

Morningstar Market Commentary

Third Quarter 2004

Morningstar Market Barometer™



Welcome to the brave new world of low expectations

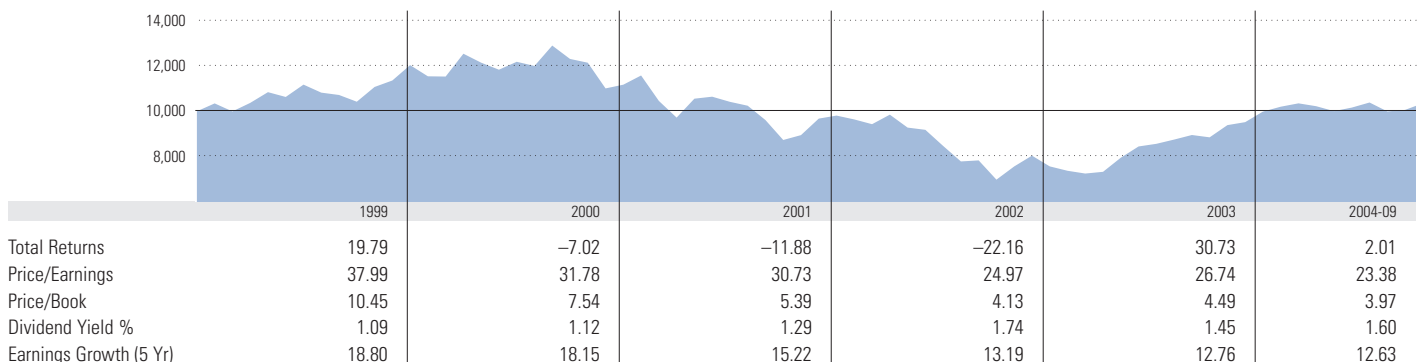
Although the market enjoyed brief periods of optimism during the third quarter, caution has generally been the word of the day. Many investors have been sitting on the sidelines ahead of the November elections, waiting until the votes are counted before putting too much equity money on the line.

The economic outlook has been mixed as well. On the plus side, inflation seems to be a less imminent threat than it was a few months ago; although oil prices remain historically steep at close to \$50 per barrel, prices on other goods have been rising at a relatively temperate pace. Economic news has generally been positive, with jobs growth accelerating in August and most other economic measures holding steady. The Federal Reserve has continued to gradually step up interest rates, implementing widely anticipated hikes of 25 basis points in both August and September. But nagging concern about the sustainability of the recovery has kept the market from surging ahead. High-profile earnings warnings from former consumer stalwarts such as Coca-Cola and Colgate-Palmolive have also weighed on investors' minds. As a result, Morningstar's US Market Index finished the third quarter with a 1.82% loss. Year to date, the Index has gained just 2.01%—a far cry from the double-digit gains enjoyed in the 2003 market rebound.

Continuing the trend of the past few quarters, value stocks have fared better than their growth counterparts, with Morningstar's US Value Index gaining 1.74% for the third quarter, versus a 6.64% loss for the US Growth Index. Commodity-driven sectors such as energy and utilities have pulled ahead, but steep losses on tech stocks have kept the growth index in negative territory for both the quarter and year to date. Morningstar's Large Cap Index lost 2.00% for the third quarter, compared with a 2.36% loss for the Small Cap Index. Across all three capitalization ranges, value stocks consistently outperformed growth stocks. The Mid Value Index was the top performer for the quarter, gaining 2.17%, while the Small Growth Index pulled up the rear with an 8.65% loss.

Among individual stocks, ExxonMobil, Chevron Texaco, and General Electric were the biggest positive contributors to the US Market Index. Technology bellwethers such as Intel, Cisco Systems, and Microsoft were negative contributors, as were beverage giants Coca-Cola and PepsiCo. Merck plummeted by about 30% on the last day of the quarter after it announced that it was withdrawing pain and arthritis medicine Vioxx from pharmacy shelves due to concerns about its safety.

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



Surveying the Sectors

With commodity prices soaring, it's no surprise that the energy sector was the best performer among Morningstar's 12 economic sectors, gaining 10.9% during the third quarter. While smaller firms benefited the most from the run in oil prices, big integrated oil companies such as ExxonMobil, BP, Total, and ChevronTexaco also fared relatively well. China-based energy companies such as PetroChina Company and China Petroleum & Chemical enjoyed double-digit share price gains thanks to continued economic growth in China, and oil-services companies such as Varco International and Transocean also continued to benefit from rising share prices. Failed Russian oil giant Yukos was one of the few big share-price losers in the energy sector for the quarter.

