

How to Invest During an Economic Slowdown

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Morningstar's Take on the Economy

By Morningstar Analysts

If recent market turmoil has kept you up at night, you're not alone. We've been up, too, combing through the economic data, revisiting our stock forecasts, and keeping a close eye on the recent purchases and sales of some of our favorite fund managers.

Our sector experts and investing specialists have also been covering specific economic events—and how they may affect your current holdings and investment decisions. An uncertain economy and a rocky market can be a time of great anxiety, but also great opportunity. We'll be keeping our eyes peeled and our ears to the ground to keep you informed on the latest developments and investment ideas.

Latest Articles and Analysis

The Bureau of Labor Statistics recently reported that the CPI rose at an annualized rate of 4.5% in January, above the rate for 2007 as a whole. This data suggests that inflation is not a 1970s-style problem, but something that investors should have on their radar screens. Rising inflation threatens investment performance, and a slowing economy is not necessarily an antidote for inflation. In a recent Stock Strategist article, analyst Bill Bergman discusses what inflation is, how it is measured, and how it has been behaving lately. Although the possibility of higher inflation may mute expectations for stock returns, it still makes sense for long-term investors to put money on the table for undervalued stocks right now. Inflation matters for deciding which ones to buy.

Recent Reports

The Upside of Downturns

Although calling a recession is a slippery business, Morningstar stock analyst and former Fed economist Bill Bergman did point out in early December that several indicators suggest a recession is likely getting under way, and he offered some stock picks that can block and tackle well in a tough economy.

But recession or not, recent volatility has made many stocks much more attractively priced, and Morningstar growth investing specialist Toan Tran is looking for opportunities. In a recent article he likened bear markets to emotional meat grinders. But, he wrote, for those who keep a level head, there is an old saying: You make all your money in bear markets, you just don't know it until later. This report is included on page 7.

How can you take advantage of the down market? With uncertainty in the air, it can be tough to be disciplined about investing, but staying the course with dollar-cost averaging, and even increasing the contributions to your investments can pay dividends, wrote Morningstar analyst Annie Sorich. Get more tips for a slowing economic environment in her report which is included below.

If "buy low, sell high" is your objective (and it should be), a down market offers you just the opportunity to get started. But is the market overall truly cheap? By the looks of the S&P 500, yes. Morningstar now covers 2,000 companies, including more than 450 of the S&P's constituent holdings, and we can roll up those estimates

to come up with a fair value for the index as a whole—and it's currently looking undervalued, says Morningstar director of ETF analysis Jeffrey Ptak. One way to invest in the index is the SPY ETF, which, at the end of January, was poised to rip off a double-digit gain.

Fed Actions

The Fed certainly was looking to ease recession concerns when cutting interest rates 50 basis points at the end of January, following an earlier emergency cut of 75 basis points on Jan. 22. Although Fed actions can lead to market gyrations, Morningstar fund analyst Lawrence Jones suggests investors exercise caution in attempting to take advantage of these developments. Learn more about how recent rate cuts may impact your portfolio.

A Closer Read on Jobs Data

Morningstar stock analyst Joel Bloomer points out that the recent Fed actions are solid evidence that the economic data are indeed as bad as they seem—including jobs data. He has dug into some of the employment indicators, noting early signs of weakness in the labor markets and reasons to be suspect of some labor data. But he has found a possible silver lining: pockets of undervaluation among some employment-service companies in our coverage universe.

Declining Dollar

While the Fed has prioritized fighting off recession, another fear has also weighed on the markets and investors' minds: inflation. The value of the dollar versus the euro dropped 10% in 2007,

following another 10% drop the year before, and is down more than 40% from its high in October 2000, fund analyst David Kathman reported in January. But even though U.S. celebrities have been waving around wads of euros in music videos, Kathman advocates investors keep a cooler head and think twice before betting against the dollar with currency funds.

Credit Crunch

One of the major culprits behind recent volatility has been the tightening credit market. Warren Buffett repeatedly stated that he was baffled by the waves of liquidity sloshing around the world and warned of the risk of a seize-up in the credit markets. Buffett, of course, was right, wrote Morningstar growth investing specialist Toan Tran. The tightening of credit certainly causes many problems in the short term, he explained, but this too shall pass. This article is included in this booklet.

Subprime mortgages have played a key role in the tightening credit markets, and in December, Morningstar fund analyst David Kathman took a broad look at the impact of the subprime mortgage crisis on both bond and stock funds. The liquidity crisis caused ripple effects in all kinds of investments without direct subprime exposure, including some previously thought to be safe.

This article originally appeared on Morningstar's web site on 02/22/2008.

Which Investments Do Best in a Recession?

By David Kathman, CFA

Everyone seems to be worried about a possible recession these days. The specter of an economic slowdown has been hovering ever since the subprime-mortgage crisis erupted last year, after which falling home prices led to a reduction in consumer spending, or at least the expectation of one. The latest bad news came Feb. 5, when the Institute for Supply Management reported a sharp drop in nonmanufacturing business activity in January, leading some people to think that we may already be in a recession.

