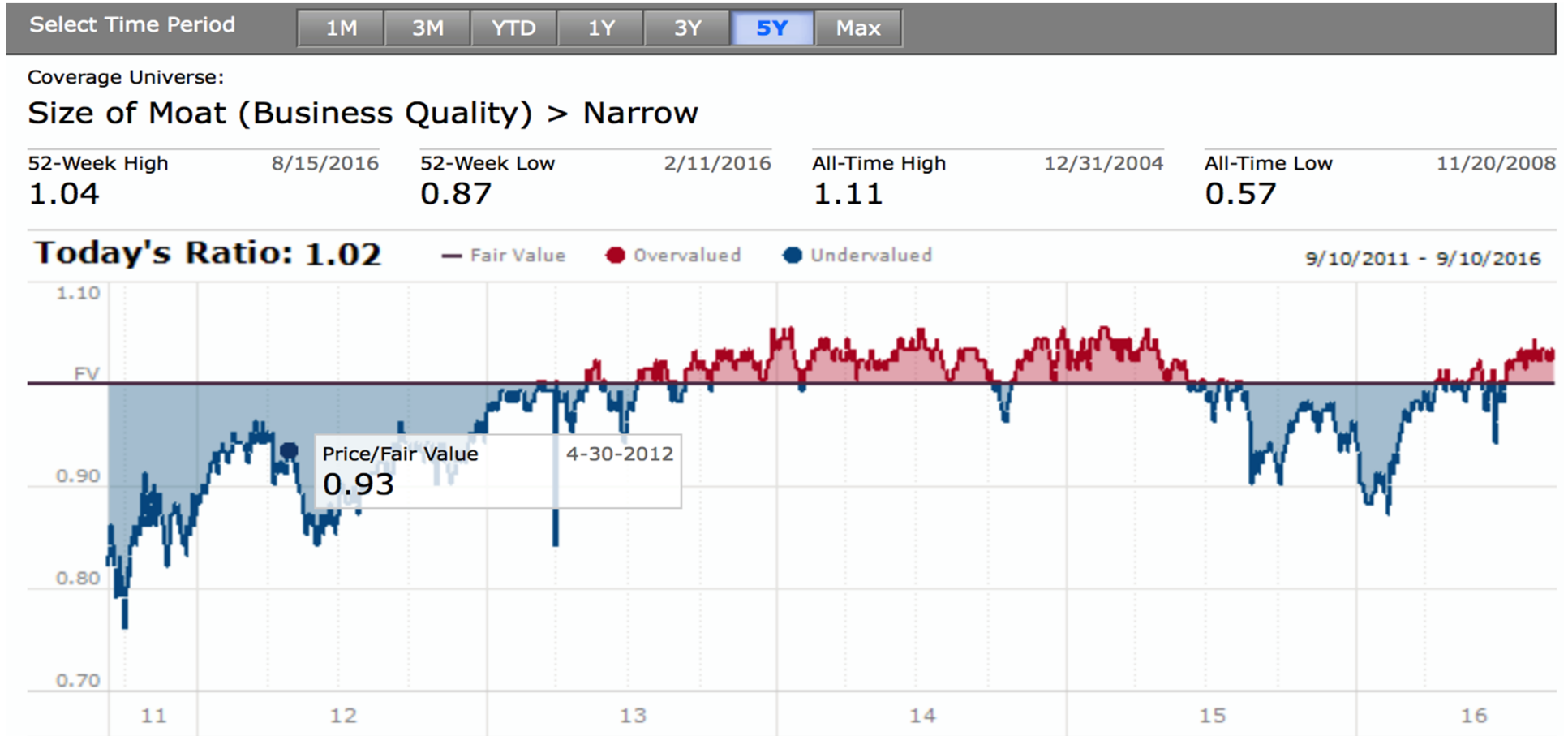


# Wide Moats Are the Cheapest of the Three Moat Bands Currently



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

# Narrow Moats: Slightly More Expensive



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

Select Time Period

1M

3M

YTD

1Y

3Y

5Y

Max

Coverage Universe:

