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# Morningstar's Best Ideas for 2019 and Beyond



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MORNINGSTAR®

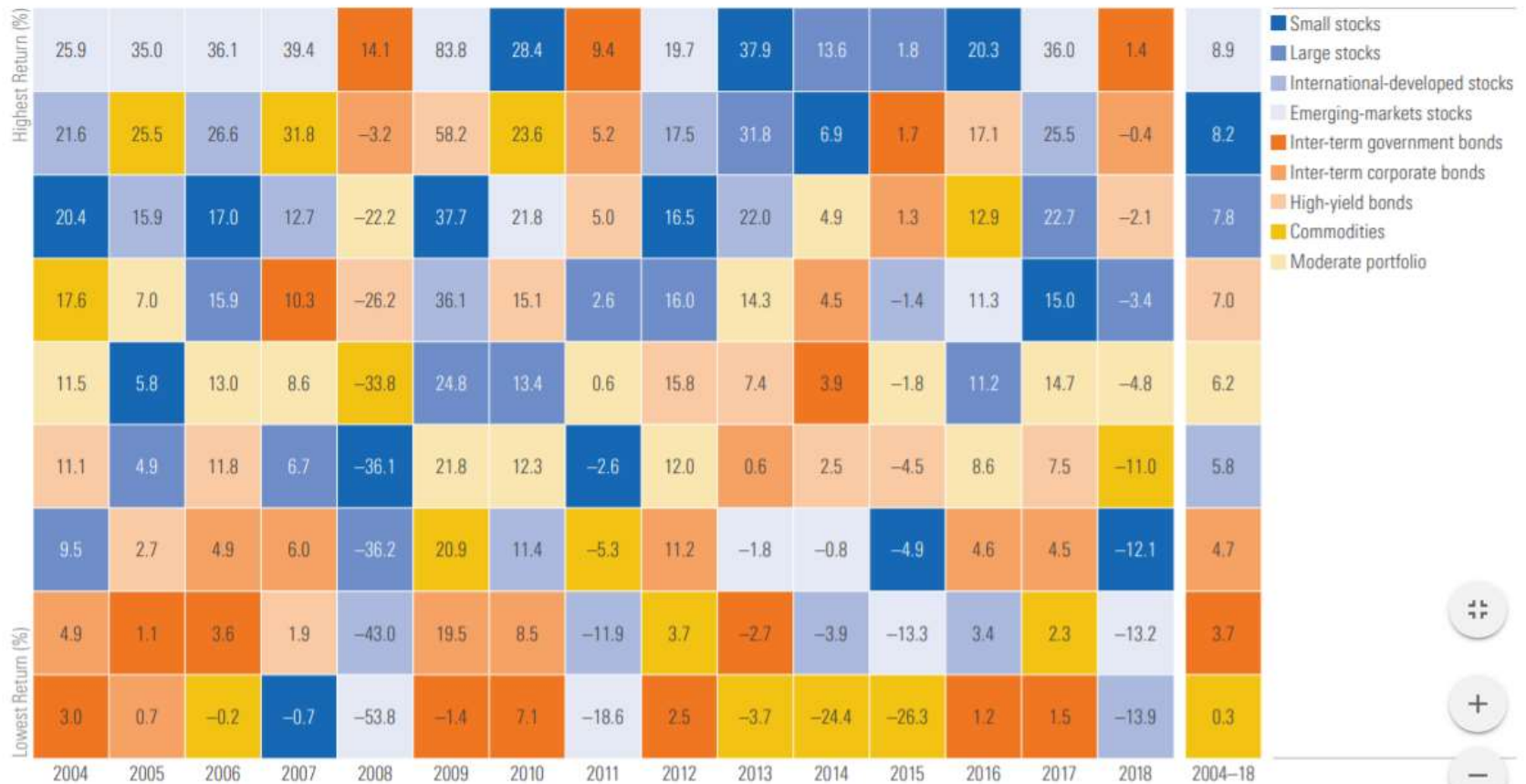
## Morningstar Overview and Philosophy

- We provide financial information and research to individuals, advisors, and institutions
- We believe our competitive edge comes through bottom-up research; we have a huge database of information
- We're best known for our fund and stock research, but also conduct research on asset allocation and retirement planning.
- 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.
- For managed products and all types of financial services, Jack Bogle said it best: "Costs matter."

