
Morningstar's Best Ideas for 2022 and Beyond



Christine Benz, Director of Personal Finance

Morningstar, Inc.

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Quick Morningstar Overview

- We provide financial information, research, and products to:
 - Individuals
 - Financial advisors
 - Institutional investors
- Provide research on:
 - Mutual funds and ETFs, separate accounts, CITs
 - 529s, HSAs
 - Bonds/credit ratings
 - Private securities (venture capital, private equity) (PitchBook)
 - Sustainable/ESG investing
 - Portfolio construction and planning

Presentation Roadmap

- Morningstar philosophy and how to use best ideas
- 2022 market recap
- U.S. equity overview and best ideas
- Non-U.S. equity overview and best ideas
- Fixed income overview and best ideas
- Inflation overview and best ideas
- Active/passive overview
- Tax planning overview and best ideas

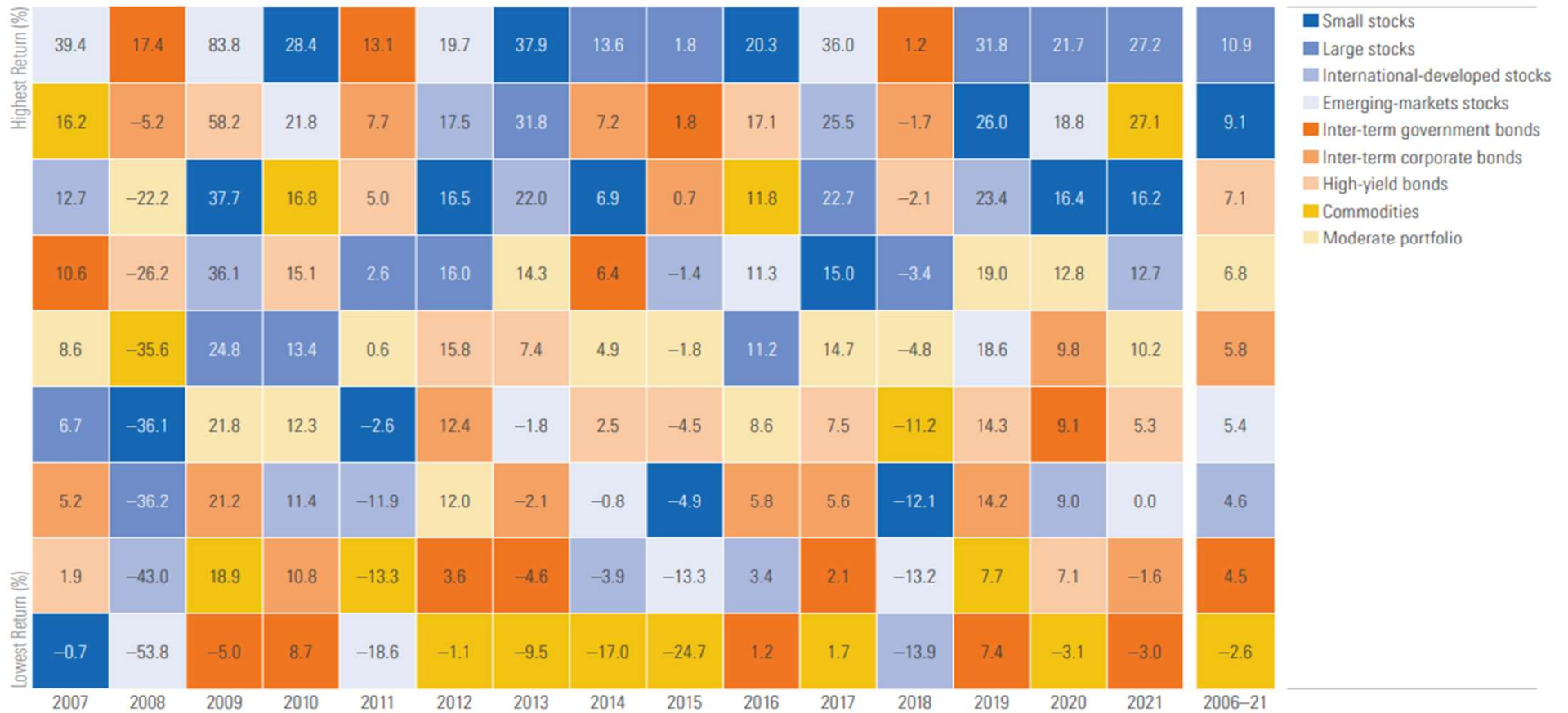
Morningstar Philosophy on Security Selection