Size of Moat (Business Quality) > None

52-Week High

8/29/2016

52-Week Low

2/11/2016

All-Time High

3/29/2013

All-Time Low

11/20/2008

1.10

0.84

1.36

0.53

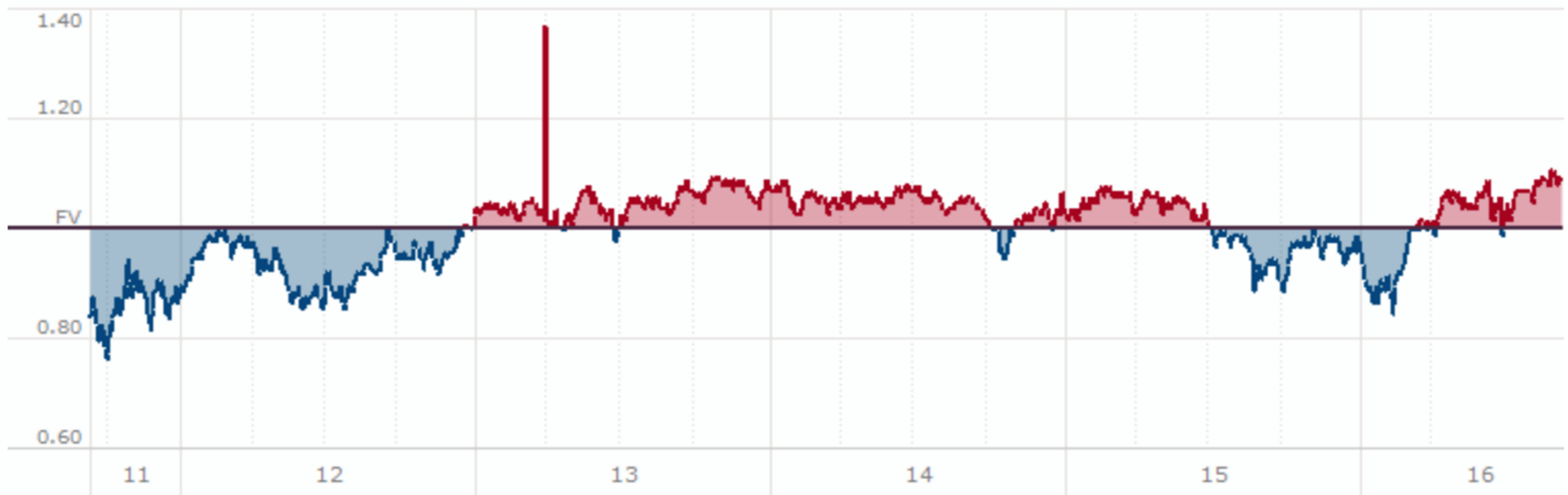
Today's Ratio: 1.09

— Fair Value

● Overvalued

● Undervalued

9/10/2011 - 9/10/2016



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.)

In aggregate, wide-moat firms with high *fair value uncertainty ratings* appear the most attractive.


		Uncertainty		
		Low	Medium	High
Moat	None	4.5	11.9	20.1
	Narrow	1.6	12.1	7.3
	Wide	-1.4	7.0	0.2
	Aggregate	8.7	4.0	-8.2

Data as of 06/30/16



---

## What are fair value uncertainty ratings?

- Fair value uncertainty ratings depict analysts' ability to predict a company's future cash flows and calculate fair value
  - Uncertainty created by erratic sales patterns, leverage, and difficult-to-predict events (litigation risk, risk that a company's products won't receive FDA approval, etc.)
  - Examples of companies with low uncertainty ratings (high visibility): Coca-Cola, Costco, McCormick, Novartis, Procter & Gamble
  - Examples of companies with medium uncertainty ratings: BlackRock, Comcast, McDonald's, Microsoft
  - Examples of companies with high uncertainty ratings: Amazon, Apple, Facebook, Ford Motor, Goldman Sachs
- 

# Large-value is the most attractive square of the M\* style box

		Style		
		Value	Blend	Growth
Size	Total Market 0.6%	-0.5	2.2	0.4
	Large	-0.6	-1.9	1.8
	Mid	6.1	4.3	5.5
	Small	-0.7	0.7	-1.5

Data as of 06/30/16.