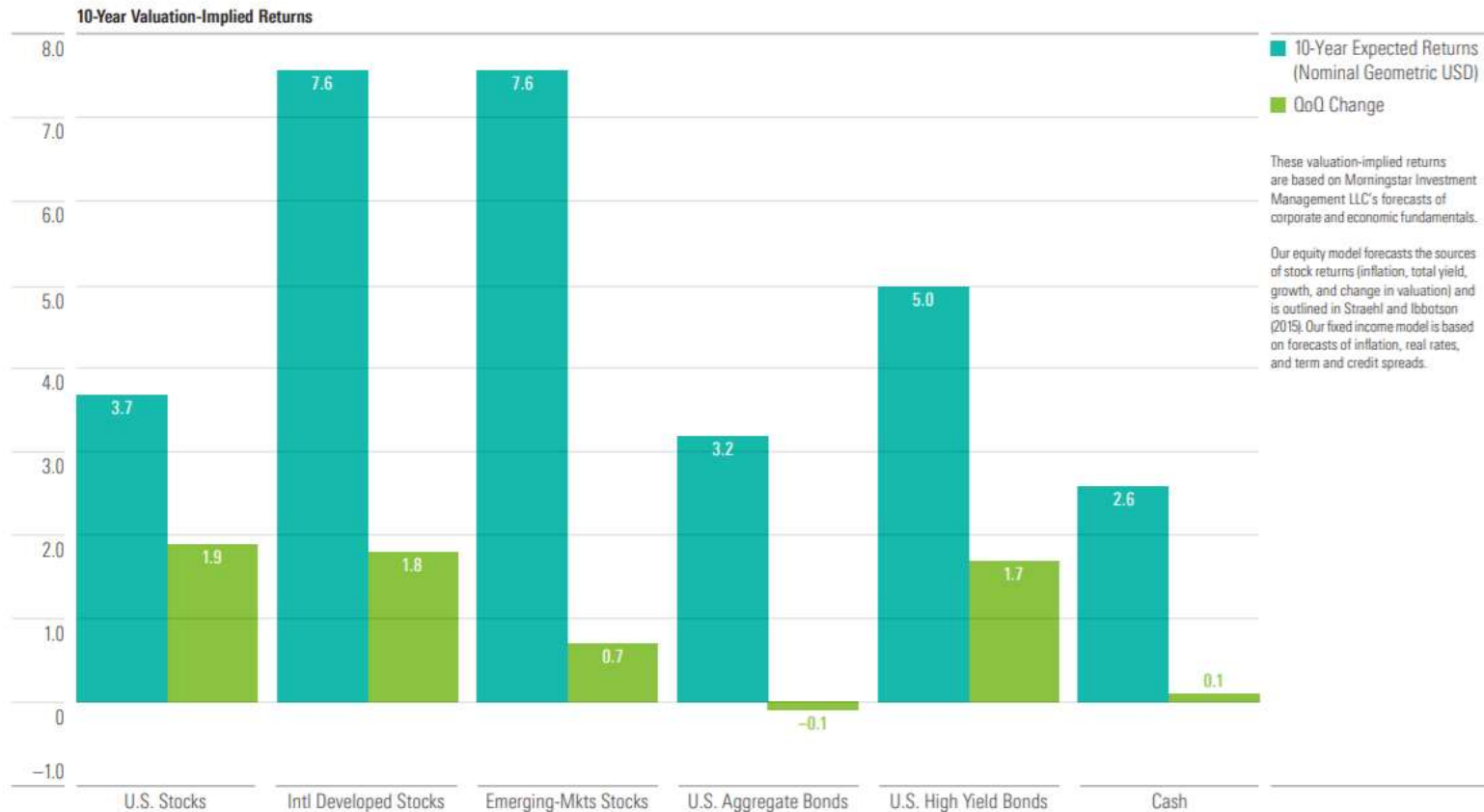
## Ground Rules for Best Ideas

- Investors can successfully employ an element of opportunism in their portfolios, provided they:
- Are operating with a sensible long-term asset-allocation mix
- 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



# Fairly High Valuations = Muted Returns for U.S Stocks and Bonds



## Outside Experts Corroborate That Pessimism

- Jack Bogle (October 2018)
  - 4-5% nominal returns for U.S. stocks over next 10 years
  - 4% returns for bonds
- JP Morgan (October 2018)
  - 5.25% nominal returns for U.S. stocks over next 10-15 years
  - 4.5% nominal returns for U.S. investment grade corporates
- Research Affiliates (Dec. 2018)
  - 0.7% real returns for U.S. large caps over next 10 years
  - 0.5% real returns for Bloomberg Barclays Aggregate over next 10 years

Let That Sink In for a Sec





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



Valuation

Updated: [View Market Fair Value By All Stocks, Sector, Moat, or Market Capitalization](#)



## Morningstar Wide Moat Focus Index

More...

Name	Ticker	Morningstar Rating	Last Close Price	Fair Value Estimate	Price/Fair Value	Moat Rating
Allergan PLC	AGN	★★★★★	138.8	240.00	0.58	Wide
Amazon.com Inc	AMZN	★★★★	1638.01	2200.00	0.74	Wide
American Express Co	AXP	★★★	107.0	110.00	0.97	Wide
AmerisourceBergen Corp	ABC	★★★★	85.79	106.00	0.81	Wide
Amgen Inc	AMGN	★★★	188.43	205.00	0.92	Wide