- Equity philosophy
 - Bottom up
 - Focus on quality and valuation
 - Expanding coverage universe with quant analysis
- Fund philosophy
 - Also bottom up
 - Agnostic on index v. active debate
 - “Costs matter” hypothesis

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



QAA1

10

Source: Morningstar Markets Observer

But Since Then....



What Just Happened?

	Value	Core	Growth
Large	- 2.41	- 11.31	- 18.2
Mid	- 0.13	-9.05	5 - 22.5
Small	-1.54	-9.16	3 - 21.4

Source: Morningstar Direct, 3/16/22.

Now Do Bonds

-2.42	-	-	High
-	4.29	10.28	Medium
2.77	6.04	8.58	Low
-	-	-	
5.49	9.10	11.33	
Ltd	Mod	Ext	

Credit Quality

Duration

Source: Morningstar Direct, 3/16/22.

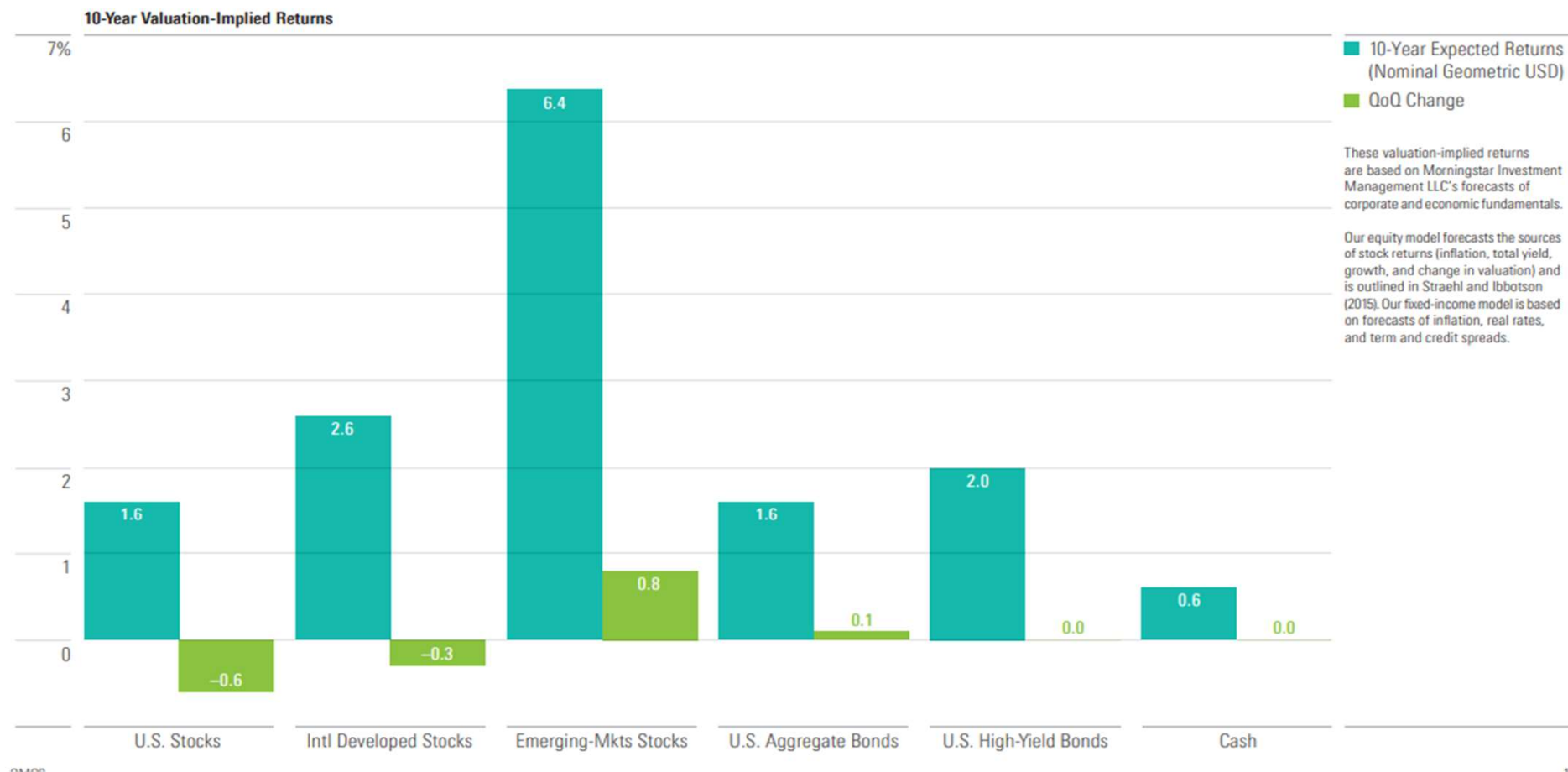
Notable Pockets of Strength: YTD returns through 3/15/22