On the negative side, the hardware sector shed 13.42% during the third quarter, driven mainly by concerns about slowing IT spending. Shares of Intel and Cisco Systems—the biggest companies in the industry behind IBM—both suffered double-digit losses during the quarter. Conditions in the hardware sector were so poor that almost all of the major stocks in the sector dropped lower for the quarter; PC maker Dell, which slipped through with a small gain, was one of the few exceptions.

Health care was the second-worst performer, closing out the quarter with a 5.68% loss thanks in part to Merck's huge decline at the end of the quarter. The software sector was another laggard, with a 5.62% quarterly loss.

Morningstar Sectors: 3rd Quarter 2004 Return %

	Quarter	1 Year	3 Year
Information	-7.62	3.62	-0.48
Software	-5.62	1.87	10.95
Hardware	-13.42	-1.87	12.15
Media	-4.77	5.16	-5.75
Telecommunication	5.71	23.36	-28.07
Service	-1.54	12.62	19.90
Health Care	-5.68	6.49	-5.21
Consumer Services	-1.00	13.69	41.5
Business Services	-3.51	14.31	30.79
Financial Services	1.36	15.83	30.25
Manufacturing	1.89	26.83	30.75
Consumer Goods	-5.83	15.32	27.16
Industrial Materials	1.63	27.66	30.04
Energy	10.9	45.56	47.63
Utilities	5.44	18.59	10.67

The telecom sector came in a distant second with a 5.71% gain for the third quarter. Wireless communications companies such as Nextel Communications have continued to suffer as they've grappled with intense price competition and continuously shifting new technologies. However, stocks of most diversified telecom companies and foreign telecom players have performed relatively well.

The utilities sector was another strong performer, gaining 5.44% for the quarter. Companies such as Exelon, Southern, and Duke Energy have benefited from a generally favorable regulatory environment, while international utilities such as Korea Electric Power and Companhia Energetica de Minas Gerais have been buoyed by strong economic growth abroad.

Industry Performance

At the industry level, the gold and silver industry was the top performer, gaining 19.17% for the quarter. Because gold prices have been so volatile, however, the industry still has a negative total return year to date. The mining nonferrous and nonmetals industry was a close second, gaining 16.02%. Water transport, real estate, and steel/iron also ranked as industry standouts during the quarter. In other words, it was a great time to invest in tangible assets.

The air transport industry suffered a 23.14% average loss during the quarter, as stocks such as Southwest Airlines, Ryanair Holdings, British Airways, and JetBlue continued to suffer from high fuel prices and industry overcapacity. The semiconductor and data networking industries also experienced significant losses for the quarter, falling well below the prices reached in the 2003 market runup. All told, slightly more than half of Morningstar's 129 industry groups finished the quarter with losses.

Top and Bottom Five Industries: 3rd Quarter 2004 Return %

Gold & Silver	19.17
Mining (Nonferrous & Nonmetals)	16.03
Water Transport	15.80
Real Estate	15.57
Steel/Iron	15.52
Semiconductor Equipment	-20.28
Medical Goods & Services	-21.82
Semiconductors	-21.94
Data Networking	-22.24
Air Transport	-23.14

Style and Cap Indexes

Value Saves the Day

After putting in a middling showing in the second quarter, value stocks took a decisive lead in the third quarter. In fact, the gap between index returns for the Value Index and the Growth Index was a gaping 8 percentage points during the quarter—demonstrating the huge impact investment style can have on shareholder returns. Value stocks have also pulled well ahead of their growth counterparts for the year to date, as well as the trailing one- and three-year periods.

Morningstar US Value Index: +1.74%

The US Value Index was the only one of the three style-based indexes to finish the quarter with positive returns. As market uncertainty has generally kept investors away from pricier stocks, the Value Index has also been the top performer so far in 2004. Energy stocks—including ExxonMobil, ChevronTexaco, ConocoPhillips, and Occidental Petroleum—were among the biggest positive contributors to returns. Financials,

such as Bank of America and J.P. Morgan Chase & Co., also chipped in decent gains during the quarter. While most of the weaker stocks in the index occupied relatively small positions, heavyweights Merck, Citigroup, and Altria Group were notable exceptions. Fannie Mae was another drag on returns for the value benchmark; the stock suffered steep losses after the Office of Federal Housing Enterprise Oversight raised questions about its accounting practices.

