

Morningstar Market Commentary

Second Quarter 2004

Morningstar Market Barometer™



Overview: Markets in a Holding Pattern

As the second quarter drew to a close, the market was more inclined to go out with a whimper than a bang.

After the gut-wrenching highs and lows of the past few years, this year's market has been in more of a holding pattern. Investors held back ahead of a widely anticipated hike in interest rates at the end of June, and rising commodity prices have also prompted new worries about inflation. On the plus side, the economic recovery has generally been strong. But the real test of a sustainable recovery lies with bottom-line profits, and investors have been in wait-and-see mode ahead of second-quarter corporate earnings reports due out in July. Add in the normal uncertainty of an election year, plus continued threats of terrorism and political instability in Iraq and other areas of the world, and you've got a wall of worry that's tough to climb. As a result, Morningstar's US Market Index had a gain of just 1.56% for the second quarter.

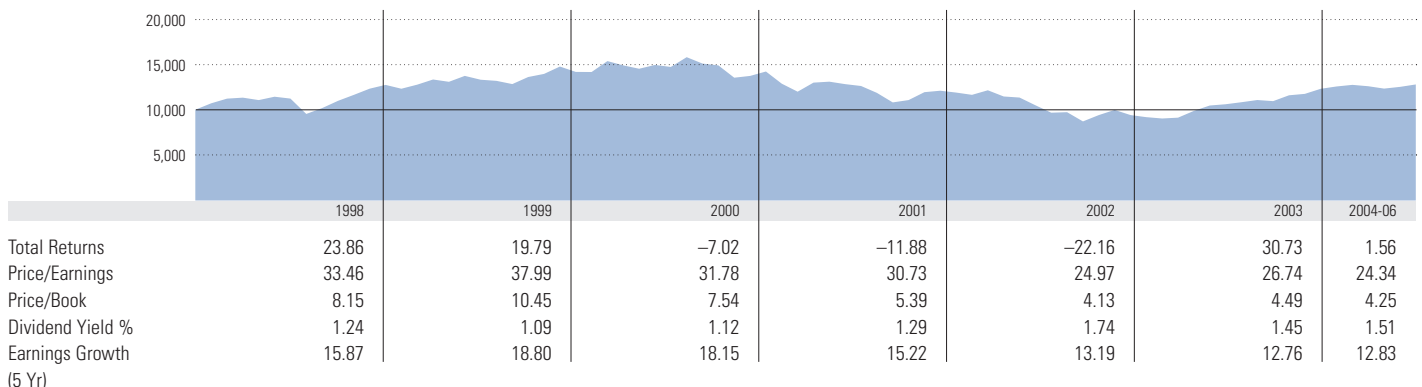
With optimism about the economic recovery weighed down with uncertainty, investors sought refuge in larger-cap stocks. Morningstar's Large Cap Index gained 1.73% for the second quarter, while the Morningstar Small Cap Index gained 1.36%. Among investing styles, value stocks generally fared better than growth issues, but size had a bigger impact on performance than style. Morningstar's Large Core Index, which gained 2.60% for the quarter, was the top performer among the

nine style indexes. The Mid Growth Index, which tracks the performance of fast-growing small-cap stocks, brought up the rear with a 0.01% loss for the same period.

Among individual stocks, blue-chip names such as Microsoft, ExxonMobil, Johnson & Johnson, and General Electric were the biggest positive contributors to returns for the US Market Index. While most of these stocks have suffered lackluster returns for the trailing three-year period, recent performance has been stronger as investors have cast favor on big names with relatively predictable earnings. Thanks to the resurgence in online advertising revenue, Yahoo! was another major contributor to index returns. eBay, which has continued to drive revenue growth by expanding into international markets, also contributed gains.

