

# Morningstar Market Commentary

1st Quarter 2006

## Morningstar Market Barometer™



## More of the same, but with a twist or two

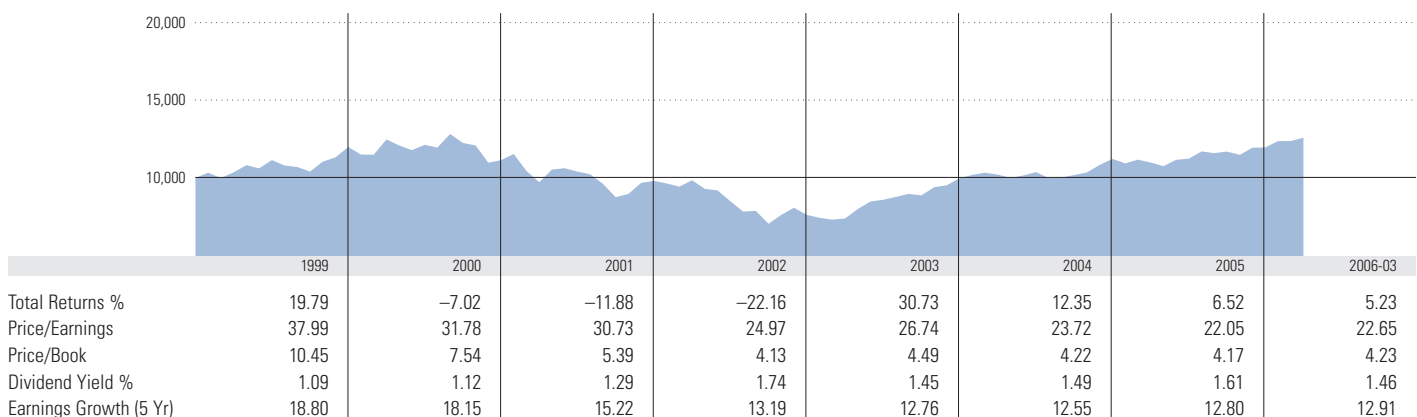
Markets picked up in the first quarter of 2006 where they left off in late 2005, posting solid gains in the face of economic uncertainty and potentially setting the stage for a fourth straight year of equity gains following the brutal bear market from 2000 through 2002. All Morningstar diversified equity indexes ended the quarter on a positive note, as small caps led the way in what is now an all-too-familiar pattern. Those anticipating a rotation to large caps will have to wait a little longer, since investors apparently haven't quite lost their affinity for smaller stocks. The Morningstar US Market Index rose 5.2%.

The market weathered additional debt downgrades and intensified solvency questions for embattled automaker General Motors, continued weakness in newspaper and traditional media stocks, such as New York Times and Time Warner, and even weakness in online search-engine Google, whose meteoric rise had previously been cited as the proximate cause of traditional media's recent swoon. Additionally, weakness in the newspaper industry encouraged McClatchy to purchase Knight Ridder. Media conglomerates and radio were among the worst performing industries, continuing their multiyear slide.

As media stocks continued to suffer, energy stocks continued to surge, finishing with a 8.75% gain for the quarter. However, commodity futures prices themselves took a breather. Additionally, falling natural gas prices led to stock-price declines in that industry. Despite commodity price declines, fears of inflation, rising rates, and a slower housing market hindered homebuilders. Nevertheless, REITs remained strong, posting a 15% surge to continue their multiyear run. Also, industries with hard asset exposure, such as iron & steel and precious metals continued to post solid gains.

New Federal Reserve Chairman Ben Bernanke will have to guide a slowdown in residential housing delicately, taking care not to send prices down precipitously as he manages inflation. The Fed's rate-raising campaign had its effect on bonds, with the Lehman Brothers Aggregate Index shedding 0.65% for the quarter.

## Morningstar US Market Index (Growth of \$10,000)



### Surveying the Sectors

Telecommunications stocks led the way for the first quarter, with a 14.6% surge. Latin American service providers did well, making up for continued poor performance among European service providers. Additionally, distressed business-service providers, such as Time Warner Telecom, rebounded. The telecom sector, however, is the second-worst for the trailing five years, with negative 4% annual returns.