Whether or not we're in an official recession (defined as two consecutive quarters of negative growth in gross domestic product), most people agree that the U.S. economy is at least slowing down, and it's natural to wonder what you, as an investor, should do. A recent column by Annie Sorich gives some good advice, which can be summarized in two phrases: Don't panic, and be prepared. A down market is usually a better time to buy than to sell, and investing steadily through dollar-cost averaging is often your best bet. Also, it's a good idea to have some savings as a cushion and to have investments in your portfolio that won't be hurt too badly by an economic downturn.

But how are you supposed to know which investments will do well (or badly) in a recessionary environment? That's not always a simple question to answer, but some general guidelines can be helpful.

Riding Out the Storm

According to conventional wisdom, the best stocks to own in a recession are those that don't depend on economic cycles and are thus capable of doing well through thick and thin. Consumer staples such as food and beverage makers are a good example, as are health-care stocks. After all, people will keep on eating and taking their medicine regardless of what the economy does. On the other hand, stocks that are susceptible to economic and business cycles, such as technology, hardware, and many industrials, traditionally do poorly in a recession. In a broader sense, defensive, relatively low-risk investments, such as blue-chip stocks with steady earnings, are supposed to do well in a downturn, while higher-risk investments, such as small-cap stocks, do worse. Also, hard assets, such as precious metals and real estate, are considered defensive and traditionally do well in a downturn.

For the most part, those expectations are reflected in the market's behavior so far this year, when recession fears have been highest. For example, among Morningstar's 12 stock sectors, the two worst performers have been hardware and software, with average losses of 14.82% and 14.04%, respectively, for the year to date through Feb. 8. Next worst have been energy and telecom, both with double-digit losses. Consumer services has been the best-performing sector, with an average loss of "only" 3.99%, followed by health care. When we look at fund categories, there is a similar pattern. Technology and communications funds have been the worst-performing domestic-stock categories for the year to date, while the best-

performing category (apart from bear market and long-short) has been real estate, despite the weak housing market, with health-care funds not far behind.

A Mixed History Lesson

In reality, however, the markets haven't always responded predictably to recessions. That's because other factors, such as the valuations of various asset classes at the outset of the recessionary period, can affect what performs well and what suffers during an economic downturn.

For example, in the last recession, which lasted from March 2001 to November 2001, highly cyclical tech stocks sunk like a stone. At the same time, equally cyclical industrial materials stocks held up quite well, despite the widespread view that they should be avoided during a downturn. That was partly because industrials were so cheap after being beaten down during the tech bubble of the late 1990s. Similarly, small- and mid-cap stocks did quite well in 2001, even though they're generally considered less recession-resistant than large caps. Again, recent history is the reason: Small caps had been laggards in the late 1990s, so when the market began to sink, they were poised to hold up relatively better than large-cap darlings that had been priced for perfection.

Things looked rather different in the last recession before that, which officially lasted from July 1990 to March 1991. For the trailing six months through February 1991, the best-performing funds

included several health-care funds, but also many growth and technology funds, such as 20th Century Ultra (now American Century Ultra). The worst-performing funds were mostly gold and precious-metals funds, because the price of gold had been falling after rising sharply the previous July and August.

Caveat Emptor

As these examples show, every recession is different, despite some similarities. The 2001 recession followed the popping of a huge bubble in technology stocks and a great run for large-growth stocks in general; the current downturn has followed a dramatic slowdown in the housing market, and large-growth stocks, including many big tech names, have been in the doldrums for years. The 1990-91 recession played out against the buildup to the first Gulf War and fears of a possible oil shortage, but it was also a time when the use of computers and other technology was growing fast enough to overcome the headwinds. When the war started in January 1991 and it became apparent that it would not be a long, drawn-out affair, the stock market jumped and the recession was over soon afterward.

These examples also show that it's not a good idea to try to time the market in reaction to a recession. Someone who was defensively positioned at the time of the 2001 recession would have been in good shape, because even though the recession officially ended in November 2001, a cascade of corporate scandals, led by Enron and Worldcom, undermined investor confidence and extended the bear market for more than a year. On the other

hand, as noted above, a new bull market started even before the 1990-91 recession was over, and investors had been dumping gold and other traditional defensive investments months earlier. The market is generally very good at anticipating both recessions and recoveries, so they're often priced into the market well ahead of time.

In the end, your best bet is to make sure that your portfolio is diversified, and be prepared to ride out short-term shocks to the market. If you have a short time horizon and are really concerned about your exposure to economically sensitive areas of the market, you can use the Portfolio X-Ray tool on Morningstar Investment Research Center to get a quick estimate of your exposure.

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The Bear Market Ahead

By Toan Tran, Editor of
Morningstar GrowthInvestor

This too shall pass...

As I wrote in a recent blog post, I'm pessimistic about the potential for equity returns this year. A consumer-led recession will have a substantial effect on corporate profits, and the depressive atmosphere of a bear market will weigh on the multiples that investors are willing to pay for those profits. I want to prepare you, at least psychologically, for what is coming in the short term, but it's also important to remember that this too shall pass. The economy will take its lumps as misallocated capital is destroyed, but then the creative forces of capitalism will again be ready to take hold. It's hard not to be a long-term optimist.