Found on Morningstar.com  
"Markets" tab

# Our Global Coverage Universe = 3% Undervalued as of 2/12/19

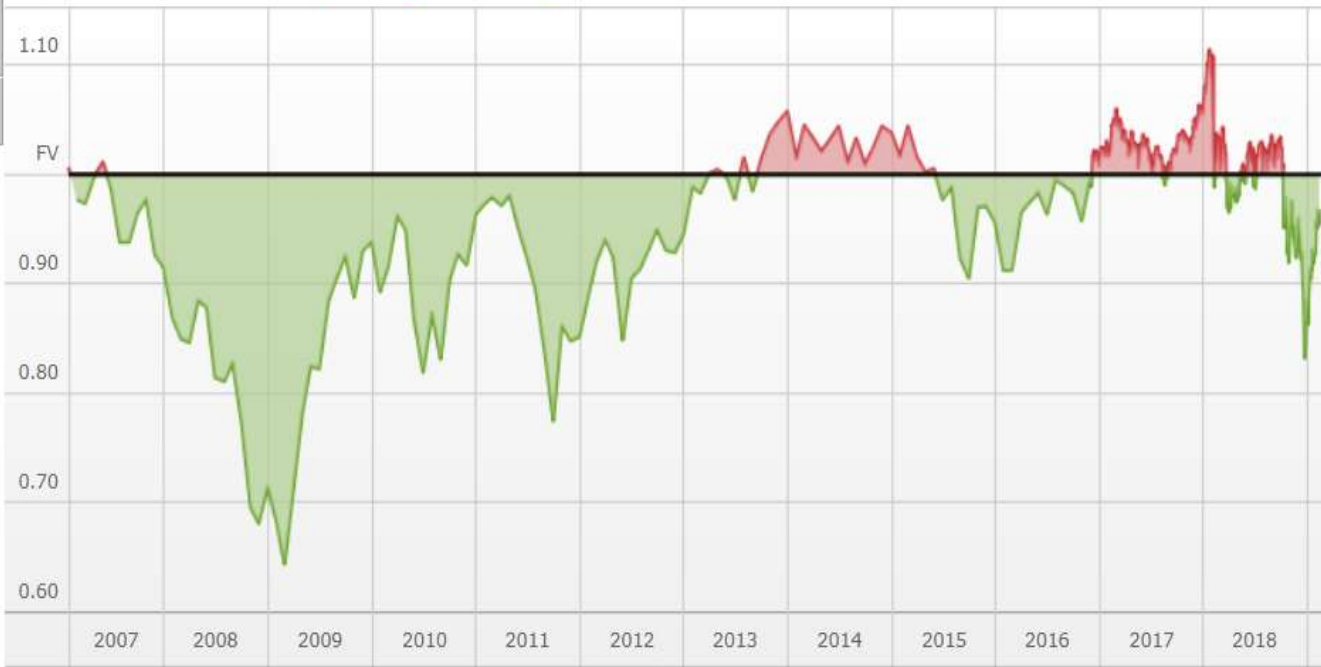
All Rated Stocks

1 Mo 3 Mo YTD 1 Yr 3 Yr 5 Yr **MAX**

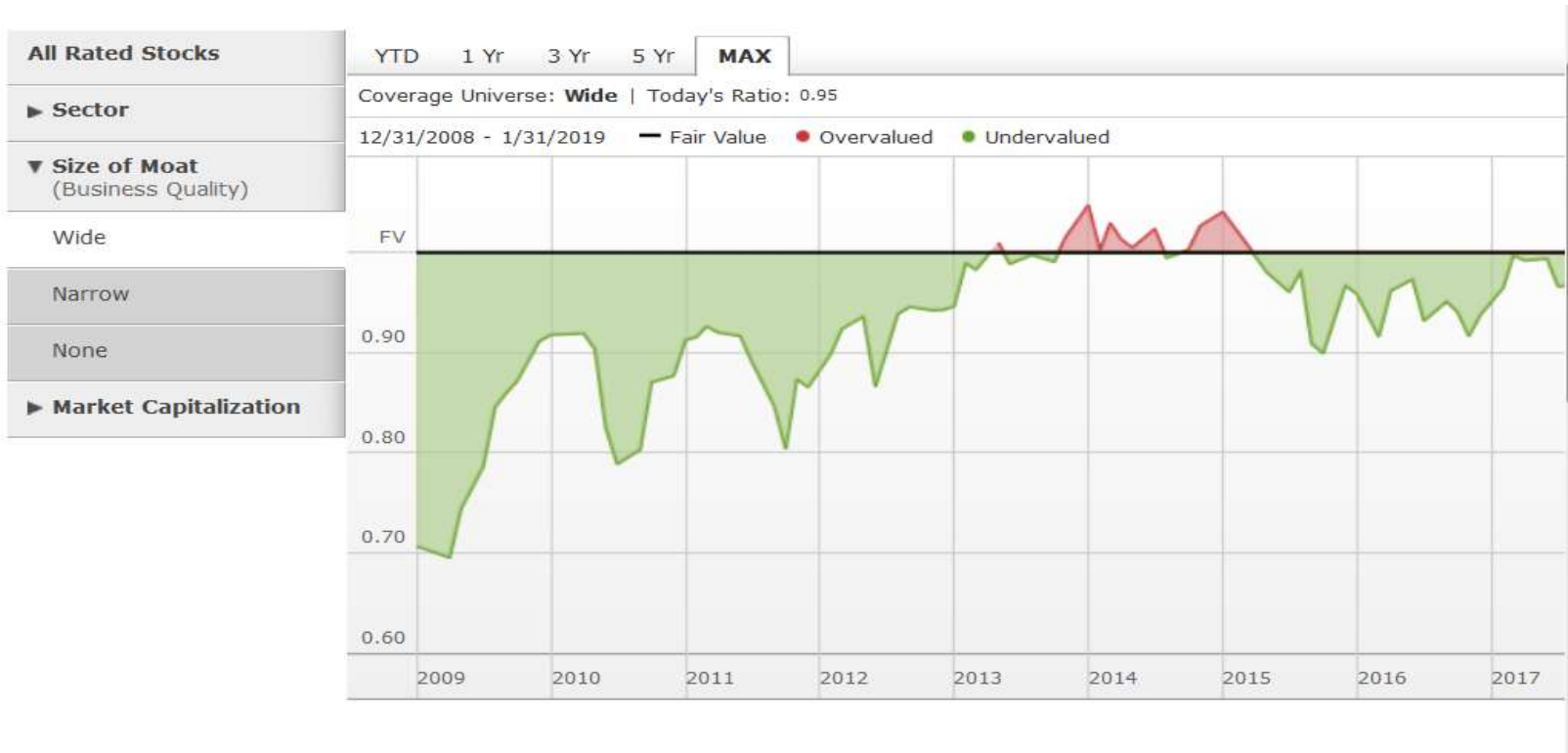
- ▶ Sector
- ▶ Size of Moat (Business Quality)
- ▶ Market Capitalization