### Industry Performance

Steel and iron led the way with a whopping 42% gain, as increased global development drove commodity prices up. Optical equipment makers, meanwhile, posted a 33% gain for the quarter. Ciena, maker of advanced transmission and switching systems for fiber-optic communication networks, surged 75%, and JDS Uniphase powered up 77%. Increased business spending on communications infrastructure, including spending by telephone companies seeking to provide broadband, helped the industry.

#### Morningstar Sectors: 1st Quarter 2006 Return %

	Quarter	1 Year	3 Year
<b>Information</b>	6.57	12.34	16.03
Software	4.91	12.59	13.21
Hardware	7.12	17.84	19.87
Media	0.18	-6.73	7.62
Telecommunication	14.63	20.21	18.87
<b>Service</b>	4.19	16.30	17.94
Health Care	1.81	10.95	10.41
Consumer Services	4.71	9.73	19.39
Business Services	8.00	31.15	25.24
Financial Services	4.45	19.00	20.81
<b>Manufacturing</b>	5.96	13.21	23.82
Consumer Goods	1.70	4.36	14.76
Industrial Materials	8.42	12.33	24.13
Energy	8.75	24.52	34.42
Utilities	-0.09	9.76	22.48

The developing world's torrid growth helped industrial-materials stocks as well. Cement companies such as Lafarge and steel companies such as Mittal rose sharply. Global development has helped this sector post 24% annual returns for the trailing three years, placing it second behind energy.

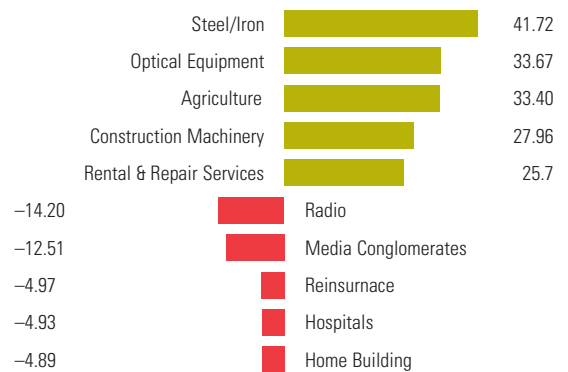
Energy companies, for their part, continued their multi-year run, with drillers such as Schlumberger and Weatherford International tacking on gains of over 25%. The sector has risen 34% annually for the trailing three years and 14.5% for the trailing five years, leading all sectors.

Financials also surged, with Brazilian banks such as Banco Bradesco SA leading the way. U.S. investment banks such as Goldman Sachs also did well, as mergers, "going privates," and other corporate maneuvers occurred.

Online retail suffered, dropping 13%, as eBay, Expedia, and Amazon showed weakness. The themes here were varied. For example, eBay's 2006 outlook disappointed Wall Street, additional growth led to compressed margins for Amazon, and Expedia's unanticipated capital expenditures to fend off increasing competition gave investors the jitters.

Media conglomerates continued to suffer, with the advertising environment unclear due to the popularity of the Internet and the uncertainty of the economic climate. Radio was the worst performing industry, dropping 14% for the quarter, just as it did in the last quarter of 2005. Radio content provider Westwood One shed 32% after reporting poor fourth-quarter results.

#### Top and Bottom Five Industries: 1st Quarter 2006 Return %



### Style and Market Cap Indexes

#### Morningstar US Value Index +6.0%

Once again, value beat growth, continuing that multiyear trend. The Morningstar US Value Index added 6.0% for the quarter, while the Morningstar US Growth Index added 4.0% over the same period. The value index has added nearly 9.0% annually for the trailing five years, while the growth index was flat over the same period. Growth certainly looks more stable now, even teasing us at moments into thinking that it has come back into favor; but value's outperformance continues for now.