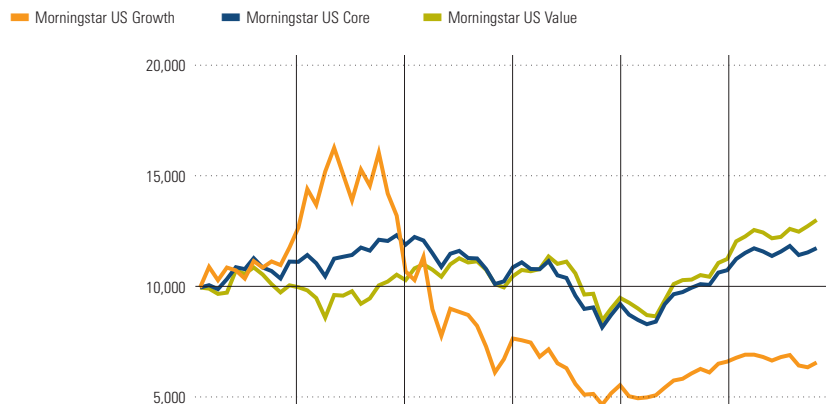
Morningstar US Core Index: -0.82%

The US Core Index—which contains stocks that share both value and growth characteristics—dipped slightly into the red for the third quarter. While most of the top holdings in the index finished the quarter with either mild losses or small gains, there were some notable performers. General Electric, Home Depot, Wells Fargo & Co., and Sprint were among the biggest positive contributors to the index. Holdings in financial services and industrial goods also generally fared well during the quarter. On the negative side, the index has virtually no exposure to surging energy stocks. Consumer products giants such as PepsiCo, Colgate-Palmolive, and Anheuser-Busch were a big drag on returns. Industrial conglomerates 3M and Tyco International also contributed losses.

Morningstar US Growth Index: -6.64%

The US Growth Index continued to trail the other two style-based indexes by a wide margin during the third quarter. There were a few winners reminiscent of last year's bull-market run, with stocks such as UnitedHealth Group, Symantec, and Guidant Corp. all contributing double-digit returns. For the most part however, the more heavily weighted stocks in the index saw their share prices sink. Top-10 holdings such as Intel, Cisco Systems, and Coca-Cola all dropped well into the red for the quarter. Health-care stocks, such as Pfizer and Cardinal Health, also had a negative impact on returns.

Growth of \$10,000



	1999	2000	2001	2002	2003	2004-09
Morningstar US Value						
Total Returns	-1.27	10.06	-0.68	-13.68	29.75	1.74
Price/Earnings	22.12	20.19	21.85	20.53	18.58	16.66
Price/Book	4.40	4.15	3.00	2.17	2.83	2.46
Dividend Yield %	2.79	2.30	2.74	3.40	2.69	2.89
Earnings Growth (5yr)	10.59	11.52	10.21	9.08	8.48	8.68
Morningstar US Core						
Total Returns	14.67	7.10	-9.31	-21.18	28.63	-0.82
Price/Earnings	32.05	33.53	28.24	21.46	23.75	21.94
Price/Book	7.22	8.12	6.03	4.24	4.64	4.18
Dividend Yield %	1.09	0.86	1.04	1.59	1.27	1.3
Earnings Growth (5yr)	14.33	14.94	14.35	12.46	12.11	11.99
Morningstar US Growth						
Total Returns	44.51	-28.45	-26.32	-33.20	34.12	-6.64
Price/Earnings	51.50	44.60	47.43	32.89	38.45	32.29
Price/Book	15.98	10.56	6.92	5.61	5.93	5.3
Dividend Yield %	0.19	0.13	0.17	0.50	0.43	0.56
Earnings Growth (5yr)	26.30	28.12	21.75	17.52	17.26	17.47