Coverage Universe: **All Rated Stocks** | Today's Ratio: 0.97

1/31/2007 - 2/12/2019 — Fair Value ● Overvalued ● Undervalued



# Wide-Moat Companies' Valuations in Line with Broad Market's



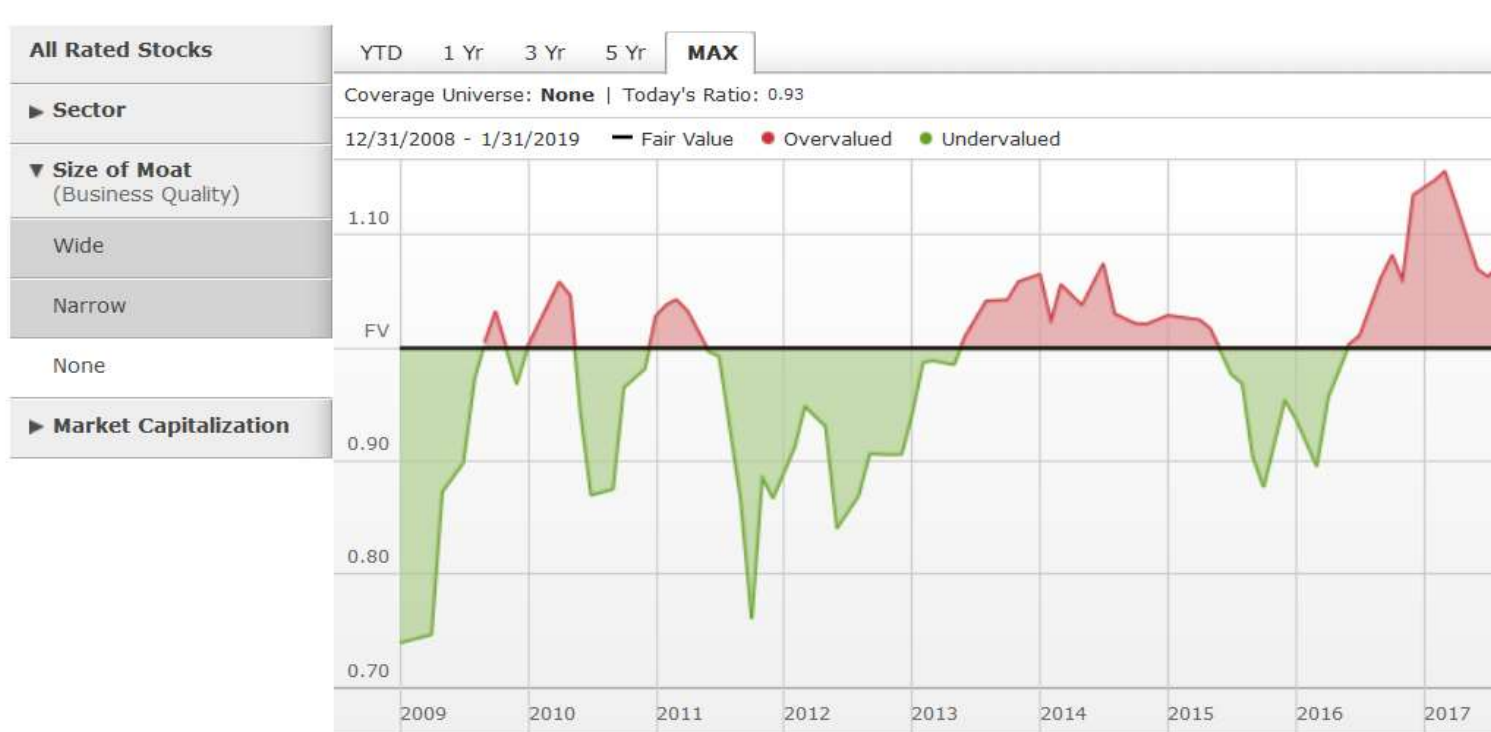
Wide economic moat examples (12% of coverage universe) include Altria, BlackRock, Alphabet (Google), Harley-Davidson, Amazon.com.