Bear markets are painful and emotionally grinding, but they also present us with exceptional investment opportunities. There is an old saying that you make all your money in bear markets, you just don't know it until later. The key, however, is to keep your emotions from forcing you into bad decisions. Today, I want to talk about the emotions that suffuse a bear market, and how I believe our Growth Portfolio will be affected by a recession. If you can understand what is coming, you will be able to make decisions with your head, rather than succumb to that sinking feeling in your stomach.

An Emotional Meat Grinder

I've spent the last 10 minutes pecking at my keyboard trying to come up with a less macabre way to describe a bear market, but I can't seem to better the visceral accuracy of "emotional meat grinder." The chart found by going to <http://www.mississauga4sale.com/images/Market-Emotions-Cycle2.jpg>, widely posted on the

Web, is popular because I think it accurately captures investor emotions in both boom and bust cycles. The cascade of emotions from anxiety to denial to fear to desperation to panic to capitulation to despondency, and then finally to depression is gut-wrenching to say the least. As if that were not enough, the market may stage several rallies that bring temporary emotional relief, only to pound investors into the ground once again.

In this environment, keeping your head firmly in control of your investment decisions is extremely difficult, but exceptionally important. The only thing that matters, in any market, is the intrinsic value of our holdings. Selling your shares for less than they are worth because fear or panic grips you would be a mistake. On the flip side, you should recognize when other investors have given in to emotions and are selling shares for substantially less than they are worth. In that case, you should happily take the other side of that trade. We have a lot of cash in GrowthInvestor's Growth Portfolio, and I'm looking forward to some great bargains.

Growth Portfolio Holdings

The companies in the Growth Portfolio will have to endure a recession, though some stocks may hold up better than others. I've "bucketized" all of our holdings and here are my thoughts on some of them.

In this first bucket, I have firms that should hold up relatively well in a bear market for various company-specific reasons—companies including **MannKind MNKD** and **Cheniere Energy LNG**. The

ultimate value of MannKind, for example, doesn't depend on manufacturing output or interest rates, but rather on whether Technosphere insulin is approved by the FDA and is able to successfully find a place in multibillion dollar insulin market. The value of Cheniere is backstopped by take-or-pay contracts with major oil companies.

In the second bucket, I'm putting growth holdings such as **MSC Industrial Direct** **MSM**. Companies in this category are broadly exposed to an economic slowdown. These stocks will likely have a difficult time in the short run and in some cases intrinsic values will be impaired. For example, Morningstar analyst Matt Warren recently reduced his fair value estimate for MSC to \$53 from \$60 per share to account for a recessionary environment over the next few quarters. However, MSC and many other stocks in this bucket are rated 5 stars, and I'm content to hold on to them.

That's my quick take on some of my holdings. Please bear in mind these short-term factors will not affect my decisions to buy or sell stocks in the Growth Portfolio. I really am focused on the long-term value of these businesses. My goal is simply to prepare you for what might lie ahead during the next few quarters. Claiming to be a long-term investor is easy; putting it into practice, especially in a bear market, is hard. I want to make it as easy for you as possible to be a true long-term investor.

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Recession-Proof Your Portfolio

By Annie Sorich

There's lots of talk of a recession these days, making many investors nervous. What exactly is a recession? The technical definition is two quarters (six months) of negative gross domestic product growth. (GDP is the total market value of the new goods and services produced during a specified time span.) More simply, a recession describes a shrinking economy rather than a growing one.

Although a downturn in market performance isn't necessarily a recession, the two can go hand in hand, as the last two recessions in 1990 and 2001 suggest. Currently there's not a consensus on whether the U.S. economy is already in a recession, heading for a recession, or simply slowing down, but it never hurts to be ready. Below are a few important steps to take when the economy turns sour.

Buy, Don't Sell

We all know the old adage "Buy low, sell high." Yet that's the opposite of what some people do when the economic climate looks gloomy. The start of a recession is not the time to liquidate your investments. Depending on your time horizon, you most likely have enough time to ride out short-term stock price drops that might happen during a recession. If you're in your 30s and saving for retirement, a few market bumps will be ironed out in the long run. Still, it's important to construct your portfolio with your time horizon and risk tolerance in mind, which can help you sleep easy if the market continues to tumble.

A recessionary environment could even be a time to increase your contributions to your portfolio. Some mutual fund managers, particularly those who are attentive to valuation, have told us they've found bargains amid the market's recent volatility. For example, the team at **Longleaf Partners LLPFX** urged current investors to consider adding more to their holdings because it's finding a lot to buy right now, and it also opened the fund to new shareholders after being closed since July 2004. By continuously contributing to your portfolio, you'll participate in purchasing those deals.