On the negative side, big banks and securities firms—including Citigroup, J.P. Morgan Chase, Morgan Stanley, and Goldman Sachs—suffered from worries about rising interest rates and lackluster returns in the equity markets. With several legal developments weighing down tobacco stocks, Altria was another drag on returns for the US Market Index. The stock doesn't rank as one of the top 10 holdings in the index, but its 7% loss for the quarter still made it one of the biggest negative contributors to performance.

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



Surveying the Sectors

Performance for Morningstar's 12 economic sectors was mixed for the quarter, with half of the sectors posting gains and the other half suffering losses. The spike in oil and gas prices has been bad news for consumers filling up at the pump, but great news for the energy sector, which gained 8.06% for the quarter. Even though smaller exploration and production and services stocks surged the most because they're more leveraged to commodity prices, the big integrated oil companies such as ExxonMobil, BP, Total, and Royal Dutch Petroleum, generally posted solid returns for the quarter.

With a 1.03% loss for the same period, the utilities sector was another laggard. Many of the bigger stocks in the industry, such as Exelon, Southern, and Duke Energy, were weighed down by regulatory concerns, and there hasn't been much of a catalyst to drive stock performance for the rest of the sector.

Industry Performance

Drilling down to the industry level, the coal industry was at the top of the heap with a 25.2% gain for the quarter. Online retail came in second place, posting a 20.29% gain. Online auction leader eBay has continued to thrive thanks to its successful push into international markets, and Amazon.com has also benefited from stronger trends in consumer spending. Global unrest and strong economic growth boosted share prices for stocks in the security services industry, which gained 19.38% over the same period. The biggest players in the industry—Brink's Company, Kroll, and Corrections Corp of America—all posted above-average total returns for the period. The groceries and oil/gas products industries also delivered double-digit gains for the quarter.

On the negative side, the gold and silver industry's 18.1% loss made it by far the worst performer for the quarter, as metal prices fell off their peaks from last year's big runup. Because gold and silver stocks are inexorably tied to commodity prices, only a few stocks in the industry made it through the quarter with positive returns. With higher interest rates looming on the horizon and mortgage rates already increasing, investors gave the cold shoulder to the home-building industry, which dropped 12.68% for the quarter, and the retail furniture industry, which dropped 10.67%. Most of the biggest stocks in these two industries, including Lennar, DR Horton, Centex, Bed Bath & Beyond, and Pier 1 Imports, closed out the quarter with losses.

Morningstar Sectors: Return %

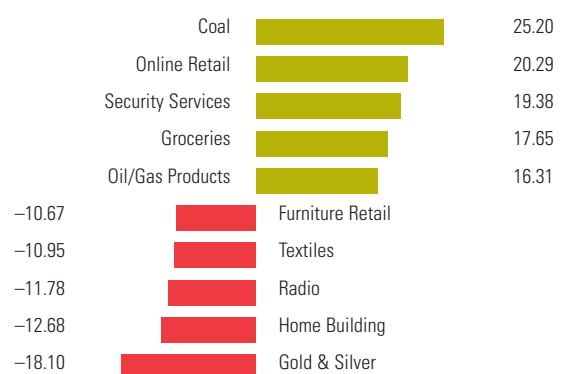
	Quarter	1 Year	3 Year
Information	0.51	19.13	-6.19
Software	7.31	16.04	-7.59
Hardware	-1.44	29.98	-3.28
Media	-0.28	6.96	-8.96
Telecom	-0.43	8.17	-10.08
Service	-0.20	17.50	5.13
Healthcare	2.71	9.40	1.62
Consumer Services	-1.59	21.52	9.05
Business Services	5.42	23.68	6.25
Financial Services	-2.55	20.29	5.64
Manufacturing	5.10	27.67	5.83
Consumer Goods	3.05	23.44	10.76
Industrial Materials	6.68	32.97	3.50
Energy	8.06	32.02	6.17
Utilities	-1.03	12.78	0.64

With corporate technology officers willing to open up their wallets to pay for software upgrades, the software sector was the second-best performer for the quarter, posting a 7.31% gain. Chicago-based Midway Games surged about 20% for the quarter as Sumner Redstone snapped up enough shares to become the company's biggest shareholder, but stodgier software names like Microsoft, Adobe Systems, and Check Point Software Technologies also fared well relative to the broader market.