# Narrow Moats: A Hair Cheaper But Not Meaningfully So



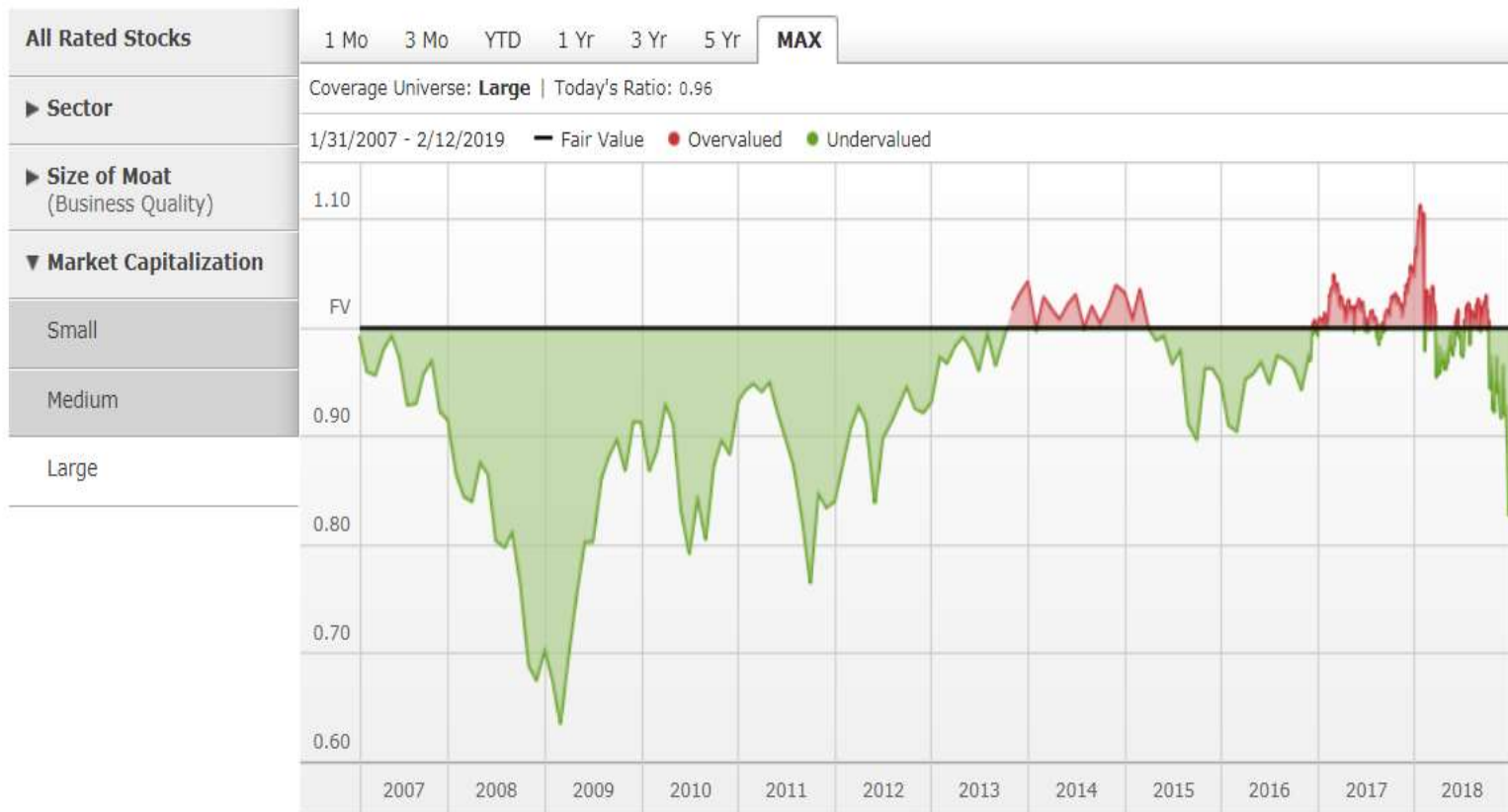
Narrow economic moat examples include Citigroup, Lululemon, Chipotle. Within our coverage universe, 42% of companies have narrow moats.

# No Moats: In Line with Narrow Moats



Examples of companies with *no* economic moats include Allstate, Dick's Sporting Goods, Honda Motor, Southwest Airlines. (46% of stocks in our coverage universe do not have moats.)

# Large Stocks Look a Touch Cheaper Than Small and Midsize But Not Especially Cheap



## The Sector Lens: Few Screaming Buys

### *Economically Sensitive Cyclical*

Communications Svc.

P/FV: 0.90

Energy P/FV: 0.86

Industrials: 0.97

Technology: 0.95

Basic Materials: 0.91

Consumer Cyclical P/FV:  
0.98

Financial Services P/FV:  
0.92

Real Estate 1.03

### *Defensive*

Consumer Defensive  
P/FV: 1.00

Utilities P/FV: 1.07

Health P/FV: 1.03

Data as of 2/12/2019.