- Equity Energy: +22%
- Commodities (Broad Basket): +21%
- Energy Limited Partnership: +11%
- Precious Metals Equity: +8.5%
- Latin America Stock: +6.5

Notable Pockets of Weakness: YTD returns through 3/15/22

- China Equity: -26%
- Technology: -23%
- Foreign Small/Mid Growth: -21%
- Diversified Pacific Asia: -19%
- Foreign Large Growth: -19%
- U.S. Mid Growth: -19%

At Year-End 2021, Return Expectations for U.S. Stock Were Low

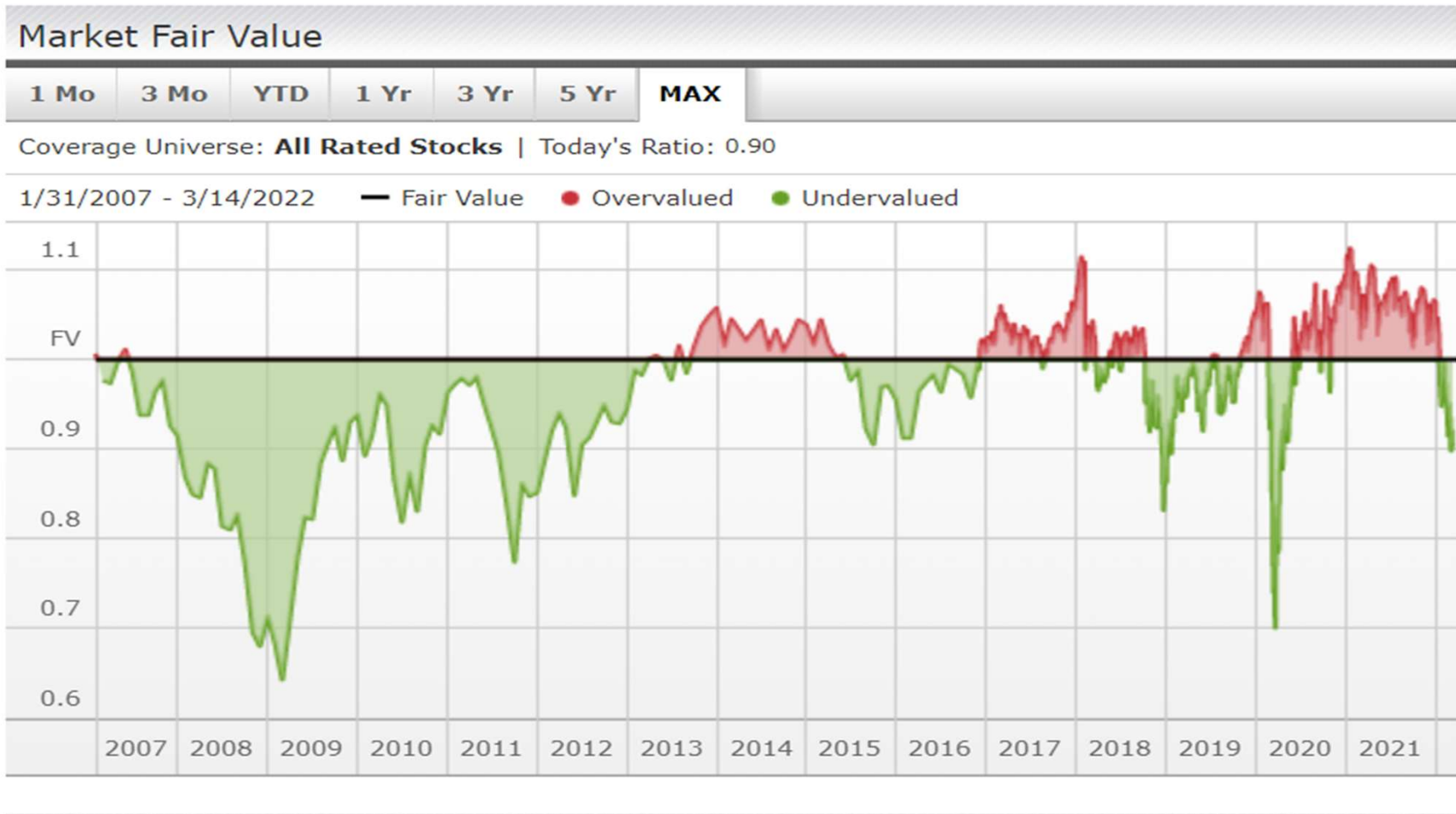


Source: Morningstar Markets Observer, 12/31/21.

Outside Experts Largely Corroborated That Pessimism

- BlackRock (September 2021)
 - 6.7% nominal returns for U.S. large caps over next 10 years
 - 1.6% returns for bonds
- Research Affiliates (February 2022)
 - 1.9% real returns for U.S. large caps over next 10 years
 - 2.6% real returns for Bloomberg Barclays Aggregate over next 10 years
- Vanguard (September 2021)
 - 3.3% nominal returns for U.S. stocks over next decade
 - 1.9% nominal returns for U.S. bonds

M*'s Bottom-Up Research Tells a More Sanguine Tale Today



Market Fair Value, 03/15/22

Wide Moats Priced in Line with Narrow, No Moats

Median Price/Fair Value for Wide Moats: **0.90**

➤ Wide economic moats (16% of coverage universe) include Altria, BlackRock, Alphabet, Amazon.com

Median Price/Fair Value for Narrow Moats: **0.89**

➤ Narrow economic moats (44% of coverage) include Citigroup, Lululemon, Nordstrom

Median Price/Fair Value for No Moats: **0.88**

➤ No economic moats (39% of coverage) include Allstate, Dick's Sporting Goods, Southwest Airlines

Every Style Box Square Undervalued, at Least Slightly

	Value	Core	Growth
Large	0.85	0.92	0.91
Mid	0.89	0.92	0.92
Small	0.58 *	0.87 *	0.60 *

Source: Morningstar Direct, 3/14/22.