The strong economic recovery also boosted the business-services sector, which gained 5.42% for the quarter. Transportation stocks such as JB Hunt Transport Services, Landstar System, and Overseas Shipholding Group were among the top performers in the sector. More traditional business services companies, including United Parcel Service, First Data, and Accenture, also contributed gains.

The financial services sector brought up the rear, posting a 2.55% loss for the quarter. Investors have continued to fret about the impact of higher interest rates on bank earnings, and the uncertain state of the market has weighed on share prices of securities firms.

Top and Bottom Five Industries: 2nd Quarter Return %



Style and Cap Indexes

The Happy Medium

With investors in a cautious mood, neither growth stocks nor value issues took a decisive lead. Growth stocks fared well in the large-cap arena, but value issues performed better in the mid- and small-cap arenas. With so much uncertainty weighing on the market over the past few months, investors were more likely to take refuge in high-quality stocks with solid track records of profitability, good prospects for steady growth, and clean balance sheets. As a result, Morningstar's US Core Index, which tracks the performance of stocks that combine both value and growth characteristics, was the best performer of the three style-based indexes, posting a 2.13% total return for the quarter.

Morningstar US Value Index: 1.3%

After taking the lead in the first quarter of 2004, the US Value Index finished up with a middling performance during the second quarter. Although financial services stocks were a significant drag on performance, energy stocks such as ExxonMobil, ChevronTexaco, and ConocoPhillips offset some of the damage. Stocks in industrial goods—which account for about 11% of the index—also helped pull the index into the black for the three-month period.