## Best Ideas for Equity Investors

5 stars (low market valuations relative to our estimates of fair value), wide moats, and low uncertainty ratings (2/12/19)

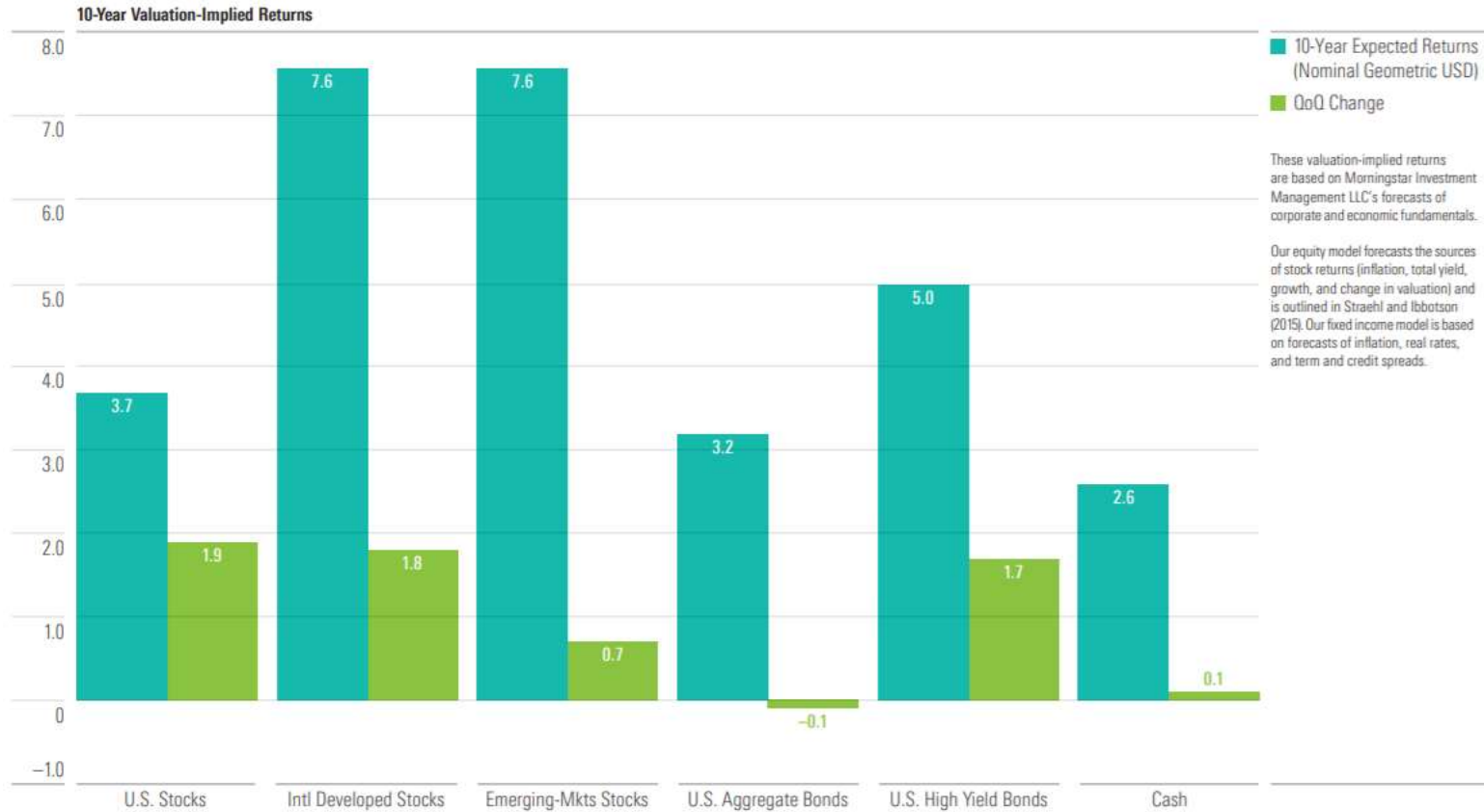
- Altria MO
- AnheuserBusch InBev BUD (5)
- British American Tobacco BTI
- Colgate Palmolive CL
- Dominion Energy D
- Enterprise Products Partners EPD
- General Mills GIS
- Imperial Brands PLC IMBBY
- Magellan Midstream MMP
- Pepsico PEP
- Philip Morris International PM
- Pfizer PFE
- Procter & Gamble PG
- Reckitt Benckiser Group RBGLY
- Roche Holdings RHHBY
- Unilever UL