Stay the Course with Dollar-Cost Averaging

With uncertainty in the air, it can be tough to stay disciplined about investing. Therefore it's a good idea to set accounts on autopilot in order to avoid the temptation of hoarding cash under your mattress. Most investors in 401(k) plans make contributions on a regular basis; you might also consider doing so with your other accounts. Dollar-cost averaging, or investing a set amount of money at regular intervals, can also help bolster your savings when the economy starts growing again. For example, say you invest \$500 a month in a mutual fund. The fund's shares are worth \$10 apiece initially, meaning you can purchase 50 shares a month. If the underlying assets appreciate a total of 20%, and now the fund's NAV is at \$12, you purchase fewer than 42 shares that month. But if the fund's NAV drops 20% to \$8 a share, your \$500 will purchase almost 63 shares. Therefore, consistent dollar-cost averaging can result in a lower overall price you pay for shares; it will also ensure that you don't lose your resolve to invest amid market turbulence.

Saving Matters

Unemployment can skyrocket when economic growth slows. Losing your job is a huge financial blow. Regardless of what the economy is doing, you should prepare for the worst by saving three- to six-months' worth of living expenses in an emergency fund. It's best to store the money in a very liquid account like a money market fund, which isn't usually subject to price drops and generally pays more interest than a regular checking or savings account.

Check Your Diversification

Still worried? Take some time to make sure your portfolio is well-diversified. A good place to start is Morningstar Investment Research Center's Portfolio tool. There you can see your portfolio's exposure to different asset classes, sectors, and world regions. In a recessionary market, it's a good rule of thumb to make sure your portfolio includes exposure to companies that should thrive in a depressed environment, such as health care and consumer staples. People need to buy food and take their medicine regardless of what the economy is doing. Exposure to foreign stocks could also be a good defense if the U.S. is the primary economy hit by a slowdown. On the flip side, you'll want to make sure your portfolio doesn't have too much allocated to cyclical sectors such as industrial materials, media, and consumer services.

Likewise, make sure your fixed-income allocation is skewed more toward high-quality bonds rather than their junkier counterparts. When the economy hits the skids, prices on bonds of lower credit

quality can precipitously drop, and make a serious dent in your savings. Yet those funds holding bonds with the highest credit quality can benefit from investors looking for a safer haven. You can investigate the overall credit quality of your bond holdings using Instant X-Ray by clicking on the Bond Style tab in the drop-down menu.

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We See a 16% Return in the S&P 500's Future

By Jeffrey Ptak, CFA, CPA

Let's cut right to the chase: Our research suggests that SPDRs Trust SPY, an ETF that tracks the S&P 500 Index, will return 16% annualized over the next three years.

Lest you wonder which hat we pulled that number out of, rest assured that there were no wands or seers involved. And because top-down macro forecasting isn't our bag (were you expecting the second coming of Bill Gross?), we kept the focus squarely on the stocks in front of us.

As it turns out, that's a lot of stocks—we cover 2,000 companies, including more than 450 of the S&P 500's constituent holdings. Therefore, we can harness the work that our analysts do in evaluating company fundamentals, such as the presence and durability of competitive advantages each business might boast. That work culminates in a fair value estimate that our analysts place on each stock they cover. We can roll up the fair value estimates that our analysts have placed on the S&P 500's holdings and, voila!, we have a fair value estimate for the index as a whole (roughly 1,600 as of Jan. 31).

But how does that get us to an expected return? We ordinarily expect a stock's price to converge to fair value over a three-year time horizon. Assuming that we compound our fair value estimate at the cost of equity—which is the minimum compensation that we demand for owning a stock—the expected return represents the return that will cause the stock's price to converge to fair value at some point in the future, not to exceed

three years. This same math holds for an index like the S&P 500, provided we have adequate coverage of its underlying assets. (The 450 S&P 500 stocks that we cover account for 99.5% of the index's assets).

Consider then that the S&P 500 was trading at a 15% discount to our fair value estimate as of Feb. 1 and that our weighted-average cost of equity for the index stands at roughly 10%. When you take the two together, it translates to a 15.89% expected return for the S&P 500. Subtract the SPDR's infinitesimal 0.09% expense ratio from that tally, and you end up with a 15.8% return.

Of course, a cushy return does not a screaming buy make. Otherwise, we'd throw caution to the wind and buy nothing but very risky stocks such as biotechs. That's why we have to consider SPDR's return in relation to its risk.

The verdict? We'd recommend the fund at these levels, as investors stand to reap a hefty 5.7% excess return (the difference between SPDR's 15.8% expected return and its 10.1% cost of equity). Put differently, investors can buy a security that's less than half as volatile as our typical below-average-risk stock at 85 cents on the dollar. We'd take that trade.

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The Credit Crunch Explained

By Toan Tran, Editor of
Morningstar GrowthInvestor

No doubt you have heard the phrase “credit crunch” numerous times during the last few weeks in relation to the problems in the secondary mortgage market and the resulting volatility in the stock market. Warren Buffett has repeatedly stated that he was baffled by the waves of liquidity sloshing around the world and warned of the risk of a seize-up in the credit markets. Buffett, of course, is right, as many debt investors are finding out with unforgiving speed. What puzzles me is how investors could ignore the plainly obvious for so long.