Pretty Big Shift Since Year-End 2021

	Value	Core	Growth
Large	0.98	1.24	1.04
Mid	0.95	1.10	1.06
Small	0.80 *	0.92 *	0.82 *

12/31/21

	Value	Core	Growth
Large	0.85	0.92	0.91
Mid	0.89	0.92	0.92
Small	0.58*	0.87*	0.60*

3/14/22

The Sector Lens: A Few Sectors Look Notably Cheap

Economically Sensitive

Communications
Svc. P/FV: 0.85

Energy P/FV: 0.97

Industrials: 0.94

Technology: 0.84

Cyclical

Basic Materials:
0.96

Consumer Cyclical
P/FV: 0.79

Financials P/FV:
0.87

Real Estate 0.88

Defensive

Consumer
Defensive P/FV:
0.87

Utilities P/FV: 1.06

Health P/FV: 0.95

Data as of
3/15/2022.

Best Ideas for Individual Equity Investors

4 or 5 stars (low market valuations relative to our estimates of fair value), wide moats, and *low uncertainty ratings* (3/14/2022)

- Clorox CLX
- Novartis NVS
- Unilever UL
- Roche Holdings RHHBY

Best Higher-Risk Ideas for Individual Equity Investors

5 stars (low market valuations relative to our estimates of fair value), wide moats, and *medium uncertainty ratings*

(3/14/2022)

- Adobe Systems ADBE
- Anheuser Busch InBev BUD
- BlackRock BLK
- British American Tobacco BTAFF
- Equifax EFX
- Guidewire Software GWRE
- Imperial Brands IMBBY
- Salesforce.com CRM
- Taiwan Semiconductor TSM
- Veeva Systems VEEV
- YUM China Holdings YUMC
- Zimmer Biomet ZBH

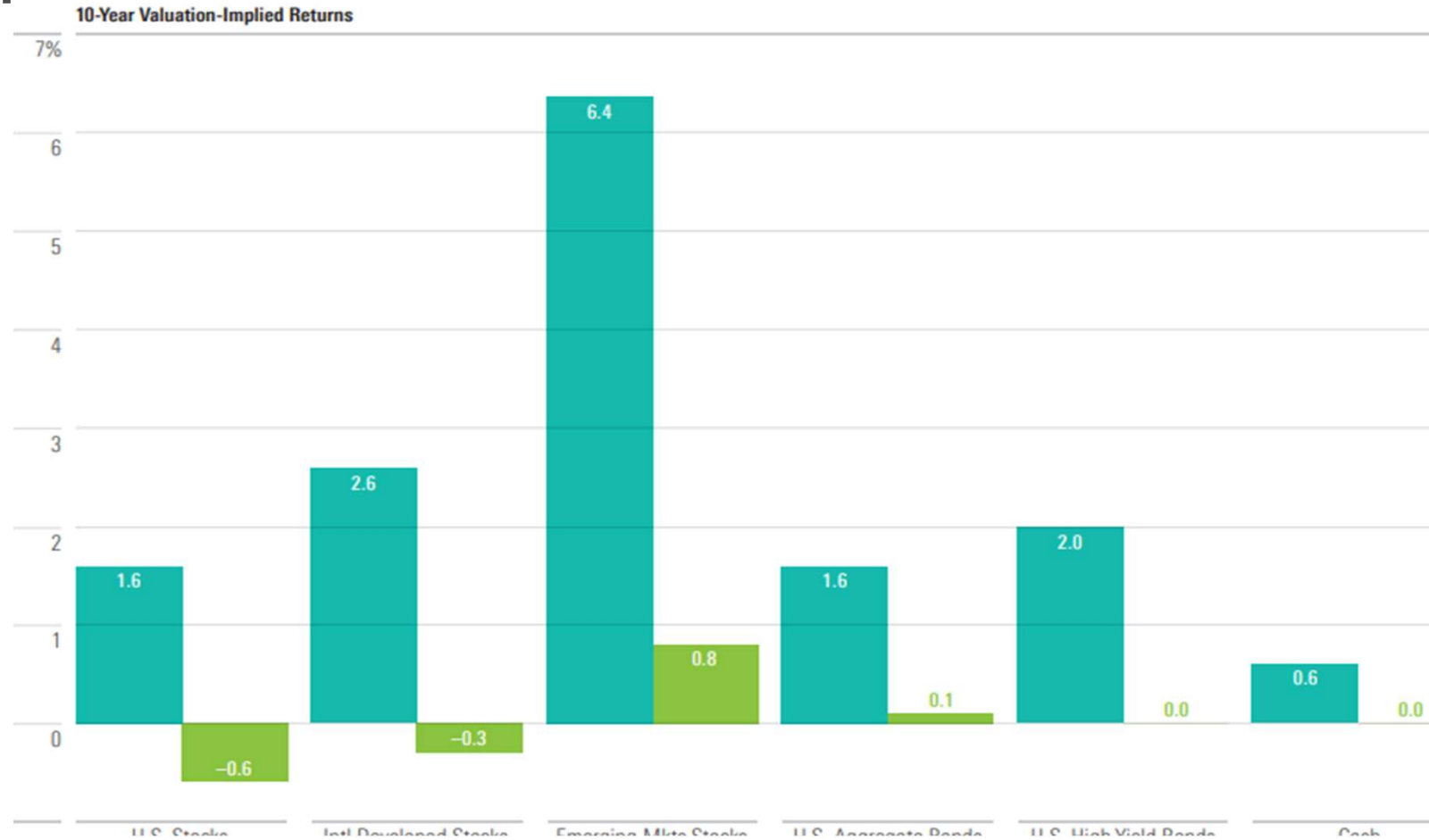
Best Ideas for U.S. Equity-Fund Investors: Funds That Focus on Quality, Pay Attention to Valuations