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

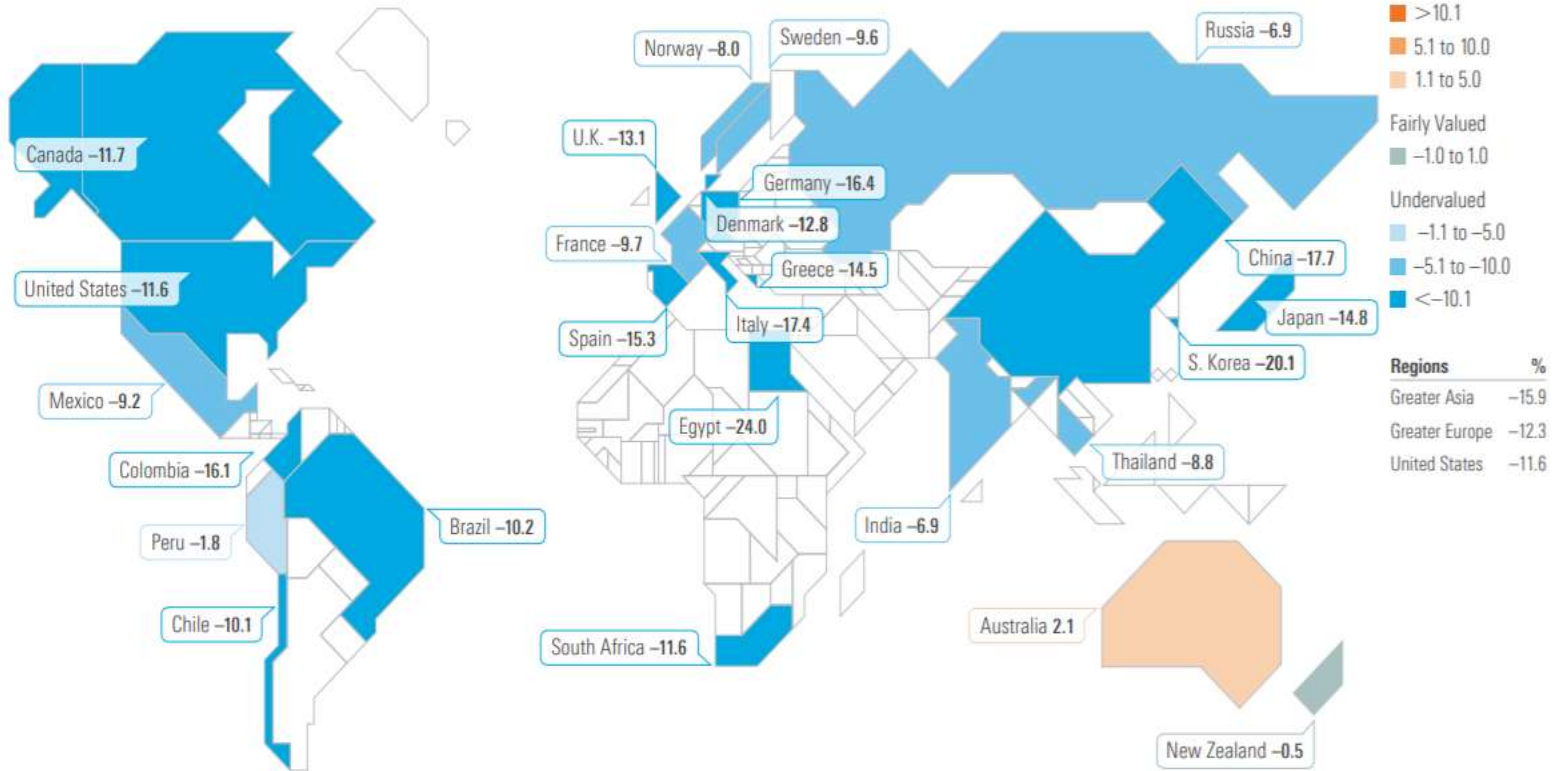
- In a fairly valued market, seems reasonable to focus on quality, dividends, valuation
- Top-rated large-cap funds with such an emphasis:
  - AMG Yacktman YACKX
  - Jensen Quality Growth JENSX
  - Mairs & Power Growth MPGFX
  - T. Rowe Price Blue Chip Growth TRBCX
  - Vanguard Dividend Appreciation VDADX/VIG
  - Vanguard High Dividend Yield Index VHDYX/VYM

# Prospects Look Better for Non-U.S. Equities Over Next Decade



# Foreign Stocks: Pockets of Value Relative to U.S.

Market-Cap-Weighted Valuation



Data as of 12/31/2018.

## Foreign Stock Takeaways

- Lower starting valuations suggest better returns from foreign stocks than U.S. over the next decade
- Morningstar's research calls for high returns from both developed and emerging markets
  - Expected return developed foreign equities over next 10 years: 7.6%
  - Expected return emerging markets equities over next 10 years: 7.6%
- Some market experts believe emerging markets equities still have significant upside
  - GMO: 4% real returns for emerging markets equities over next 7 years
  - Research Affiliates (valuation-dependent model): 8% real return on emerging markets equities over next decade