The primary innovation of the secondary mortgage market is that risk of default is borne by investors who are many steps removed from borrowers. Traditionally, home mortgages were kept by the local bank. If a borrower defaulted, it was the bank that suffered. Therefore, the bank had the incentive to only make loans to creditworthy borrowers. Today, with an active secondary mortgage market, lenders are able to securitize or sell their customers’ loans to investors. This, in turn, frees up the lender’s capital to make more loans. However, the danger is that there are no longer any “gate keepers” along the securitization pathway who have an incentive to shut the door on uneconomic loans.

As a result, mortgage lenders continued to extend loans to ever-more-marginal borrowers because there was a ready party in the secondary market willing pay a fancy price for those loans. At best, the debt-rating agencies relied on false information provided by borrowers, which caused them to incorrectly rate packages of mortgage loans.

At worst, the agencies perhaps compromised their institutional integrity to earn the resulting fee that came along with an adequate debt rating. The hedge fund managers, who levered up to purchase the mortgage-backed securities, were simply hoping to make it to Dec. 31 and collect a hefty, nonrefundable incentive fee. The parties left holding the bag, the investors who ultimately owned the mortgage-backed securities, were too blinded in their quest for yield to ask if the extra 200 basis points of income was really worth the risk.

Once the underlying mortgages began performing poorly, the prices of the mortgage-backed securities declined. These securities often served as collateral for hedge funds’ margin loans, so as prices declined, brokers demanded more collateral. If the fund was unable to meet the margin call, the securities would be involuntarily liquidated, leading to further price declines that sent more funds head-first into the vicious margin call cycle. After a few high-profile fund disasters, skittish investors began to withdraw capital from all funds with mortgage exposure leading to more liquidations and driving down prices even further. You can see how this story ends. Could it have ended any differently considering starting conditions described above?

The tightening of credit certainly causes many problems in the short term, but this too shall pass. Markets correct by destroying misallocated capital, and we’re certainly witnessing that now. Yes, it’s not fun to experience short-term volatility, but what is happening in the credit markets is unlikely to affect our Growth Portfolio holdings in the

long run. I'm sure five years from now Wall Street will have a different crisis to worry about. Hopefully by that time, our holdings will be worth substantially more because we were right about what really matters: the underlying economics of the businesses we own.

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Dow 18,500? Believe It

By Jeffrey Ptak, CFA, CPA

We think the Dow Jones Industrial Average will rise more than 6,000 points to roughly 18,500 over the next three years.

How We Arrived at That Estimate

The Dow was trading at a very hefty 17% discount to our estimate of its fair value, which stood at around 14,000 as of Feb. 7, 2008. We base that fair value estimate on the fair value estimates that our equity analysts have placed on the Dow's 30 component stocks. The Dow hasn't looked this cheap to us since September 2002 when the index stood at 7,592.

When we take the Dow's market price and fair value estimate together with its 9.7% weighted average cost of equity (our analysts assign a percentage cost of equity to every stock they cover, including all of the Dow's components), it translates to a 17% annualized expected return. In other words, this is the return an investor would reap if the prices of the Dow's components converged to our fair value estimates over a three-year holding period (not ad infinitum).

To isolate the Dow's expected price return—which is what directly influences the index's value—we deducted the benchmark's 2.2% dividend yield from the 17% annualized return we derived. When we compound the Dow's closing value on Feb. 7 by this 14.8% annualized price return, we arrive at an 18,510 index value.

No Top-Down, No Short Cuts

Notice what's absent from the approach we've taken: a top-down macroeconomic overlay of any kind. For instance, we're not guesstimating the short-term direction and level of interest rates, the trajectory of the dollar, the size of the trade deficit, and so forth. Nor are we shortcutting our way to a forecast by, say, ginning up an aggregate earnings growth projection or trying to handicap where earnings multiples and yields are likely to settle in three years. Methods like these are notoriously imprecise. So, we don't use them.

Instead, we've built our forecast one company at a time by rolling up the fair value estimates that our analysts have placed on the Dow's components. When our analysts estimate a firm's intrinsic worth, they're forecasting cash flows over a very long time horizon. Therefore, while we're mindful of how the economy could impact a firm's results in the near term, it doesn't govern our outlook. In short, we think that a business' value is a function of the cash it's likely to generate over many years, not the next few quarters or so.

What the Market Is Missing

That distinction becomes very plain when we take a closer look at many of the Dow's cheapest names. To that end, we've published a companion piece—"Anatomy of a Bargain: Diamonds Trust"—in which we more closely examine why many of the Dow's components look so darn cheap. This article is included in this booklet on page 16.

In that piece, you'll find a synopsis of the Dow's valuation from a high level and our take on

whether it's a bargain or not. What's more, we've canvassed our analysts to get their perspective on what the market is missing, so to speak, in its valuation of some of the Dow's cheapest names. For each of those stocks, we've provided a capsule summary of why our analysts think these firms are so inexpensive to begin with.

Caveat

In summary, our research suggests that the Dow will rise more than 6,000 points in the next three years. However, there were only about 1,750 points separating the Dow's recent 12,247 index value from our 14,000 fair value estimate. So, where do the other 4,250 or so points come from? In a nutshell, they come from the Dow's weighted average cost of equity.