- In a fairly valued market, it seems reasonable to focus on quality, dividends (bird in the hand?), valuation
- Top-rated large-cap funds with such an emphasis:
 - Jensen Quality Growth JENSX
 - Parnassus Core Equity PRBLX
 - T. Rowe Price Dividend Growth PRDGX
 - Vanguard Dividend Appreciation VDADX/VIG
 - Vanguard Dividend Growth VDIGX
 - Vanguard High Dividend Yield Index VHDYX/VYM

If Your Small-/Mid-Cap Value Exposure Needs Topping Up

- Top-rated small- and mid-cap funds
 - Mid-Cap
 - Diamond Hill Mid Cap DHPYX
 - Vanguard Mid-Cap Value VMVAX/VOE
 - Vanguard Mid-Cap Index VIMAX/VO
 - Small-Cap
 - Diamond Hill Small Cap DHSCX
 - LSV Small Cap Value LVAQX
 - Dimensional US Targeted Value DFAT
 - Vanguard Small Cap Value VISVX/VBR
 - Vanguard Small Cap VSMAX/VB

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



Source: Morningstar Markets Observer, 12/31/21.

And It's Not Just Us

BlackRock Investments Institute (September 2021)

- 6.7% nominal returns for U.S. equities over next 10 years
- 8.7% nominal returns for emerging markets large caps over next 10 years
- 9.2% nominal returns for European large caps over next 10 years

Research Affiliates (February 2022)

- 1.9% nominal returns for U.S. large caps over next 10 years
- 6.9% nominal returns for MSCI EAFE index over next 10 years
- 10% nominal returns for emerging markets equity over next 10 years

Vanguard (September 2021)

- 3.3% nominal returns for U.S. equities over next 10

Non-U.S. Stocks Look More Attractive on a Few Metrics

Valuation

U.S. Stocks' P/FV: 0.94

Non-U.S. Stocks' P/FV: 0.87

Dividend Yield

U.S. Stocks' Median Dividend Yield: 2.26%

Non-U.S. Stocks' Median Dividend: 2.52%

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

Best Ideas for International Fund Investors: Core Foreign Stock Funds

- Morningstar favorite core or value-leaning international funds include:
 - Vanguard Total International Stock VTIAX/VXUS
 - iShares Core MSCI Total International Stock IXUS
 - Oakmark International OAKIX
 - Vanguard International Value VTRIX
 - Dodge & Cox International Stock DODFX
 - Causeway International Value CIVVX
 - American Funds International Growth & Income IGIFX