The large-value index is stuffed with financial-services and energy names. Larger financial components of the index Citigroup and Bank of America were roughly flat. Oil component ExxonMobil rose 8.9%, but ChevronTexaco was flat. Tobacco giant Altria lost ground, while struggling drugmaker Pfizer gained. Consumer goods and utilities also helped the index.

#### Morningstar US Core Index +5.5%

The Morningstar US Core Index nearly matched the value index, surging 5.5% for the quarter. Top component gains included Coca-Cola (+4.6%), Home Depot (+4.9%), and Abbott Labs (+8.4%). Additionally, nearly 24% of the index is in industrial goods, many of which tacked on healthy gains. For example, Rockwell Automation, maker of industrial process control equipment such as motor starters, relays, and sensors, added 22%. Industrial conglomerate General Electric was flat for the quarter, however. This may indicate that the market has been discounting conglomerates and pushing for spin-offs lately, as benchmark-conscious investors search for "pure plays" in a particular industry or sector.

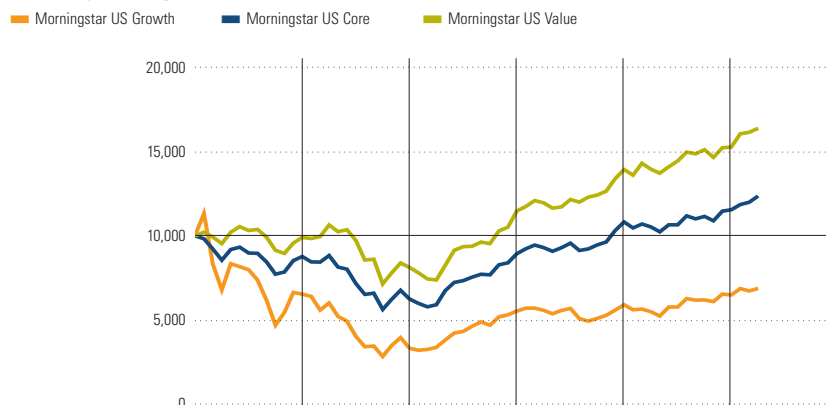
#### Morningstar US Growth Index +4.0%

The Morningstar US Growth Index rose 4.0% for the first quarter of 2006. This index is populated with companies growing their earnings at fast clips. Top index component Microsoft added 4% for the quarter, surging in early March and then falling back on news that the introduction of its Vista software would be delayed. Microsoft isn't the torrid grower it once was, but it still sports impressive growth in its maturity.

The second-largest index component, Johnson & Johnson, posted a modest loss of 0.9% for the quarter, after halting a swoon dating from mid-2005. The market responded negatively to the company's failure to acquire device-maker Guidant over rival Boston Scientific. Biotechs and top index components Amgen and Genentech were also weak after a solid run in 2005.

Although health care was weak, hardware boosted the index. Internet router and infrastructure company Cisco powered ahead. Wireless telephone equipment maker Qualcomm also added nearly 18% for the quarter, enjoying increased profits from new wireless phone sales using its patented technologies.

### Morningstar Style Indexes: Growth of \$10,000



	2001	2002	2003	2004	2005	2006-03
<b>Morningstar US Value</b>						
Total Returns %	-0.68	-13.68	29.75	16.85	7.82	6.02
Price/Earnings	21.85	20.53	18.58	16.79	14.98	16.10
Price/Book	3.00	2.17	2.83	2.57	2.53	2.63
Dividend Yield %	2.74	3.40	2.69	2.68	2.89	2.57
Earnings Growth (5yr)	10.21	9.08	8.48	8.77	8.00	8.51
<b>Morningstar US Core</b>						
Total Returns %	-9.31	-21.18	28.63	15.62	5.19	5.54
Price/Earnings	28.24	21.46	23.75	21.90	20.92	21.28
Price/Book	6.03	4.24	4.64	4.33	3.95	3.85
Dividend Yield %	1.04	1.59	1.27	1.30	1.43	1.31
Earnings Growth (5yr)	14.35	12.46	12.11	11.89	12.13	12.18
<b>Morningstar US Growth</b>						
Total Returns %	-26.32	-33.20	34.12	4.37	6.41	4.04
Price/Earnings	47.43	32.89	38.45	33.50	30.62	31.02
Price/Book	6.92	5.61	5.93	5.96	6.04	6.25
Dividend Yield %	0.17	0.50	0.43	0.40	0.53	0.48
Earnings Growth (5yr)	21.75	17.52	17.26	17.74	18.17	18.17