Let us explain. Our fair value estimates aren't static. They compound over time at a certain rate—the COE. That compounding is meant to reflect the ongoing receipt of cash flows, which gradually increase a company's intrinsic worth. Therefore, if a firm's actual results (i.e., cash flows) roughly approximate what we've forecast, then that business' intrinsic worth should increase at the cost of equity.

Let's take IBM for example. We have a \$120 fair value estimate on that stock. Provided that the firm hauls in cash at the pace we've forecast, we'd expect IBM's fair value to approach \$131 in one year (\$120 fair value compounded at stock's 9.5% cost of equity over 12 months), \$144 in two years, and \$158 in three years. Those increases

are attributable to the incremental receipts of cash flow that take place.

Logic notwithstanding, the caveat is that if our fair value estimates don't compound at the cost of equity, then the Dow won't be worth the 18,510 we're projecting in three years.

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Anatomy of a Bargain: Diamonds Trust

By Jeffrey Ptak, CFA, CPA

Judging from the valuation of its underlying holdings, **Diamonds Trust DIA**, an exchange-traded fund that tracks the Dow Jones Industrial Average, looks very cheap to us. As of Feb. 7, 2008, the fund was trading at a hefty 17% discount to our estimate of the portfolio's intrinsic worth. That's the cheapest the fund has been since September 2002.

Bargain-Hunting

Where are the bargains? You don't have to squint very hard to spot them in the fund's portfolio: Eighteen of Diamonds' 30 holdings were trading at least 15% below their intrinsic worth as of Feb. 7, and 13 of those names were at 20% or greater discounts. Only two names—**McDonald's MCD** and **AT&T T**—were hovering at, or slightly above, fair value.

All told, 19 of Diamonds' 30 names garner 4- or 5-star ratings from our analysts and none carries fewer than 3 stars.

Diamonds: Good as Gold?

But does that make the fund worth buying? To answer that question, we have to evaluate the portfolio's risk, as the fund's riskiness will determine the discount to fair value we'd demand before recommending it.

So what about Diamonds' risk? Generally speaking, the portfolio has a pleasing risk profile. Many of the Dow's components—which include the likes of Microsoft MSFT, Wal-Mart WMT, and Citigroup C—are among the highest-quality firms that we cover. Most boast competitive advantages of some sort. In fact, our analysts have awarded

wide economic moat ratings to 21 of the fund's holdings, which collectively soak up around 72% of assets.

Not coincidentally, there are very few businesses in the portfolio that we'd consider excessively risky. Our analysts consider 13 of the fund's 30 holdings—representing roughly half of the fund's assets—to be below-average risks. And the only two names that pose above-average risk—**Altria MO** and **GM GM**—account for only 7% of assets. The portfolio is also well-diversified across stocks and industries. For instance, IBM sits alongside ExxonMobil XOM in the portfolio's upper rungs. That diversification has kept a lid on volatility.

Given this, we wouldn't demand a significant margin of safety before recommending Diamonds, as the fund doesn't pose extreme risks. We'd be buyers anytime the fund traded at an 8% or greater discount to our fair value estimate.

In that light, the fund positively gleams, as it was recently trading 17% below what we think it's worth. That affords a margin of safety, and plenty more.

What the Market Is Missing

Still, the question naturally arises: What's the market missing? Why are these names so cheap?

With that in mind, we thought we'd take a deeper dive into the portfolio to examine what's driving the fund's valuation. We canvassed our analysts to get their take on what's creating the

disconnect between our assessment of these businesses' intrinsic worth and the value the market is pricing into the shares. We've set forth their capsule summaries below.

You'll hear a few recurring themes: One is that while economic weakness is likely to weigh on some of these firms' results in the near term, that doesn't have a disproportionate impact on our fair value estimates. Why? We think that the best measure of a firm's value is the cash flow it produces over the long haul. Although some market participants view "long" in relative terms (i.e., two quarters from now), our analysts forecast results over many years. This affords us the ability to look beyond near-term murkiness and focus on enduring sources of value creation—such as whether a firm possesses a durable competitive advantage and what benefits it's likely to confer many years hence.

Also, many of these firms do a lot of business abroad. For instance, in 2006, the top eight names—IBM, ExxonMobil, Boeing United Airlines, Caterpillar, Procter & Gamble—realized a whopping 62% of their net revenue outside of the United States. The market seems to be discounting these firms' global diversification—and the superior growth that many developing markets are likely to furnish in the future—in its rush to sell.

Here's our analysts' take on some of the Dow's cheapest names.

IBM

Analyst Rick Hanna thinks the market is pricing a recession into IBM's shares but not considering the recurring nature of the revenue from the company's software and services units, which comprise approximately 60% of IBM's business. What's more, businesses still appear willing to continue to spend on information technology to grow, reduce costs, and develop new capabilities. That has benefited IBM's services businesses, which have shown strong year-over-year growth, short-term bookings, and total order backlog. In addition, Hanna expects IBM to exploit several pockets of growth within the information technology universe, including storage and a high-end server product line. Finally, Hanna points out that the opportunities in information technology are global, a fact underscored by IBM's European and Asian revenue growth, which has been roughly triple that of its domestic business.