Morningstar Large Cap Index: –2.00%

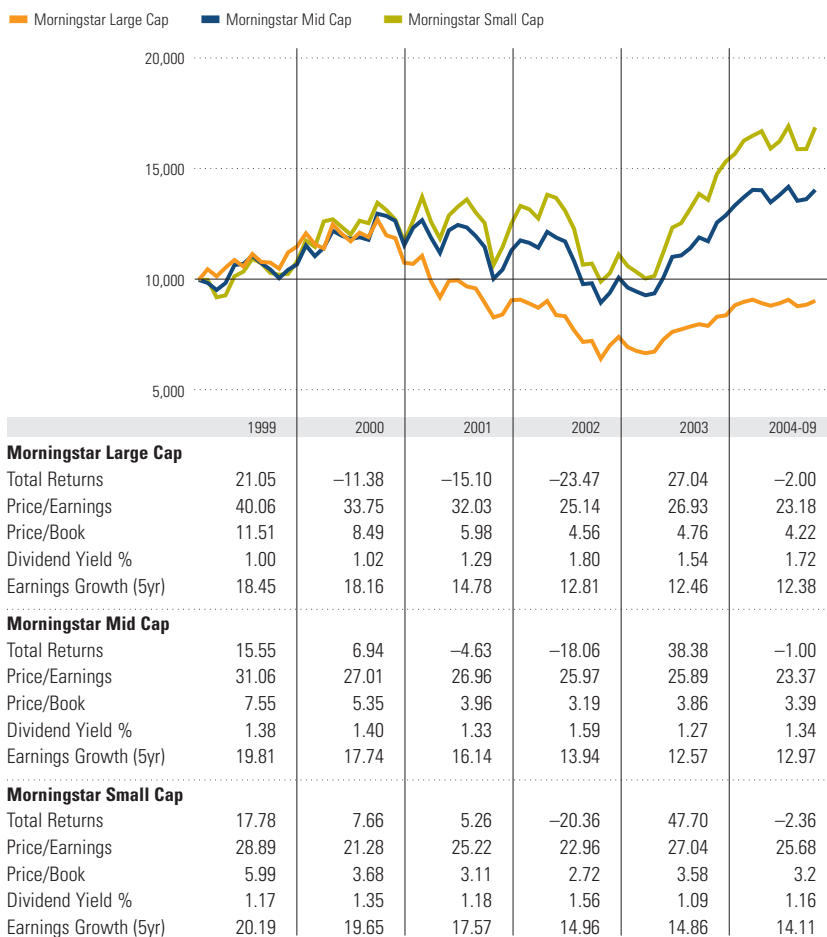
After taking the lead in the second quarter as investors sought refuge in larger, more reliable stocks, the Large Cap Index fared somewhat worse in the third quarter thanks to late-quarter losses on several of the bigger holdings in the index. While the Large Cap Index held up slightly better than the Small Cap Index, it fell behind the Mid Cap benchmark. ExxonMobil, General Electric, Verizon Communications, and ChevronTexaco were the most significant positive contributors to index returns. Home Depot also contributed gains during the quarter, as consumers continued to spend on real estate and home improvement. With the market still relatively skittish, though, a greater number of stocks had negative returns. Health care, consumer stocks, and big tech names such as Intel and Cisco Systems all helped pull the index into negative territory for the quarter to date.

Morningstar Mid Cap Index: –1.00%

Mid-cap stocks actually finished the quarter ahead of both their large-cap and small-cap peers, but still ended up with a negative return. Mall real estate investment trust Rouse was the biggest contributor to returns for the Mid Cap Index; the stock's price surged more than 40% thanks to a bid from General Growth Properties, which agreed to pay a healthy premium over the previous market price. Perennial turnaround candidate Eastman Kodak was another positive contributor to returns; the stock gained about 19% during the quarter as it seemed to make some progress on its plan to shift to digital photography. Some of the biggest negative contributors to performance were health-care stocks and beleaguered semiconductor stocks, including National Semiconductor, KLA-Tencor, and Micron Technology.

Morningstar Small Cap Index: –2.36%

The Small Cap Index remains the top performer of the three capitalization indexes for the trailing three-year period, but it fell behind for the most recent quarter. Investors generally gravitated towards larger, more stable names amid the uncertain market. Rising interest rates have also had a negative effect, as smaller companies are often valued based on expectations for future cash flows. While energy stocks and other commodity-sensitive fare performed well in the small-cap arena, smaller-cap stocks in hardware and telecommunications suffered as companies pulled back on investing in new IT projects. Conexant Systems, eResearch Technology, Applied Micro Circuits, and Foundry Networks were among the biggest negative contributors to the Index during the quarter.

