

Uncovering Opportunities in a Tumultuous Market

By Christine Benz

Article Highlights

- A number of market segments appear to be cheap, and opportunities lurk for those willing to look for them.
- Morningstar's approach focuses on company-specific issues, discounted valuations and business moats.
- Investors looking to allocate money into equities should focus on value-oriented stocks and funds.

The current market environment is a head-scratcher on a number of fronts.

Despite a little spackle here and there, Europe still doesn't appear to be on the mend, and the specter of slowing growth looms large across the globe.

Perhaps even more worrisome, given that low valuations are a better predictor of market performance than growth in GDP (gross domestic product), is that stocks in aggregate don't appear to be a screaming buy right now. The price-earnings ratio for the S&P 500 index was a not-unreasonable 16 as of early August 2012, putting it in line with historical averages. But the so-called Shiller price-earnings ratio, which attempts to smooth out effects of business cycles, is 22. That's a bit worrisome when you consider that the long-term mean of the Shiller price-earnings ratio is 17. U.S. stocks have gained about 14% on an annualized basis over the past three years, so it's probably not surprising that stocks look fairly valued, if not downright overvalued, right now.

Yet, as in nearly every market environment, opportunities lurk for investors who are willing to roll up their sleeves and look for them. While a handful of market segments look notably expensive right now—dividend-rich areas like real estate and utilities seem particularly frothy—a number of market segments appear to be trading cheaply, based on Morningstar analysts' bottom-up research. That not only presents opportunities for individual stock investors, but also translates into investment ideas for mutual fund and exchange-traded fund investors as well.



Let the Hunt Begin

Morningstar's approach to stock investing hinges on a few key ideas. The first is that the most successful investors build their portfolios from the bottom up, focusing on company-specific attributes and tuning out the day-to-day market noise. The second key underpinning of our approach to equity analysis is that valuation matters: The best way to identify winning stocks is to focus on those that are trading at a discount to their fair value. To gauge fair value, our analysts estimate a company's future free cash flows using discounted cash-flow modeling. If the business is such that future free cash flows, and in turn the fair value, cannot be estimated with a great degree of certainty, the analyst would require that a company trade at a bigger discount to its fair value before recommending it. Finally, our equity analysts prize companies with moats—sustainable competitive advantages and future economic profits. The reason is that competitive forces in a free-market economy tend to chip away at firms that earn economic profits because eventually competitors attracted to those profits will employ strategies to capture those excess returns. The primary differentiating factor among firms is how long they can hold competitors at bay. Only firms with economic moats—something inherent in their business model that rivals cannot easily replicate—can stave off competitive forces for a prolonged period.

To help home in on companies with some or all of those characteristics, Morningstar's Market Fair Value graph, a free tool available on the Markets page of Morningstar.com, provides a good starting point. The graph displays the

ratio of median price to fair value for all rated stocks in our coverage universe. As of early August, the median price/fair value ratio was 0.93, indicating that the median stock in our coverage universe was trading at a 7% discount to our analysts' estimate of fair value. If a company is trading perfectly in line with our analysts' estimate of what it's worth, its price/fair value ratio would be 1.00; if our analysts think a company is 20% overvalued, its price/fair value ratio would be 1.20.

Based on our aggregated fair-value estimates, stocks aren't quite as cheap as they were at this time a year ago, when Europe's woes and the U.S. debt-ceiling flap drove down stocks. And they're certainly not as cheap as they were in late 2008 and early 2009, when the median stock in our coverage universe was trading at 55% to 60% of our analysts' estimate of fair value. But they are more attractively valued than they were at the end of the first-quarter rally this year, as you can see in Figure 1.

Armed with that baseline price/fair value ratio, it's possible to take a closer look at which pockets of the market are cheap and which are dear. Using the same fair-value graph as a starting point, we can segment our coverage universe by sector, by industry or by a company's moat rating, among other metrics. From there, we can home in on undervalued individual stocks or let the broad trends guide us to funds that appear well-poised to capitalize on those inexpensive areas.

The Sector Lens

While the median price/fair value ratio for all of the stocks in Morningstar's coverage universe is 0.93, individual sectors look substantially cheaper or more expensive. In general, the most cyclical stocks sport the most attractive valuations at this juncture. Stocks in the basic materials (0.81), energy (0.87) and financial services (0.87) sectors are trading at a more than 10% discount to our analysts' estimate of fair value. The fact that our analysts are finding the greatest discounts in those sectors isn't too surprising, given that concerns over

Figure 1. Median Price/Fair Value Ratio for All Stocks Covered by Morningstar



slowing economic growth have pushed down economically sensitive stocks over the past three months. Of course, those sectors could stay cheap if recessionary fears persist, but our analysts think current valuations reflect undue pessimism about economic performance.

