

# Fact Sheet: The Morningstar® Rating for Stocks

## Investor Benefits

- ▶ Provides an indication of whether a stock is overvalued or undervalued based on the forward-looking estimates of Morningstar's equity analysts
- ▶ Offers up-to-date, daily insight into the valuation of more than 2,000 companies globally
- ▶ Leads investors to well-run businesses trading at reasonable prices—not simply to fads or “story stocks”

Our goal with the Morningstar Rating for Stocks is to help investors answer the most difficult question in stock investing: Is a company worth the price that the market is asking for its shares? To shed light on this question, we calculate star ratings that represent our opinion of the firm's intrinsic value relative to its market price.

## What It Means for Investors

There are three key components to the Morningstar Rating for stocks; our analysts' estimate of the stock's fair value; our uncertainty about how tightly we feel we can bound that fair value; and the stock's current market price. Our fair-value estimates are based on our projection of a company's future cash flows, and our estimate of the appropriate discount rate to apply to those cash flows. Our analysts follow their companies daily, and if their inputs change, we update our assessment of the stock's fair value. (See the Morningstar Equity Research Methodology for

more information on how our analysts arrive at their estimates.) In comparing our fair-value estimate to each stock's current market price, we also consider our level of uncertainty—low, medium, high, very high, or extreme—about how tightly we feel we can bound the fair-value estimate. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating. Factors that influence our uncertainty rating are sales predictability, operating leverage, financial leverage, and a firm's exposure to contingent events. There are no predefined distributions of stars—that is, the percentage of stocks earning 5 stars can fluctuate daily—so the star ratings can also be used as a general gauge of the broader market's valuation.

## Frequently Asked Questions

### How does the Morningstar Rating for stocks differ from the Morningstar Rating for funds?

Because stocks and funds are very different types of investments, our stock and fund ratings are designed to do two different things. The Morningstar Rating for funds describes how well a fund has balanced return and risk or volatility in the past. The Morningstar Rating for stocks uses projections of a company's future operating performance to estimate whether the stock is currently overvalued or undervalued.

### How do you choose the companies that receive a Morningstar Rating for stocks?

Currently, our coverage list exceeds 2,000 stocks. These are generally the largest companies in terms of market capitalization and sales across more than 130 industries globally. We also rate stocks that aren't as well known, but that we think have wonderful businesses that would make attractive investments at the right price.

### What are the key factors in the Morningstar Rating for stocks?

The Morningstar Rating for stocks:

- ▶ Is a measure of whether or not the stock is over or undervalued based on forward-looking estimates
- ▶ Is adjusted for uncertainty
- ▶ Is based on both quantitative and subjective inputs—it includes analysts' opinions, which are embedded in their estimates of future cash flows
- ▶ Is calculated daily
- ▶ Does not divide stocks into comparison groups, nor does it have a fixed distribution of stars—the percentage of stocks receiving 5 stars will fluctuate daily

## Morningstar's Approach to Rating Stocks

### Our Key Investing Concepts

- ▶ Economic Moat™ Rating
- ▶ Discounted Cash Flow
- ▶ Discount Rate
- ▶ Fair Value
- ▶ Uncertainty
- ▶ Margin of Safety
- ▶ Consider Buying/Consider Selling
- ▶ Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based

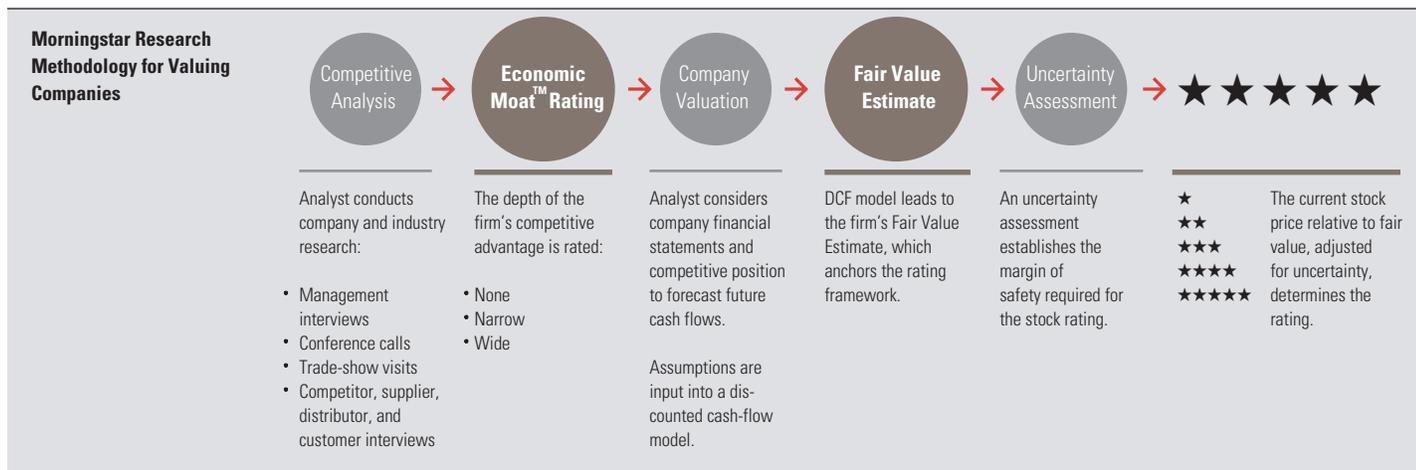
just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at \$40 than they were at \$50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

### Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such



## Morningstar's Approach to Rating Stocks (continued)

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economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

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### Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

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### Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

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### Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

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### Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High,

Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

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### Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth. The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

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### Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

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### Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."

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