---

## Equity star ratings corroborate that assessment

- % of stocks within a given style box with 4 or 5 stars
  - Large Value: 24% (cheapest square of style box currently)
  - Mid Value: 22% (second-cheapest square)
  - Mid Growth: 10% (most expensive square)
  - Mid Blend: 16% (second most expensive square)

Data as of 06/30/16.



---

## The Sector Lens: Few Screaming Buys

**Economically  
Sensitive (1.07)**

Communications Svc.  
P/FV: 1.01

**Energy P/FV: 1.22**

Industrials: 1.04

Technology: 1.07

**Cyclical (1.00)**

**Basic Materials: 1.18**

Consumer Cyclical  
P/FV: 0.99

**Financial Services  
P/FV: 0.93**

Real Estate 1.03

**Defensive (1.06)**

Consumer Defensive  
P/FV: 1.07

Utilities P/FV: 1.09


Health P/FV: 0.99

Data as of 09/09/16.

*Sector Valuation graph available on Stocks cover page.*

---

## Takeaways for 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
  - 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 (5 as of 09/09/16)

- Amgen AMGN
- Magellan Midstream Partners MMP
- Novartis NVS
- Pfizer PFE
- Procter & Gamble PG
- Roche RHHBY
- Spectra Energy SEP
- Wal-Mart Stores WMT

---

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

4 or 5 stars, wide moats, and *high* uncertainty ratings (6 as of 09/09/16)

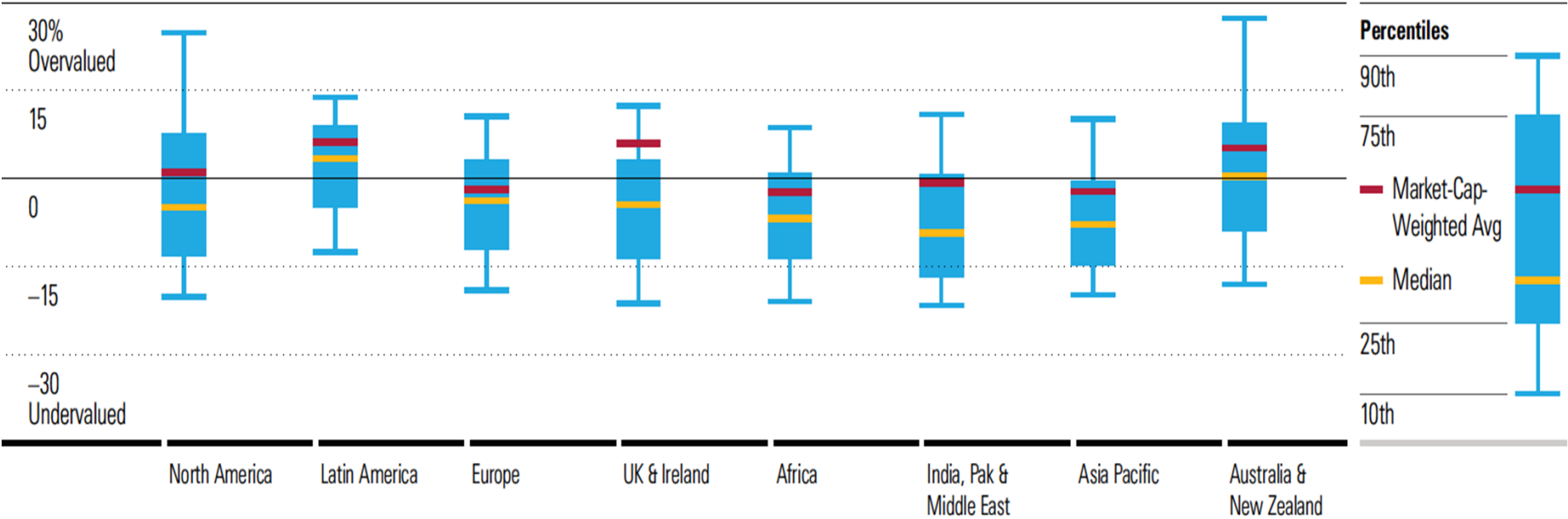
- Blackstone Group BX
- CBRE CBG
- Jones Lang LaSalle JLL
- Julius Baer Gruppe JBAXY
- Polaris PII
- Salesforce.com CRM