Boeing BA

5.29% weighting | 0.70 price/fair value

The market continues to focus on the possibility of further production delays of Boeing's game-changing 787 Dreamliner, the first commercial airplane made mostly of lightweight composites. And although analyst Brian Nelson thinks further delays are more likely than not, concerns over penalty payments and cost overruns are severely overblown in his opinion, throwing by the wayside both the stability of Boeing's defense business and the strong demand for its in-production commercial airplane programs. Boeing is also being weighed down by concerns over a potentially

deteriorating global economy, which would increase the likelihood of cancellations or deferrals by airplane customers. However, even after factoring in an aggressive cancellation rate, the jet maker would still have about four to five years' worth of deliveries in a backlog that is much more geographically diverse than it has been in years past. Finally, Nelson thinks the market is heavily discounting expectations for double-digit earnings-per-share growth over the next three years and a return to normalized free cash flow, which, when achieved, would imply a double-digit free-cash-flow yield at the current share price.

3M

5.25% weighting | 0.82 price/fair value

Although 3M's 2007 results reflect a continued slowdown in U.S. sales, the firm's international operations remain strong. Analyst Adam Fleck acknowledges that a potential economic recession could materially weaken much of the firm's consumer-product-driven business. But Fleck notes that many segments—especially the firm's health-care and safety, security, and protection units—enjoy more inelastic domestic demand and account for a much larger piece of the company as a whole. Similarly, Fleck believes 3M's international supply-chain improvement initiatives will continue driving solid growth abroad. Finally, with returns on invested capital north of 20%, Fleck thinks the conglomerate can make bolt-on acquisitions relatively cheaply during a downturn, ensuring further long-term success.

Johnson & Johnson JNJ

4.17% weighting | 0.79 price/fair value

Analyst Damien Conover believes the market is focusing on Johnson & Johnson's patent expirations within its pharmaceutical business and missing the strength across several of the company's other business segments. Although Conover expects patent losses on antipsychotic Risperdal and neuroscience drug Topamax will slow the company's growth in the near term, he expects Johnson & Johnson's leading position in several other health-care businesses to offset this weakness. In particular, with the purchase of Pfizer's consumer health-care business, Johnson & Johnson is well positioned in the consumer care industry.

American International Group AIG

3.43% weighting | 0.62 price/fair value

Analyst Matt Nellans contends AIG's stock-price decline largely relates to the panic-selling across the entire mortgage market. True, AIG has invested billions of dollars in mortgage-backed securities and written credit default swaps on securities collateralized by subprime mortgages. However, Nellans believes the market is ignoring the fact that the vast majority of AIG's exposures have plenty of subordination—that is, mortgage defaults must be catastrophic for AIG to incur a permanent capital loss.

Wal-Mart WMT

3.31% weighting | 0.83 price/fair value

In analyst Joseph Beaulieu's opinion, Wal-Mart currently has two major problems: Its core customer is a bit light in the wallet, and its apparel and housewares businesses suffer from poor merchandising. The first problem isn't permanent, and the second is fixable. Another factor that people tend to overlook is that while Wal-Mart has pledged to rein in new store growth, the company can't turn on a dime given the sheer amount of time it takes to identify sites, obtain the required permits, and build a store. In the interim, while the company generates massive amounts of operating cash flow, much of it will continue to go into new stores. Over time, however, more of this cash will be freed up for other uses, such as addressing the company's aforementioned merchandising problems. Beaulieu thinks that if the company can solve its merchandising problems and slow new store additions to prevent cannibalization at existing stores, earnings, operating cash flow, and free cash flow should improve sharply. He also points out that if we're moving into a period of higher inflation, there isn't any retailer in the world that's in a better position to force suppliers to eat their share (and then some) of those price increases. That's where Wal-Mart's wide moat could really come to the fore.

American Express AXP

3.08% weighting | 0.66 price/fair value

In the U.S., you can get a credit card from multiple providers, and your bank won't always be your first choice. The large banks are among the largest card issuers, but American Express is putting up a

decent fight. Card companies have been in the hot seat lately, as many investors became concerned about their prospects following the mortgage debacle. After all, why would people keep spending money on their credit cards if they cannot afford their mortgages? Although these are legitimate concerns, analyst Michael Kon thinks they are short-lived. Even if the U.S. slips into a recession, the long-term prospects of the card companies aren't as bleak as many expect. Credit quality of card loans is going to deteriorate and growth will slow over the next five years, but Kon points out that we account for all of that in our models and we still think that the card companies trade below the value of the cash flow we expect them to produce in the long run. What's more, AmEx has seen a gradual shift away from travel and entertainment related expenditures (which are more cyclical by nature) toward everyday consumer needs, such as gas and groceries. That spending should, we think, help buffer AmEx somewhat from a consumer-spending slowdown.

J.P. Morgan Chase & Co.