Growth of \$10,000

Active vs. Passive, 3rd Qtr 2004

	Value	Core	Growth
Large Cap	14.0 1.6	15.4 -0.6	91.6 -7.4
Mid Cap	7.4 2.2	49.7 -1.8	36.8 -3.5
Small Cap	12.3 1.7	37.0 -0.4	83.8 -8.7

○ 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 September 30, 2004, there were 2,428 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 3rd Quarter

Fund Categories vs. Benchmarks

Even though active management was supposed to prove its mettle in weaker markets, it proved to be another tough quarter for active managers: The returns of the average mutual fund fell behind those of the relevant style-based benchmark for seven of Morningstar's nine style-based categories. Active managers were able to acquit themselves best in the large growth category, where the average fund posted a loss of 4.39%, compared with a 7.37% loss for the Large Growth Index. The average large growth fund currently holds about 4% of its assets in cash, which helped mitigate some losses during the quarter. Many growth managers also benefited from going light on hardware, software, and health-care stocks relative to the benchmark index, a decision that helped them sidestep some losses during the quarter. Active managers also fared relatively well in the small growth category, where close to 84% of all funds beat the relevant benchmark index.

But the picture was less impressive in other categories. In the large value category, for example, the average fund fell almost 2 percent behind the benchmark index. One major factor behind that shortfall: The average large value fund has a far lower stake in the financial services sector than the benchmark index, which held back returns as most financial stocks continued to churn out above-average returns. Large blend funds—which currently rank

as the largest fund category with more than \$800 billion in fund shareholder assets—lagged the benchmark index by about 2.72 percent, partly because of the impact of expenses and adverse stock selection.

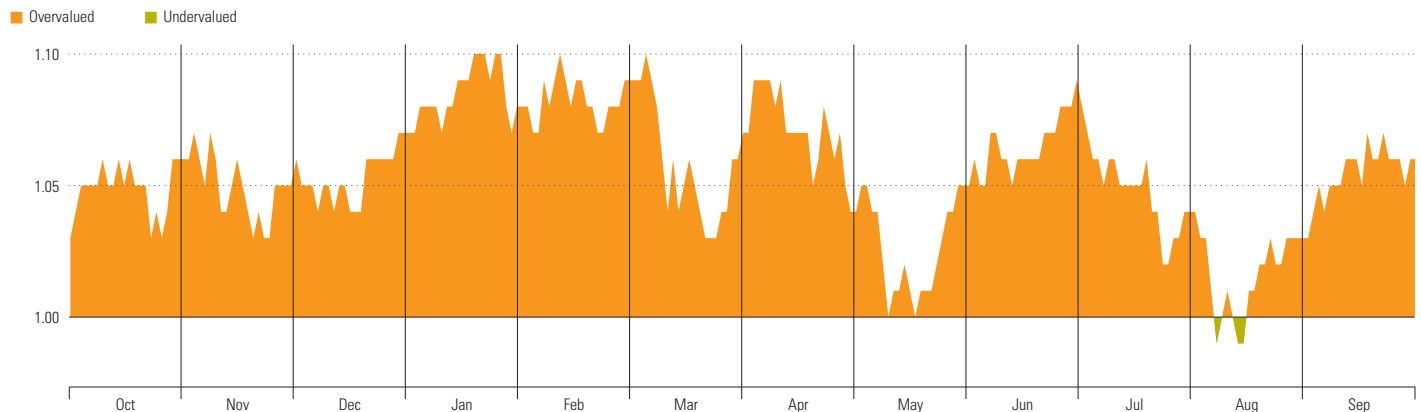
Conclusion

If there's a bright side to this year's choppy market, it's that equity valuations have declined to somewhat more reasonable levels. Thanks to generally strong earnings growth and lower stock prices, the Morningstar US Market Index currently trades at about 23 times trailing earnings—down from about 27 at the end of 2003. In aggregate, the median stock in Morningstar's coverage universe now trades at about a 5% premium to analyst-driven fair value estimate, down from a 7% premium at the end of the second quarter.