**Morningstar Large Cap Index +3.8%**

The Morningstar Large Cap Index rose 3.8% for the quarter, but it continued the familiar pattern of trailing both its mid-cap and small-cap brethren. Additionally, the large-cap index has gained 3% annually for the trailing five years versus 14% for the small-cap index and 12% for the mid-cap index over the same period. Finally, the large-cap index finished 15th out of 16 diversified Morningstar indexes, with the Morningstar Large Growth Index finishing 16th. Among the large-cap indexes, only Morningstar Large Value made a decent showing, finishing eleventh out of 16 diversified indexes.

If small caps, mid-caps, and value indexes outperformed in their familiar manner, so did top large-cap component ExxonMobil, surging 8.9%. Financials Citigroup and Bank of America lost 1.7% and 0.24%, respectively. The larger drug components were mixed, with Johnson & Johnson losing 0.9% but Pfizer surging 8%. Retailer Wal-Mart surged in early March, but then quickly slid, adding only 1% for the quarter. Consumer-products giant Procter & Gamble was flat for the quarter.

**Morningstar Mid Cap Index +7.9%**

Everything went right for mid-caps as the Morningstar Mid Cap Index rose 7.9%. Top component Advanced Micro Devices AMD surged 8.9% as increased sales and its first-ever agreement to supply computers for Dell boosted shares. The index is heavy in industrial goods, and stocks in that sector—such as Nucor Steel, which tacked on 58%—led the charge.

Weatherford International, maker of oil and natural gas drilling equipment, added 26%, as commodity-related businesses continued their run. Although oil prices remained high, natural gas prices tumbled; nevertheless, Weatherford didn't suffer.

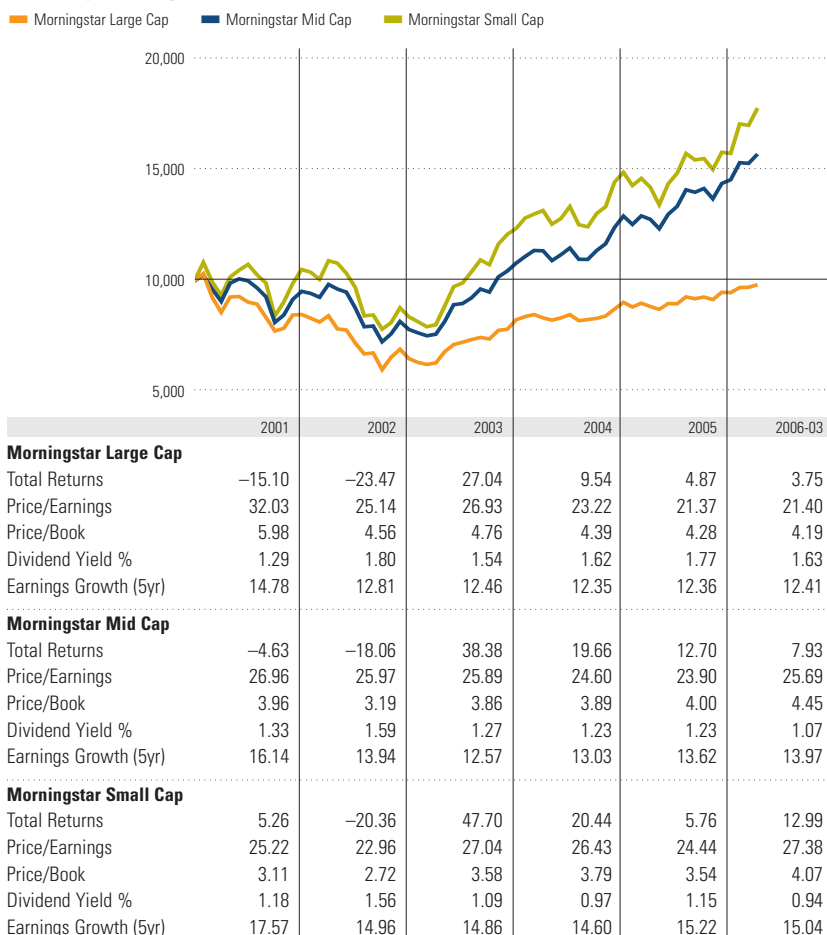
Additionally smaller biotechs outperformed, distinguishing themselves from their larger-cap brethren. Top index component Celgene, producer of drugs for cancer and immunological diseases, added more than 30%.