Best Ideas for Emerging Markets

- Morningstar's favorite emerging markets funds include:
 - GQG Partners Emerging Markets Equity GQGRX
 - American Funds New World NEWFX
 - Seafarer Overseas Growth & Income SIGIX
 - Vanguard FTSE Emerging Markets VWO
 - iShares Edge Min Vol Emerging Markets ETF EEMV

Fed Tightening Has Crimped Bond Prices

-2.42	-	-	Duration
-	4.29	10.28	
2.77	6.04	8.58	
-	-	-	Low
5.49	9.10	11.33	
Ltd	Mod	Ext	
Credit Quality			

Source: Morningstar Direct, 3/16/22.

Corporate Credit Spreads Remain Narrow



Source: St. Louis Fed (FRED), 03/16/22.

What Should Be on Bond Investors' Radar?

- Return expectations are meager, volatility could continue
- Market expecting six quarter-point rate increases in 2022
- Remember that bonds are shock absorber, not return engine
- Hold cash for very near-term expenses
- Use credit-sensitive bonds to augment, not supplant, high-quality bonds
- Duration stress test
 - Vanguard Long-Term Treasury
 - Duration of 19 years
 - 2.4% SEC yield

Best Ideas for Bond Investors

- Some of Morningstar's favorite funds for time horizons of five years or more:
 - Vanguard Total Bond Market Index VBTLX/BND
 - iShares Core Total USD Bond Market IUSB
 - Harbor Bond HABDX
 - Metropolitan West Total Return MWTRX
 - Dodge & Cox Income DODIX
 - Fidelity Total Bond FTBFX
 - Baird Aggregate Bond BAGIX
- Favorite short-term funds:
 - Fidelity Short-Term Bond FSHBX
 - Vanguard Short-Term Inflation-Protected Securities VTAPX
- Cash for short time horizons!

What About Inflation?

- Inflation currently running about 7% YOY
- 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
- High inflation argues against holding too much in cash, fixed rate investments
- Treasury Inflation-Protected Securities (TIPS) and I-bonds can help hedge against *unexpected* increases in inflation
- Stocks are also a reasonable way to out-earn inflation over long time horizons.
- Commodities, precious metals also holding their own in an inflationary environment.

Best Ideas for Active/Passive Investors: Mind the Data!

- Morningstar constantly monitors the data on the performance of actively managed mutual funds versus passive (index funds and ETFs)
- Over the past 10 years (through 12/31/21), 26% of all active funds:
 - Survived
 - Beat index funds within that same category

U.S. Stocks a Sensible Spot to Index

Exhibit 1 Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year
U.S. Large Blend	41.4	33.5	20.6	9.5	9.4	9.3
U.S. Large Value	34.1	37.0	21.9	14.8	12.8	13.4
U.S. Large Growth	31.9	31.5	31.8	8.2	6.2	5.5
U.S. Mid Blend	66.7	30.0	18.8	16.9	7.7	6.6
U.S. Mid Value	28.8	53.2	37.1	10.7	25.6	—
U.S. Mid Growth	46.0	52.2	56.1	37.9	22.3	—
U.S. Small Blend	58.6	39.1	23.2	17.2	12.3	19.8
U.S. Small Value	37.1	41.4	36.2	20.2	26.9	17.9
U.S. Small Growth	47.4	65.8	55.1	44.0	27.9	12.9

Source: Morningstar's Active Passive Barometer, February 2022.