---

## 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:
  - Dodge & Cox Stock DODGX
  - Diamond Hill Large Cap DHLAX
  - Oakmark OAKMX and Oakmark Select OAKLX
  - Vanguard Equity-Income VEIRX

# Foreign Stocks: They Must Be Cheap, Right?



Data as of 6/30/16



---

## Foreign Stock Takeaways

- U.S. market has outperformed, so N. American stocks appear to be a bit more expensive than many foreign markets currently
- Latin America looks notably expensive; Europe, Asia-Pacific relatively cheap
- 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
  - Oakmark International OAKIX
- 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

## Bond Performance Since 2001: A Heck of a Run

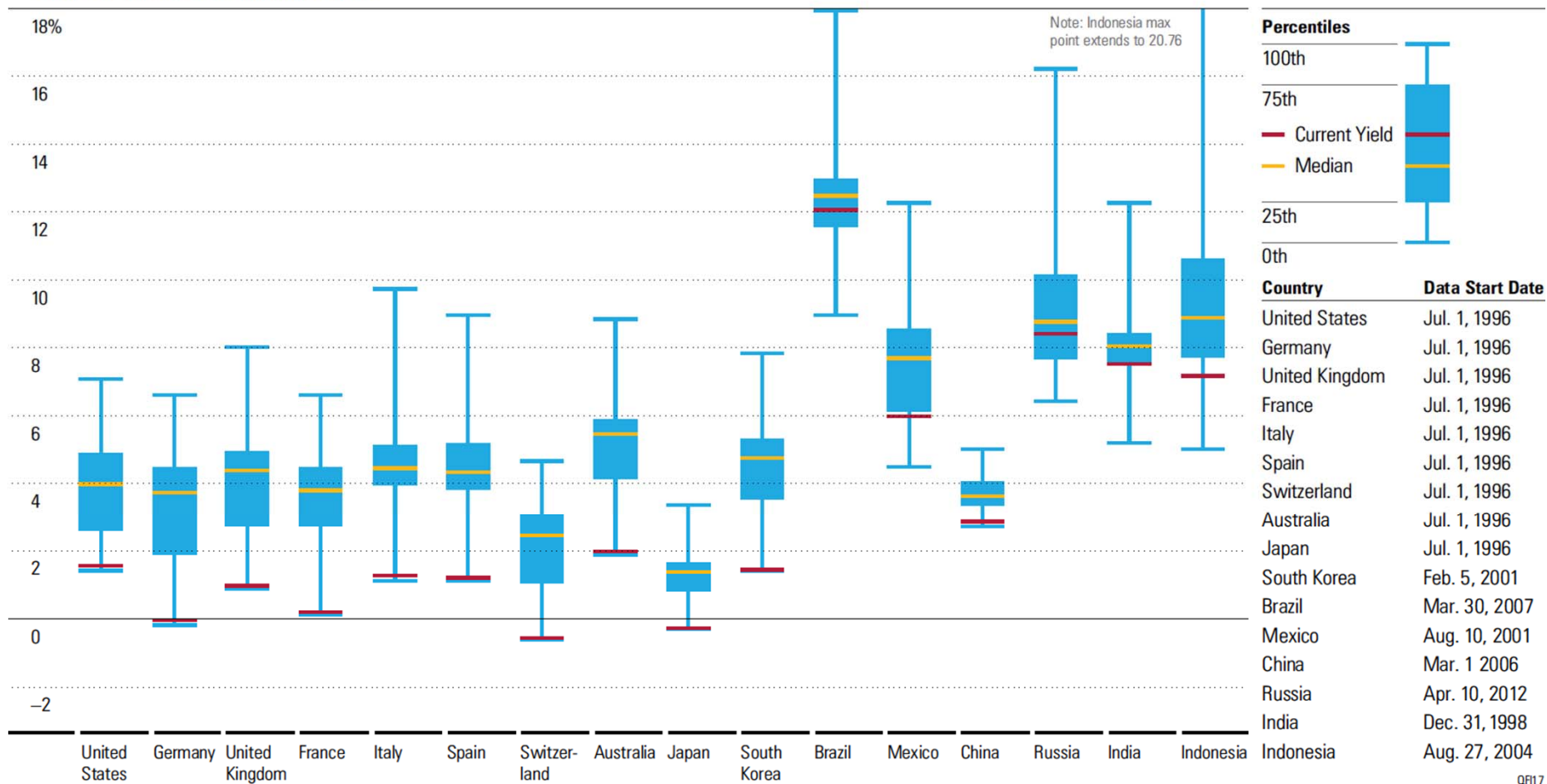
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 YTD	Entire Period
Highest return	11.7%	24.8	29.0	14.6	10.7	11.8	10.8	20.7	58.2	15.1	22.7	18.5	7.4	18.2	3.3	17.3	9.0
	9.1	16.7	25.7	11.7	5.1	9.9	10.3	14.1	51.6	12.0	11.8	15.8	5.3	12.8	1.7	11.9	7.9
	8.5	13.5	18.7	11.1	5.0	6.8	9.9	10.3	28.2	11.1	10.7	13.4	0.6	9.1	1.2	11.7	7.7
	8.5	13.1	10.2	8.0	3.5	6.7	7.4	7.6	20.2	10.1	9.4	9.7	-1.9	6.1	1.0	10.9	7.1
	5.3	10.8	10.0	6.9	2.7	4.8	7.3	5.0	12.9	9.4	8.5	6.8	-2.6	5.5	0.8	9.1	6.5
	5.2	10.4	5.3	5.2	2.7	4.3	6.3	-2.5	4.6	7.1	8.0	4.4	-2.7	3.9	0.5	5.3	5.3
	5.1	9.6	4.0	4.5	2.5	4.1	4.3	-3.5	4.2	6.3	6.9	3.9	-4.5	2.5	-0.7	4.9	5.2
	4.2	7.3	3.2	4.5	1.6	4.1	3.4	-10.9	4.2	5.8	5.0	3.5	-4.5	2.0	-2.8	4.5	5.1
	1.4	1.9	2.7	3.0	1.1	3.6	2.1	-26.2	-1.4	3.5	2.3	2.5	-6.6	1.6	-4.5	4.3	4.8
Lowest return	-3.0	-1.4	2.4	1.5	-7.3	2.2	1.9	-29.1	-9.2	2.4	1.5	1.7	-9.9	1.0	-5.0	2.1	3.5