Finally, 22% of the mid-cap index is composed of financials, and they didn't disappoint. TD Ameritrade rose 12% for the quarter as Ameritrade closed its acquisition of TD Waterhouse from Toronto-Dominion Bank in January. REITs, also included in the financials sector, helped the index. Top index component ProLogis Trust, owner of industrial distribution facilities, added more than 15%.

**Morningstar Small Cap Index +13.0%**

The Morningstar Small Cap Index surged 13.0% for the quarter with the help of semiconductor and industrial-materials stocks. Semiconductor company Rambus rocketed 143% for the quarter, and Titanium Metals rose 53%. Morningstar mutual fund analysts have been hearing small-cap fund managers praise "analog" semiconductors lately for their proprietary technologies.

Financial services, a large part of the index, also did well, thanks to real estate. REIT component Brandywine Realty Trust, owner of office and industrial properties, added 14%.

**Morningstar Cap Indexes: Growth of \$10,000**

**Active vs. Passive, 1st Qtr 2006**

	Value	Core	Growth
Large Cap	34.22 5.50	65.54 4.06	86.24 1.49
Mid Cap	52.99 6.43	40.26 7.77	40.91 9.52
Small Cap	50.00 10.86	20.81 14.22	33.59 13.78

○ Percent of actively managed mutual funds outperforming their respective benchmark. Includes the oldest share class for all US diversified mutual funds with at least a one-year history. As of Mar. 31, 2006, there were 2,448 eligible funds. Morningstar classifies funds into style categories based on the average style score (using the same 10-factor methodology as underlying benchmarks) of all available portfolio holdings over a three-year period.

● Index Returns (%), 1st Quarter, 2006

**Fund Categories vs. the Benchmarks**

Active management overcame the indexes in only three diversified categories. More than 86% of large-growth funds beat the Morningstar Large Growth Index. Having overweights in energy and industrial materials and dipping down into mid-cap stocks helped these funds dramatically. The same is true for large-core funds. Sixty-five percent of large-core category constituents beat the Morningstar Large Core Index. Although large-cap victories may seem particularly impressive, given the arguments for greater efficiency in that part of the market, this “mid-cap effect” helped. This pattern of large-core and large-growth funds beating their respective indexes continues the trend from the fourth quarter of 2005.

Interestingly, the majority of mid-cap value funds (nearly 53%) beat the Morningstar Mid Value Index. Morningstar indexes are rather “style pure,” meaning that only mid-cap stocks that exhibit clear value characteristics will fall in the mid-cap value index. So, the indexes will exhibit more pronounced performance characteristics making them more difficult to beat when they’re the darlings and easier to beat when they’re the dogs. Nevertheless, despite the mid-value index’s solid gains, the Morningstar Mid Core and Morningstar Mid Growth Indexes did even better. This means that mid-cap value funds with some growth stocks were able to outperform, and reflects a kind of rotation to growth stocks in the mid-cap realm. Of course, being overweight in energy helped here, too.