## Best Ideas for International Fund Investors

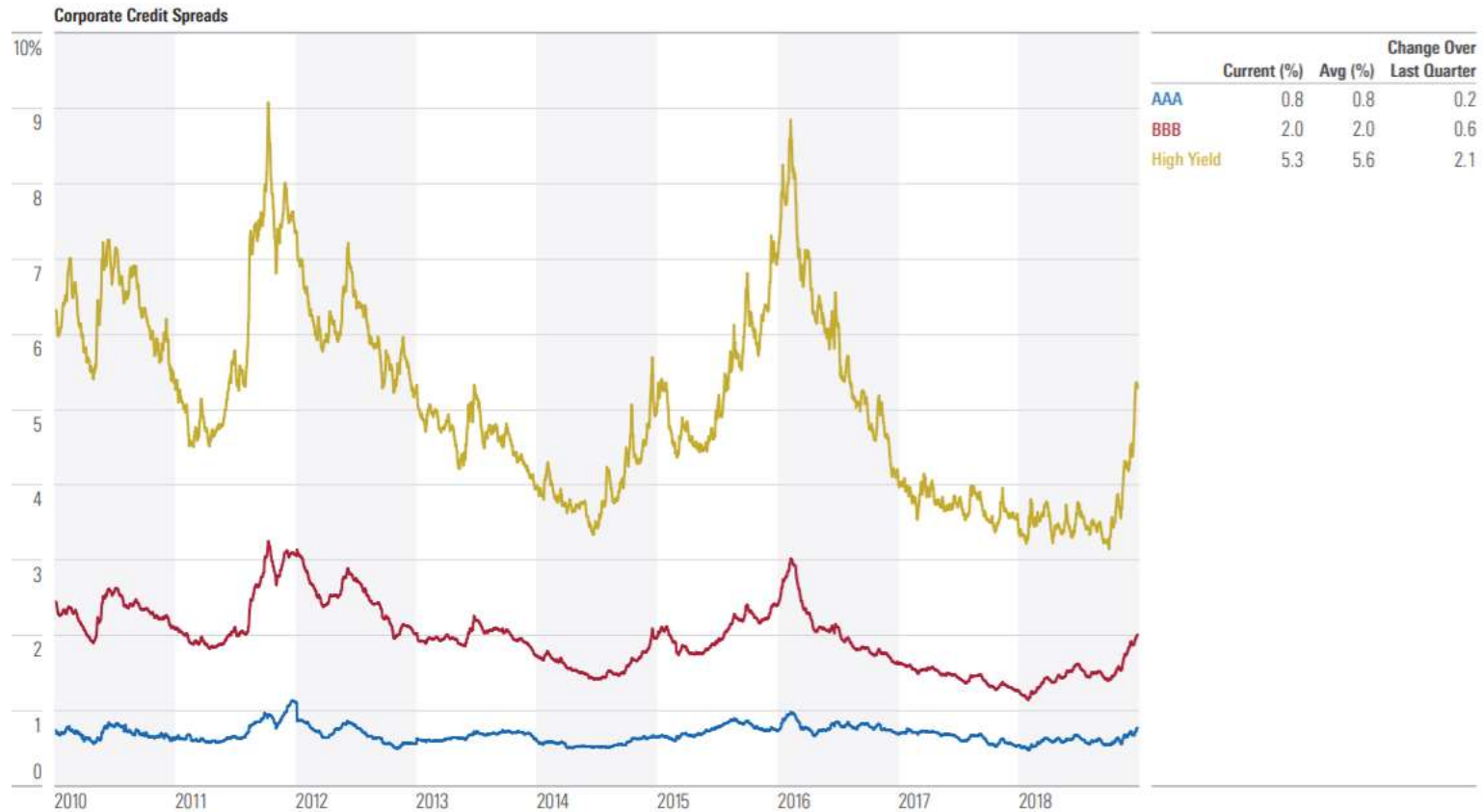
- Morningstar favorite core, value-leaning international funds include:
  - Oakmark International OAKIX
  - Vanguard International Value VTRIX
  - Causeway International Value CIVVX
  - American Funds International Growth & Income IGIFX
  - Vanguard Total International Stock VTIAX/VXUS
  - Vanguard FTSE All-World ex-US VFWAX/VEU
- Morningstar's favorite emerging markets funds include:
  - American Funds New World NWFFX

# Bonds: Market Expectations for Further Rate Increases Drop Sharply in Fourth Quarter of 2018



Implied rates on three-month Eurodollar futures act as a market prediction for U.S. interest rates at the expiration date of the contract. In the fourth quarter of 2018, the implied rates on futures expiring in 2019 and 2020 sharply declined, which implies a decreasing outlook for the path for interest rates in the future. This is in contrast with the stability of the implied rates on the 2018 contracts due to their pending expiration and convergence to the current interest rates targeted by the Federal Reserve.

# Corporate Credit Spreads Also Widened Significantly



## Higher Yields and Less Rate Sensitivity, But at a Price

### High-Yield Bonds

Current Yield: ~6%

2008 Return: -24%

### Bank Loan

Current Yield: 4%-5%

2008 Return: -17%

### Emerging Markets Bond

Current Yield: ~5%-6%

2008 Return: -18%

### Multisector Bond Fund

Current Yield: ~4%

2008 Return: -15%

Data as of 02/12/19.



## What Should Be on Bond Investors' Radar?

- Yields have begun to pop up, but that has short-term implications for bond prices
- 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 3% 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

## Best Ideas for Bond Investors

- Keep quality high, match duration to time horizon
- Morningstar's favorite funds for time horizons of five years or more:
  - Harbor Bond HABDX
  - Metropolitan West Total Return MWTRX
  - Dodge & Cox Income DODIX
  - iShares Core Total USD Bond Market IUSB
  - Fidelity Total Bond FTBFX
- Favorite short-term funds:
  - Fidelity Short-Term Bond FSHBX
  - Vanguard Short-Term Inflation-Protected Securities VTAPX
- Cash for short time horizons!

## Best Ideas for Personal Finance: Mind Tax Efficiency

- 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.)
- 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

## Best Ideas for Personal Finance: Don't Ignore Inflation!

- Inflation currently low and Fed appears vigilant, but tax package, other fiscal measures are inflationary
- 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
- Treasury Inflation-Protected Securities (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
- Stocks are also a reasonable way to out-earn inflation over long time horizons.
- Also: Bank-loan funds, precious metals equities, real estate, commodities...all in small doses

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Questions?

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