**Bonds:**

- Long-term gov't
- Long-term corp
- Municipal
- Emerging-markets
- Bank loans
- Intermediate-term gov't
- Short-term
- International
- High-yield
- Aggregate

# Every Rock Has Been Turned Over in Search of Yield

World 10-Year Government Bond Yields



---

## What Should Be on Bond Investors' Radar?

- Bonds as a group have benefited from declining yields, but that isn't likely to go on forever
- 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
- Vanguard Long-Term Treasury has a duration of 17 years and a 1.9% SEC yield
- Match duration to your time horizon; don't move it all to cash
- Use credit-sensitive bonds to augment, not supplant, high-quality bonds

---

## Higher Yields, But at a Price

### High-Yield Bonds

12-month Yield: ~ 5-6%

2008 Return: -24%

### Bank Loan

12-Month Yield: 4-5%

2008 Return: -17%

### Emerging Markets Bond

12-Month Yield: 5-6%

2008 Return: -26%

### Multisector Bond Fund

12-Month Yield: 3.5-4.5%

2008 Return: -15%

Data as of 09/09/16.

---

## 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

---

## Best ideas for Personal Finance: Employ a Total Return Approach for Retirement

- Yields on income-producing securities (bonds, dividend-paying stocks) have declined for decades, making life difficult for yield-seeking investors
- Income producers should be a key component of retiree portfolios, but not at the expense of risk control and diversification
- Successful retirees are opportunistic about where they go for cash flow on a year-to-year basis
- Income-producing securities may fill the bill in some years, but withdrawals of principal shouldn't be anathema in years when stocks have appreciated a lot
- Can extract cash you need *and* reduce risk in your portfolio by selling highly appreciated securities

---

Questions?  
[christine.benz@morningstar.com](mailto:christine.benz@morningstar.com)