To help home in on our highest-conviction stock picks within those sectors, I searched for basic materials, energy and financial services names with high star ratings (meaning that our analysts think they're cheap), and medium or low fair-value uncertainty ratings (indicating that our analysts have a high degree of confidence in their fair-value estimates). Among the names that surfaced were BHP Billiton Ltd. ADR (BHP), Suncor Energy Inc. (SU) and Western Union Company (WU). (Note that Western Union was the only financial stock that made it through my screen; most financials in our coverage universe have high uncertainty ratings.)

Investors might also consider obtaining exposure to any one of these sectors via a broad-basket mutual fund or exchange-traded fund: iShares S&P Global sector-specific ETFs are among our team's favorite sector ETFs, while Vanguard Energy fund (VGENX) is a favorite (and inexpensive) actively managed product. Selected American Shares fund (SLASX) and Vanguard Selected Value fund (VASVX), meanwhile, are

good examples of valuation-conscious, broadly diversified funds that have historically done a good job of buying cyclically oriented companies when they've been in a trough.

The communication services sector also looks inexpensive to our equity analysts at this juncture—with an average price/fair value ratio of 0.87—but not all stocks within it look cheap. U.S. dividend-paying stalwarts like AT&T Inc. (T) and Verizon Communications Inc. (VZ) look somewhat overvalued right now. Meanwhile, several of the foreign telecom names are more attractive, with big caps like France Telecom SA ADR (FTE) and NTT DoCoMo, Inc. ADR (DCM) trading at substantial discounts to our analysts' estimates of fair value at the beginning of August.

At the other end of the spectrum, a handful of sectors were looking notably overvalued to our analysts as of early August. Real estate stocks, mainly REITs (real estate investment trusts), have emerged as the most overvalued sector over the past several years; stocks in the utilities and consumer-defensive sectors are, in aggregate, trading at a similar level of overvaluation. The fact that those historically dividend-rich sectors look expensive could be the result of investors' near-mania for anything with a yield attached to it over the past few years, but current valuations—com-

Figure 2. Median Price/Fair Value Ratio for All Wide-Moat Stocks



combined with the possible expiration of the currently low tax rates on qualified dividends—could make it difficult for dividend payers to reprise their recently strong gains.

What About Moats?

In addition to displaying market valuations on a sector-by-sector basis, the Market Fair Value graph also segments the equity universe by economic moat ratings. When analysts assign an economic moat rating, they're trying to answer a basic question: How sustainable are a company's future economic profits?

The analysts assign moat ratings of "wide," "narrow" or "none." Fewer than 200 of the nearly 1,600 companies that Morningstar covers had a wide moat rating as of early August; the rest had a moat rating of narrow or none. A company is accorded a wide moat rating in a few key ways. One is if its customers incur a high cost, of either time or effort, to switch to a competing service or product. Microsoft Corp. (MSFT) is a good example of a firm with a wide moat due to high switching costs; PCs and laptops come preloaded with Microsoft software, and the firm's products are also standard issue on most company PCs. You really have to want to use competing software to opt out. Cost advantages, often because of scale, can also confer a moat, as is the

case with Wal-Mart Stores Inc. (WMT).

Periodically, investors get a chance to buy wide-moat stocks on the cheap: For much of 2010 and 2011, for example, the wide-moat stocks in our coverage universe were trading at a bigger discount to their fair values than narrow- and no-moat stocks were, in part because narrow- and no-moat names were the first movers when the market recovered in early 2009. That buying opportunity in wide-moat stocks was what Warren Buffett would call a fat pitch, but unfortunately the valuation pattern is now closer to what one might expect. Wide-moat stocks, in aggregate, have a price/fair value ratio of 0.95 as of early August (see Figure 2), slightly above the 0.93 median for our coverage universe. Narrow-moat stocks have a price/fair value ratio of 0.91, and the price/fair value ratio for no-moat stocks is 0.90.

Yet, even though attractively valued wide-moat stocks are looking scarce these days, it's not impossible to find them. I searched for companies with wide moats, price/fair value ratios of less than 0.80 and uncertainty ratings of medium or low. Seventeen stocks made the cut as of early August, including tech firms like Applied Materials, Inc. (AMAT) and Cisco Systems Inc. (CSCO), basic materials firms like Martin Marietta Materials (MLM) and Vulcan Materials Co. (VMC), and medical device maker St. Jude Medical Inc. (STJ).

Alternatively, mutual fund investors who like the moat concept might consider a valuation-conscious fund with a high share of wide-moat stocks. The stocks in Bridgeway Blue Chip 35 Index fund (BRLIX), Dreyfus Appreciation fund (DGAGX), Jensen Quality fund (JENSX), Vanguard Dividend Growth fund (VDIGX) and Yacktman fund (YACKX) all have average moat ratings of wide; plus, their managers all pay attention to valuations when putting together their portfolios. For ETF investors, Vanguard Dividend Appreciation fund (VIG) beckons as a worthy wide-moat option.