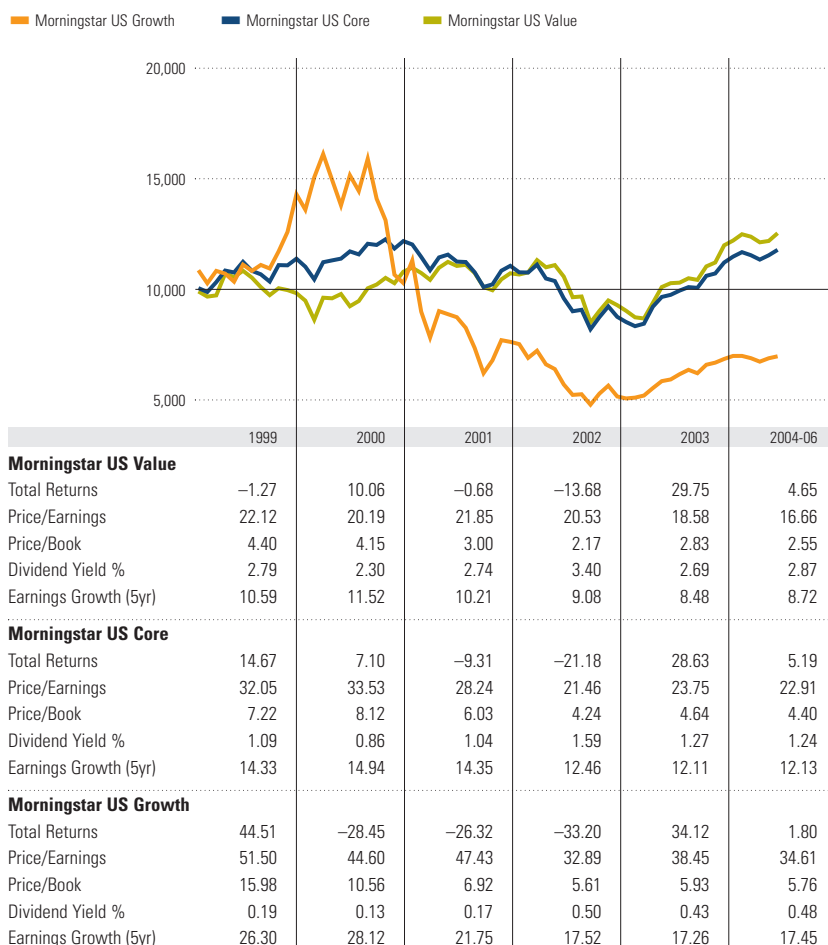
Morningstar US Core Index: +2.13%

The US Core Index finally benefited from the long-awaited market flight to quality after lagging behind its growth and value counterparts in 2003. Top holding General Electric—which accounts for about 7.42% of the index's value—performed a bit better than the market for the quarter. Most of the other major names in the Core Index—including Johnson & Johnson, Procter & Gamble, and Eli Lilly—also delivered decent returns. The index's 24% stake in lagging financial-services stocks pulled down returns, but positions in health care, consumer goods, and industrial goods offset most of the damage.

Morningstar US Growth Index: +1.25%

The US Growth Index was at the top of the heap in 2003's bull market, but it hasn't fared as well so far in 2004. The growth bogy lagged the core and value indexes both in the first quarter and the second quarter. Several of the bigger tech holdings in the index, such as Microsoft, Intel, and Dell, posted single-digit gains for the quarter, and a number of smaller holdings, including Yahoo, eBay, Zimmer Holdings, and Stryker, were double-digit gainers. Performance for the growth benchmark's underlying holdings was volatile under the surface, though, with numerous stocks also posting double-digit losses. Tech issues such as Texas Instruments, EMC, Applied Materials, and International Game Technology weighed down returns for the quarter, as did media names like Viacom and Clear Channel Communications. While the health-care sector generally performed well, biotech bellwether Amgen and specialty pharmaceutical Forest Laboratories fell behind.

Growth of \$10,000

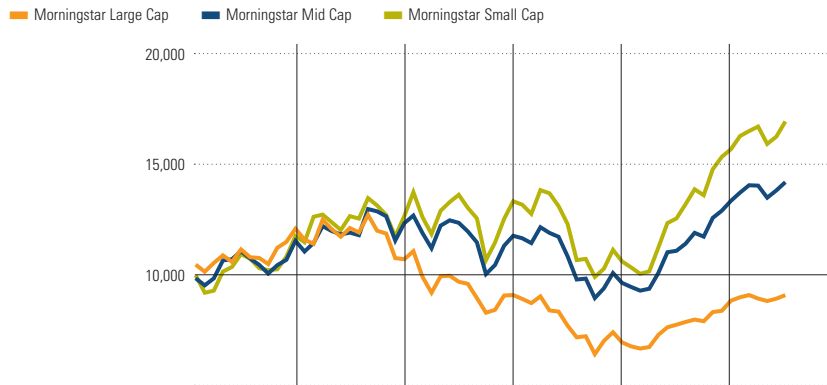


Morningstar Large Cap Index: +1.73%

It has been a long time since large-cap stocks have had a day in the sun, but they finally pulled ahead in the second quarter. After falling behind their smaller counterparts in both the bear market from 2000 to 2002 and the market rebound in 2003 and 2004, the Large Cap Index edged a bit higher in 2004's second quarter. Smaller-cap stocks often fare best in economic recoveries, but there's been enough uncertainty to prompt investors to take refuge in bigger, more reliable names. As a result, the Large Cap Index posted the best returns of Morningstar's three size-based indexes for the second quarter. Most of the biggest holdings in the index were solid performers, and with the exception of Citigroup and Wal-Mart Stores, most of the laggards occupied smaller positions in the benchmark.