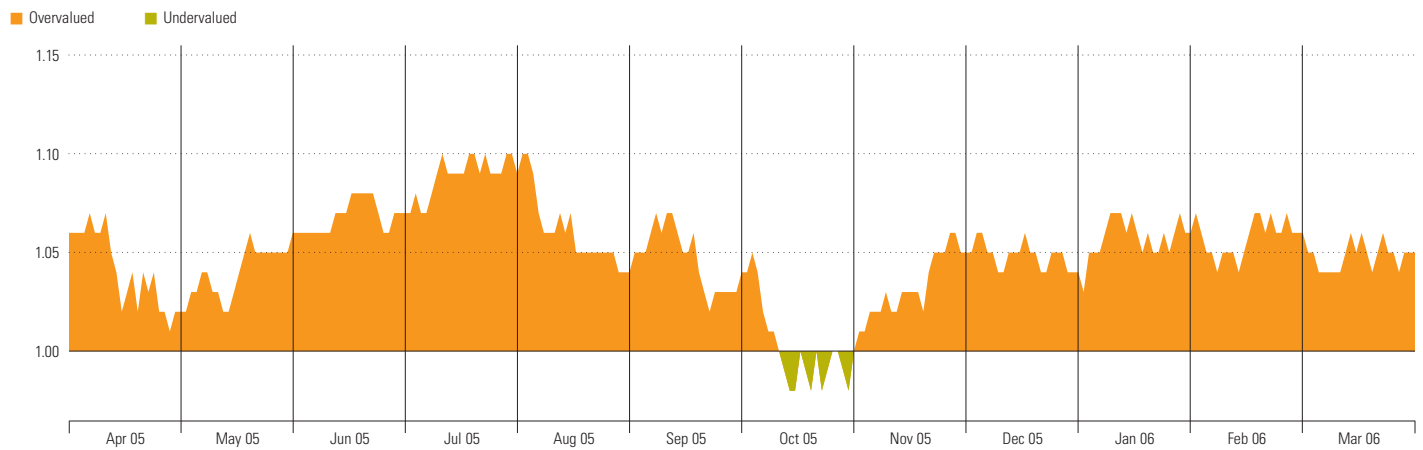
Half the funds in the small-value category outpaced the Morningstar Small Value Index. Again, however, this modest success may reflect the rotation to growth in both the small-cap and mid-cap areas of the market.

**Conclusion**

Although the market was up, high energy prices, interest rate increases, and a flat yield curve—often signaling an economic slowdown—restrained stocks for most of 2005. Morningstar’s market valuation graph shows stocks overvalued by around 5%, but the current 5-star stock list includes some businesses—such as Abbott Labs, Anheuser-Busch, Berkshire Hathaway, Boston Scientific, Coca-Cola, Diageo, Johnson & Johnson, Microsoft, Wal-Mart, and the Washington Post—that have earned Morningstar’s wide-moat designation for their competitive advantages. All except the Washington Post are large-cap stocks. It’s difficult to say when large caps will be in vogue again, and we don’t counsel investors to try to time such rotations in any case. In other words, these stocks could get cheaper before they rise to our estimates of their fair value. However, our method of analyzing one stock at a time by estimating future cash flows of the underlying business has identified high-quality larger names suitable for purchase as long-term investments.

**John Coumarianos**  
Mutual Fund Analyst

**Market Valuation**



<b>52-Week High</b> 1.10 (07-12-05)	<b>52-Week Low</b> 0.98 (10-27-05)	<b>All-Time High</b> 1.14 (12-01-04)	<b>All-Time Low</b> 0.78 (10-09-02)	<b>1st Quarter Close</b> 1.05 (03-31-06)
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**Market Valuation Chart**

The graph shows the ratio of price to fair value for the median stock in the universe of stocks covered by Morningstar over time. A ratio above 1.00 indicates that the stock’s price is higher than Morningstar’s estimate of its fair value; a ratio below 1.00 indicates that the stock’s price is lower than our estimate of its fair value. The further the price/fair value ratio rises above 1.00, the more the median stock is overvalued. The further it moves below 1.00, the more the median stock is undervalued.