2.99% weighting | 0.72 price/fair value

Although J.P. Morgan didn't do much wrong in 2007—it posted its best year ever—its stock has been dragged down by association anyway. Analyst Ganesh Rathnam does not expect the bank to emerge from the industrywide downturn unscathed, explaining why he has factored losses into his valuation of the bank's shares. J.P. Morgan chief Jamie Dimon's leadership has been prescient in avoiding the subprime trainwreck. Rathnam believes that Dimon's astute manage-

ment and foresight will help the bank weather the downturn far more successfully than its peers.

Alcoa AA

2.18% weighting | 0.73 price/fair value

Alcoa is in the midst of a large-scale reorganization that will focus the company on its core businesses of alumina mining and aluminum smelting. In the process, the company has dumped poor-performing business units at attractive prices. This provides the double whammy of improved profitability going forward as well as a hoard of cash to repurchase shares. In analyst Scott Burns' view, the impact of these moves has created financial statements that can be best described as "muddled" and that mask the firm's improved overall long-term position. On top of this restructuring, the industry also continues to consolidate, benefiting Alcoa by not only helping firm up aluminum prices, but also by making the company a potential target itself.

Microsoft MSFT

1.87% weighting | 0.80 price/fair value

Microsoft's sheer size has prevented it from exploiting new opportunities fast enough to react to emerging threats (e.g., Google GOOG is now the dominant search engine). However, the software industry is in perennial change, and advantages can shift. New trends like the software-as-a-service (SaaS) model (in which applications are delivered on demand over the Internet and customers pay for software usage instead of owning it) present a new set of opportunities and challenges. For instance, analyst Toan Tran thinks because it would cost billions to provide SaaS on a large

scale, there are tall barriers to entry to that business, and Microsoft, with its huge war chest, could exploit that. Although Tran is pessimistic on Microsoft's hostile bid to acquire Yahoo (and is likely to cut his fair value estimate for Microsoft if the deal is consummated), the shares still look cheap.

Walt Disney DIS

2.11% weighting | 0.79 price/fair value

In addition to creating great content, Disney has been very successful in exploiting that content through box office and home video sales, television network licensing, sequels, theme park attendance, and merchandising. As content migrates to digital platforms, Disney looks to find new ways to attract and retain customers. To that end, the firm has been very aggressively distributing its content through its own Web site and third parties such as iTunes. The market, however, is preoccupied with Disney's other major media property, ABC. The rise of cable television, the emergence of the Internet, and the proliferation of DVRs is leading to lower ratings for the major networks, including ABC. The ongoing writers' strike is likely to depress earnings as well. However, analyst Larry Witt estimates that ABC represents less than 10% of Disney's operating income and is not a significant driver for his fair value estimate.

Home Depot HD

1.89% weighting | 0.65 price/fair value

While analyst Brady Lemos thinks the slowing housing market could pressure Home Depot's shares over the next few quarters, he expects

the retailer to weather the storm and emerge as a more-dominant force in the home-improvement market. Lemos believes that by updating its stores and adding more full-time sales associates, Home Depot is positioning itself for profitable growth over the long haul. In Lemos' view, Home Depot has one of the widest economic moats in retail thanks to its scale advantages and prime real-estate portfolio. These competitive advantages should help protect the firm in the event of an economic downturn, and reap dividends once the housing market rebounds. The market is currently-pricing virtually zero growth into Home Depot over a three-plus-year time horizon, and that view is far too bearish in Lemos' book.

Citigroup C

1.77% weighting | 0.56 price/fair value

Analyst Ganesh Rathnam believes the market is missing the forest for the trees in its valuation of Citigroup shares. No doubt 2007 was a miserable year for the bank, as its internal controls failed spectacularly. All told, the bank wrote down its subprime securities to about 40 cents on the dollar, raised capital to strengthen its balance sheet, and retrenched its workforce to reduce expenses. Although the losses and capital infusions did destroy economic value, Rathnam believes the market is discounting in much steeper losses than is warranted, presenting a great buying opportunity for investors in the process.

Pfizer PFE

1.50% weighting | 0.73 price/fair value

Analyst Damien Conover believes the market has placed too much emphasis on the company's weak Phase III pipeline and patent losses on several blockbusters. While he expects Pfizer will likely generate flat to slightly down top-line growth over the next 10 years, Conover believes the company can employ external strategies to grow sales. With more than \$22 billion in cash, Pfizer can acquire growth opportunities through acquisitions. Through internal advancement and acquisitions, Pfizer's Phase III pipeline should grow over the next 18 months. This should increase the market's cash-flow projections and boost the firm's stock.

Intel INTC

1.33% weighting | 0.77 price/fair value

Intel has further cemented its dominant position in the microprocessor market over the past year, at the expense of smaller rival Advanced Micro Devices (AMD). After several quarters of strong PC demand, there are fears that we will now begin to see a cyclical slowdown in the industry. Nonetheless, analyst Andy Ng believes that the processor market should continue to see decent growth over the longer term, especially from emerging economies around the globe. Ng thinks that Intel's wide moat, combined with recent cost-cutting efforts, will allow the firm to generate impressive profits for years to come.

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