Morningstar Mid Cap Index: +1.12%

The Mid Cap Index managed to finish the quarter with positive returns, but fell slightly behind the large cap and small cap indexes. Some midsize stocks—especially growth stocks with steep valuations—were too risky to excel in an uncertain market, but generally held up better than small-cap names. The biggest positive contributor to mid-cap returns was Texas-based energy holding company TXU Corp, which turned in a 41.7% return thanks to an improved financial outlook and deregulation of the Texas energy market in 2002. ImClone Systems also made a major contribution to benchmark returns, rocketing up by 69% and hitting a new 52-week high during the quarter. But there were plenty of negatives to offset the positives. Generic drug makers Watson Pharmaceuticals and King Pharmaceuticals both dropped more than 30%, and Simon Property Group SPG suffered along with other REITs.

Growth of \$10,000

	1999	2000	2001	2002	2003	2004-06
Morningstar Large Cap						
Total Returns	21.05	-11.38	-15.10	-23.47	27.04	2.82
Price/Earnings	40.06	33.75	32.03	25.14	26.93	24.01
Price/Book	11.51	8.49	5.98	4.56	4.76	4.52
Dividend Yield %	1.00	1.02	1.29	1.80	1.54	1.62
Earnings Growth (5yr)	18.45	18.16	14.78	12.81	12.46	12.48
Morningstar Mid Cap						
Total Returns	15.55	6.94	-4.63	-18.06	38.38	6.32
Price/Earnings	31.06	27.01	26.96	25.97	25.89	24.70
Price/Book	7.55	5.35	3.96	3.19	3.86	3.64
Dividend Yield %	1.38	1.40	1.33	1.59	1.27	1.30
Earnings Growth (5yr)	19.81	17.74	16.14	13.94	12.57	12.97
Morningstar Small Cap						
Total Returns	17.78	7.66	5.26	-20.36	47.70	7.98
Price/Earnings	28.89	21.28	25.22	22.96	27.04	26.99
Price/Book	5.99	3.68	3.11	2.72	3.58	3.41
Dividend Yield %	1.17	1.35	1.18	1.56	1.09	1.11
Earnings Growth (5yr)	20.19	19.65	17.57	14.96	14.86	14.90

Morningstar Small Cap Index: +1.36%

Bigger was better in the second quarter, but the Morningstar Small Cap Index didn't fall too far behind. Because smaller companies are often valued based on expectations for cash flows many years into the future, the prospect of rising interest rates tends to ratchet down valuations, but the index still finished the quarter with positive returns. The Small Cap Index contains more than 1,000 stocks, and the biggest holding accounts for less than 0.25% of assets. However, some individual holdings, such as biotech drug developer OSI Pharmaceuticals, still had a meaningful impact on performance.

Active vs. Passive, 2004 Q2

	Value	Core	Growth
Large Cap	58.0	6.7	33.9
Mid Cap	32.5	52.1	62.2
Small Cap	62.7	38.6	29.7

○ Percent of actively managed mutual funds outperforming their respective benchmark. Includes the oldest share class for all US diversified mutual funds with at least one-year history. As of June 30, 2004, there were 2,620 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 three-year period.

● Index Returns (%) for 2nd Quarter

Fund Categories vs. Benchmarks

Active management is supposed to prove its worth in tougher markets, but that maxim didn't really hold true in the second quarter of 2004. On average, the returns of the average mutual fund fell behind those of Morningstar's benchmarks for five of the nine style-based categories. Active managers were able to beat the benchmark for the Mid Core, Large Value, Small Value, and Mid Growth indexes. The value of active management was most pronounced in the small-value category, where almost two-thirds of the funds in the category managed to outpace the benchmark index. The average small-value fund has about 5.9% of its assets in cash, which helped buffer losses when the market declined. In addition, most small-value managers have underweighted financial services stocks relative to the index, a decision that helped mitigate some losses.