**Trailing Returns %**

Index	Quarter	6-Month	1-Year	3-Year	5-Year	10-Year
Morningstar U.S. Market	5.23	7.58	14.43	19.28	5.26	9.03
Large Cap	3.75	5.99	11.11	15.99	2.75	8.09
Mid Cap	7.93	10.95	23.04	27.43	11.61	11.03
Small Cap	12.99	14.68	25.13	30.41	13.74	11.10
U.S. Value	6.02	6.95	14.18	22.87	9.00	NA
U.S. Core	5.54	8.47	13.40	19.63	5.79	NA
U.S. Growth	4.04	7.32	16.03	15.38	0.18	NA
Large Value	5.50	6.29	12.45	20.53	6.92	NA
Large Core	4.06	7.15	10.16	16.78	2.99	NA
Large Growth	1.49	4.41	11.01	10.62	-2.56	NA
Mid Value	6.43	7.95	18.19	28.10	13.94	NA
Mid Core	7.77	10.30	21.50	26.53	13.37	NA
Mid Growth	9.52	14.46	29.29	27.29	6.76	NA
Small Value	10.86	11.49	21.62	31.68	17.81	NA
Small Core	14.22	16.36	25.34	30.85	16.37	NA
Small Growth	13.78	16.15	28.63	28.76	7.14	NA

**Morningstar Market Barometer 1st Quarter Return %****Morningstar Market Barometer Trailing 4 Quarters Return %****2nd Quarter 2005**

1.87	-0.10	2.77
5.66	3.79	4.25
5.12	3.75	4.48

**3rd Quarter 2005**

3.85	2.91	3.46
3.62	6.13	8.34
3.78	3.83	5.99

**4th Quarter 2005**

0.75	2.97	2.87
1.43	2.35	4.52
0.56	1.87	2.08

**1st Quarter 2006**

5.50	4.06	1.49
6.43	7.77	9.52
10.86	14.22	13.78

**Biggest Positive Influence on Morningstar US Market Index**

	Style	Contribution %	1-Year	3-Year	5-Year
Exxon Mobil Corp.	■	0.23	8.92	22.40	10.24
Cisco Systems Inc.	■	0.22	26.58	18.61	6.50
Schlumberger Ltd.	■	0.13	30.54	50.21	17.75
Bellsouth Corp.	■	0.11	28.93	20.33	-0.79
Pfizer Inc.	■	0.10	7.89	-4.60	-7.28
Qualcomm Inc.	■	0.09	17.69	41.79	12.65
Hewlett-Packard Co.	■	0.09	15.19	29.58	1.98
Verizon Communications Inc.	■	0.09	14.43	3.11	-3.23
Goldman Sachs Group Inc.	■	0.08	23.10	32.87	13.56
AT&T Inc.	■	0.08	11.77	15.61	-5.79

**Biggest Negative Influence on Morningstar US Market Index**

	Style	Contribution %	1-Year	3-Year	5-Year
Intel Corp.	■	-0.24	-21.64	7.27	-5.09
Viacom Inc. Cl B	■	-0.21	-62.98	-29.62	-21.96
Yahoo! Inc.	■	-0.07	-17.66	38.97	32.56
UnitedHealth Group Inc.	■	-0.06	-10.06	34.59	30.42
Medtronic Inc.	■	-0.06	-11.68	4.66	2.67
Apple Computer Inc.	■	-0.06	-12.76	106.87	41.53
Amgen Inc.	■	-0.06	-7.75	8.12	3.86
Altria Group Inc.	■	-0.05	-4.10	38.43	12.18
Google Inc. Cl A	■	-0.04	-5.99	NA	NA
American Inter. Group Inc.	■	-0.03	-2.92	10.78	-3.43

Biggest Influence on 1-year performance is calculated by multiplying stock returns for the year with their respective weight in the Index as of the start of the year.

**News Briefs: Morningstar Introduces Dividend Indexes to Serve Income Seeking Investors**

In the first quarter of 2006, Morningstar introduced two new indexes designed to help investors understand the income potential of equities—Morningstar Dividend Composite and Morningstar Dividend Leaders. For more information visit <http://indexes.morningstar.com>. Also, First Trust Advisors launched an Exchange Traded Fund based on Dividend Leaders Index (ticker: FDL).