Success Rates Look a Bit Better for Non-U.S. Stocks

Foreign Large Blend	43.7	51.4	38.5	31.6	29.1
Foreign Large Value	33.7	54.7	35.6	29.8	11.4
Foreign Small-Mid Blend	48.1	48.5	31.3	31.8	—
World Large-Blend	38.9	26.5	18.9	16.7	—
Diversified Emerging Markets	30.1	61.3	47.4	54.4	40.7
Europe Stock	53.3	73.7	50.0	42.9	37.9

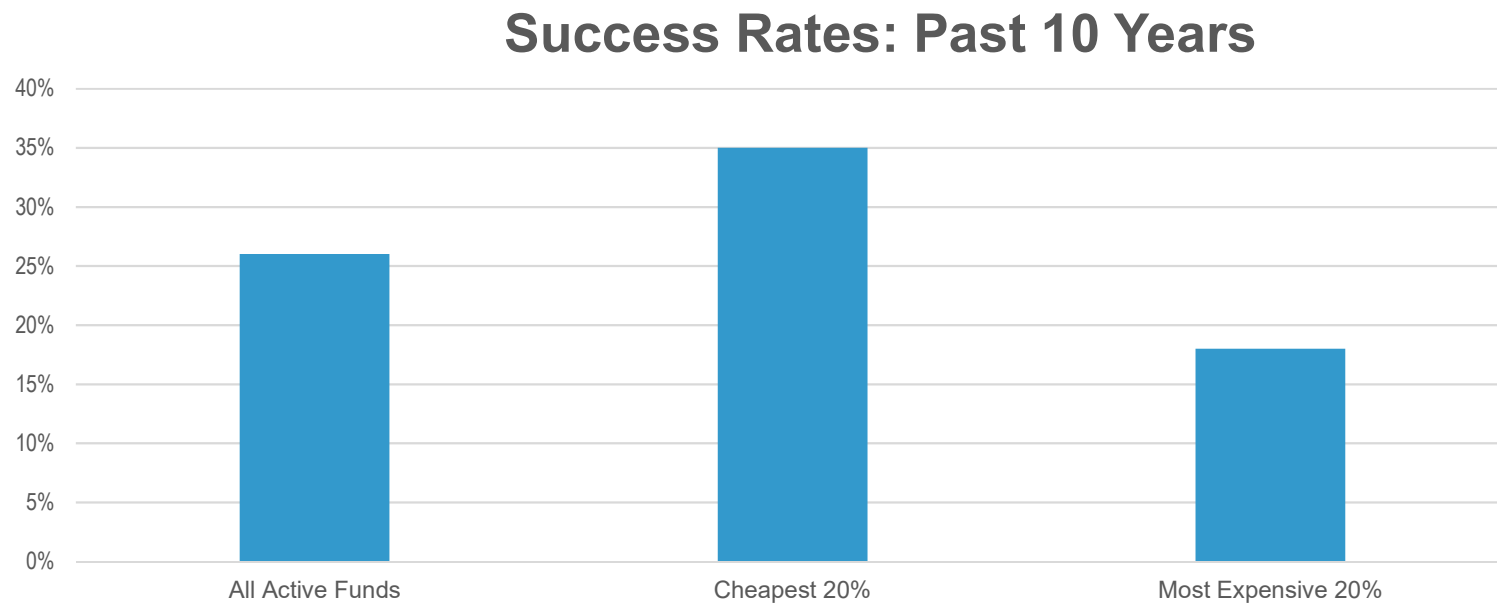
Source: Morningstar's Active Passive Barometer, February 2022.

And Bonds

Intermediate Core Bond	69.2	47.0	43.2	37.8
Corporate Bond	64.2	47.5	26.0	28.9
High-Yield Bond	72.0	56.1	44.7	55.3

Source: Morningstar's Active Passive Barometer, February 2022.

Jack Bogle Said It Best: It's the 'Costs Matter' Hypothesis



Source: Morningstar's Active Passive Barometer, February 2022.

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
- 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
 - “Mega-backdoor Roth”
- HSAs: Triple tax-advantaged

Questions?
christine.benz@morningstar.com