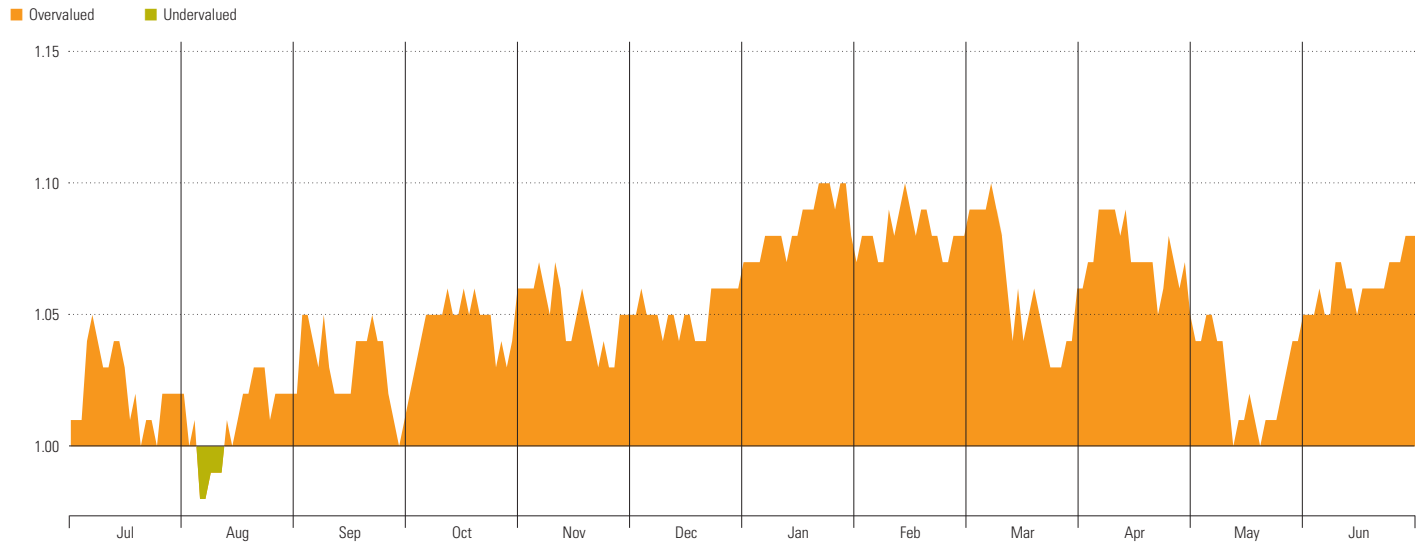
But the bulk of shareholders' assets are invested in large-cap categories, where performance of active managers was less impressive. The average large-growth fund lagged Morningstar's index benchmark by about 80 basis points, and the average large-blend fund fell about 160 basis points behind. This lackluster showing lends more support to the notion that it's difficult for active managers to add value in widely followed large-cap stocks.

Conclusion

As 2004's second quarter drew to a close, mixed economic news continued to keep the market in a holding pattern. Many of the portfolio managers we've interviewed have expressed a cautious outlook, and a few have taken refuge in cash. Some outstanding investors, including Fidelity's Joel Tillinghast, the team at Longleaf Partners, Jim Gipson and his colleagues at Clipper Fund, and FPA's Bob Rodriguez, currently have significant cash holdings because they haven't been able to find enough cheaply priced stocks.

Here at Morningstar, we've also found the market a bit on the pricey side. Our market valuation graph suggests that the average stock in our coverage universe is trading at about a 7% premium to its estimated fair market value. Only about 4% of the stocks in our coverage universe are currently undervalued enough to earn ratings of 5 stars—down slightly from 5% at the end of the first quarter. Thus, we think investors would do well to exercise caution going forward.