The Style-Box View

In addition to searching for undervalued stocks by sector and moat ratings, we can also look at which investment styles, as depicted by the Morningstar style box, might look cheap or dear at any given point in time. The style box aims to depict the investment-style characteristics of stocks and funds using a nine-square grid. The top row consists of large-size companies, the middle row has mid-size firms and the bottom row has smaller companies. From left to right the style box captures investment style: value on the left, blend in the middle and growth on the right, as you can see in Figure 3.

As of early August 2012, the median stock in the large-cap value square of the Morningstar style box was trading at a price/fair value ratio of 0.88, the lowest price/fair value ratio of any style-box square. Mid-cap value stocks were also looking attractive, with a median price/fair value ratio of 0.89. Large-cap blend stocks were trading with a median price/fair value ratio of 0.92—roughly in line with the price/fair value ratio for the median stock in our overall coverage universe, which is 0.93—while large-cap growth stocks, with a median price/fair value ratio of 0.99, were more expensive still. Mid-cap growth was the most expensive square of the style box, based on our analysts' estimates of the fair values of the companies that land in that box, with a price/fair value ratio of

1.06 for the median stock. Morningstar doesn't have enough small-cap stocks under coverage to create price/fair value ratios for the small-cap style-box squares, but based on the aforementioned patterns, it's a reasonable guess that a) small-cap stocks look more expensive than mid- and large-cap names and b) growth stocks look more expensive than value stocks.

That's not to say that there's no gas left in the tank for growth stocks: Companies that can increase their earnings despite a slack macroeconomic environment are still apt to be rewarded. But our data do suggest that if you're rebalancing your portfolio or deploying new money, value-oriented stocks or funds are a good place to focus your efforts.

Screening for large- and mid-size value stocks with wide moat ratings, price/fair value ratios of 0.90 or less and fair-value uncertainty ratings of medium

or low brings out some of the same companies we've uncovered already. Vulcan Materials fits the bill, as does Cisco Systems. A few additional companies fit our criteria, however, including Johnson & Johnson (JNJ), Medtronic Inc. (MDT), Microsoft, Exelon Corp. (EXC) and Pfizer Inc. (PFE).

Broad Takeaways

Although we've viewed the equity universe through a variety of different lenses, there are some overarching themes that emerge.

Value stocks look relatively attractive to our equity analysts relative to growth names right now. That's especially true if investors are willing to delve into value-oriented companies that are more cyclical in nature, such as those in the energy and basic materials sectors.

Many stocks in dividend-rich sectors

Figure 3. Morningstar's Equity Style Box

Equity Style Box			
	Large	Medium	Small
	0.88	0.92	0.99
	0.89	0.92	1.06
	Value	Blend	Growth
	N/A	N/A	N/A

like real estate and utilities, meanwhile, look relatively expensive and could be good sale candidates if investors are trimming long-held winners from their taxable portfolios in anticipation of higher dividend and capital gains taxes. ▲

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Feature: Trading Strategies

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a 'stop-point' for completing the Dow Theory for 21st century signals, in case they were not completed prior to those thresholds being attained.

Buy Signal

The classic buy signal is developed as follows: After the low point of a primary downtrend in a bear market is established (point 1 in Figure 1 on page 8), a secondary uptrend bounce will occur (point 2). After that, a pullback (point 3) on one of the averages must exceed 3%, according to Robert Rhea. That setback must, ideally, hold above the prior lows on both the industrial and the transportation averages. Finally, a breakout above the previous rally high (point 4) by both averages constitutes

a buy signal for the developing bull market.

Figure 1 represents how the Dow Jones industrial average and the transportation averages might look.

More than one bounce can occur within the confines of the bounce highs and the lows. A common variation is when one of the averages makes newer lows but then rejoins the other in making newer highs.

Sell Signal

The classic sell signal is determined in much the same way, but opposite to a buy signal. When a bull market tops and sets back, with a subsequent rally that goes back up (again, over 3%) but falls short of reaching the previous high and then penetrates the recent lows on

the next decline as measured by both the industrial and transportation averages, a sell signal is generated, indicating a bear market.

Figure 2 on page 9 illustrates a classic sell signal.

Performance

Historically, the traditional Dow Theory has outperformed a buy-and-hold approach by 1% to 2% a year, a seemingly small percentage until one considers the compounding effect over a number of years, where the difference is substantial.

Improvements to the Dow Theory for the 21st century would appear to increase that advantage going forward. ▲

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