Market Valuation



52-Week High
1.10 (03-05-04)

52-Week Low
0.98 (08-06-03)

All-Time High
1.10 (03-05-04)

All-Time Low
0.78 (10-09-02)

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 %

Morningstar Indexes	Quarter	6-Month	1-Year	3-Year	5-Year	10-Year
US Market	1.56	3.90	20.57	-0.09	-1.42	11.47
Large Cap	1.73	2.82	17.21	-2.12	-4.00	11.17
Mid Cap	1.12	6.32	27.92	4.72	5.07	11.66
Small Cap	1.36	7.98	34.84	7.51	9.11	12.06
US Value	1.30	4.65	22.40	4.35	3.01	NA
US Core	2.13	5.19	21.25	1.58	0.96	NA
US Growth	1.25	1.80	18.24	-7.42	-9.09	NA
Large Value	0.96	3.16	18.77	1.99	0.66	NA
Large Core	2.60	4.51	17.51	-1.16	-1.68	NA
Large Growth	1.63	0.75	15.76	-8.49	-11.89	NA
Mid Value	2.51	8.88	30.85	9.66	8.79	NA
Mid Core	0.77	6.42	30.63	9.57	7.31	NA
Mid Growth	-0.01	3.56	21.43	-5.58	-1.80	NA
Small Value	1.30	7.59	35.14	15.64	12.71	NA
Small Core	1.69	9.00	35.70	10.50	15.01	NA
Small Growth	1.09	7.35	33.79	-2.62	0.73	NA

Morningstar Market Barometer 2nd Quarter Return %**Morningstar Market Barometer Trailing 4 Quarters Return %****3rd Quarter 2003**

-0.16	1.95	4.35
5.07	6.94	4.88
7.38	7.73	9.90

4th Quarter 2003

15.32	10.29	10.10
14.38	14.79	11.80
16.96	15.57	13.40

1st Quarter 2004

2.18	1.86	-0.86
6.21	5.61	3.56
6.21	7.19	6.19

2nd Quarter 2004

0.96	2.60	1.63
2.51	0.77	-0.01
1.30	1.69	1.09

Biggest Positive Influence on Morningstar US Market Index

Style	Contribution %	3 Month	1 Year	3 Year
Microsoft Corp.	0.35	14.56	1.93	-2.33
General Electric Co.	0.19	6.82	21.95	-6.95
Exxon Mobil Corp.	0.18	7.43	25.24	3.21
Yahoo! Inc.	0.17	50.20	105.75	46.36
Johnson & Johnson	0.14	10.38	-5.71	5.21
eBay Inc.	0.11	32.72	61.89	61.01
Tyco International Ltd.	0.09	15.72	142.96	-14.42
Boeing Co.	0.08	24.88	56.91	-8.29
Bank of America Corp.	0.08	5.48	23.53	19.59
Merck & Co. Inc.	0.07	8.33	-8.31	-11.57

Biggest Negative Influence on Morningstar US Market Index

Style	Contribution %	3 Month	1 Year	3 Year
Citigroup Inc.	-0.18	-9.28	51.97	4.98
Wal-Mart Stores Inc.	-0.13	-11.39	18.17	7.87
Texas Instruments Inc.	-0.06	-17.18	70.33	-1.65
Altria Group Inc.	-0.06	-6.83	62.18	8.44
IBM Corp.	-0.05	-3.82	17.84	1.51
J.P. Morgan Chase & Co.	-0.05	-6.77	100.80	0.62
Viacom Inc. Cl B	-0.04	-8.75	0.65	-6.67
EMC Corp.	-0.04	-16.24	72.89	-27.21
Pfizer Inc.	-0.04	-1.71	24.49	-0.29
Home Depot Inc.	-0.04	-5.55	57.16	-4.74

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

News Brief: BGI Launches ETFs on Morningstar Indexes

On July 2, 2004, Barclays Global Investors commenced trading of nine Morningstar Index exchange traded funds (ETFs) on the New York Stock Exchange. The nine ETFs represent each of the nine squares of the Morningstar Style Box™ and are first investment vehicles based on Morningstar Indexes.