However, it's still tough to find bargains in the market. We always advocate looking for companies with wide economic moats that are trading low enough to offer a margin of safety, but it's not easy to find stocks meeting those requirements. At the end of third quarter only about 6% of all stocks rated by Morningstar—or 70 stocks out of a universe of about 1,440—currently receive ratings of 5 stars. That means investors have to do a fair amount of digging to find reasonably priced stocks—and be willing to ride out continued volatility in the market. ■■

Amy C. Arnott
Director of Securities Analysis

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)

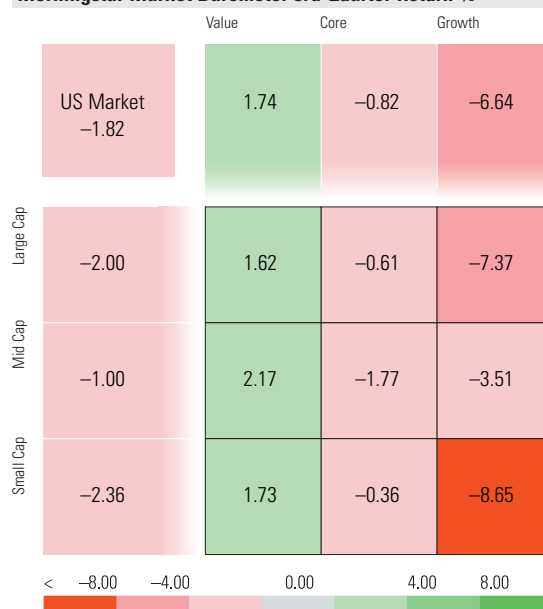
All-Time Low
0.78 (10-09-02)

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	-1.82	-0.29	14.67	5.11	-0.43	10.69
Large Cap	-2.00	-0.30	12.58	2.39	-3.22	10.45
Mid Cap	-1.00	0.11	19.76	39.90	6.88	10.81
Small Cap	-2.36	-1.03	21.52	15.67	10.08	10.96
US Value	1.74	3.06	22.72	8.19	5.64	NA
US Core	-0.82	1.29	16.40	5.05	2.51	NA
US Growth	-6.64	-5.47	5.24	1.69	-10.04	NA
Large Value	1.62	2.59	20.89	5.59	3.20	NA
Large Core	-0.61	1.98	14.56	1.95	-0.32	NA
Large Growth	-7.37	-5.87	2.75	-0.49	-13.10	NA
Mid Value	2.17	4.73	27.23	14.33	11.76	NA
Mid Core	-1.77	-1.02	19.99	13.72	9.81	NA
Mid Growth	-3.51	-3.52	11.71	6.33	-1.65	NA
Small Value	1.73	3.05	28.02	19.95	15.38	NA
Small Core	-0.36	1.32	25.51	17.43	16.18	NA
Small Growth	-8.65	-7.65	11.20	9.21	-0.16	NA

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

3rd Quarter 2004

1.62	-0.61	-7.37
2.17	-1.77	-3.51
1.73	-0.36	-8.65

Biggest Positive Influence on Morningstar US Market Index

	Style	Contribution %	3 Month	1 Year	3 Year
Exxon Mobil Corp.	■	0.25	9.44	34.89	9.15
ChevronTexaco Corp.	■	0.14	14.84	54.33	10.99
General Electric Co.	■	0.13	4.26	15.33	-1.21
Verizon Cmctns. Inc.	■	0.09	9.88	26.14	-6.66
Home Depot Inc.	■	0.08	11.61	24.05	1.36
UnitedHealth Group Inc.	■	0.08	18.46	46.60	30.41
SBC Communications Inc.	■	0.06	8.30	22.56	-14.37
Bank of America Corp.	■	0.05	3.47	15.27	17.62
Wells Fargo & Co.	■	0.04	5.03	19.34	12.83
Dow Chemical Co.	■	0.04	11.83	42.96	14.50

Biggest Negative Influence on Morningstar US Market Index

	Style	Contribution %	3 Month	1 Year	3 Year
Intel Corp.	■	-0.29	-27.17	-26.60	-0.13
Cisco Systems Inc.	■	-0.24	-23.63	-7.61	14.10
Pfizer Inc.	■	-0.20	-10.24	2.90	-6.91
Merck & Co. Inc.	■	-0.18	-29.73	-31.86	-17.52
Coca-Cola Co.	■	-0.15	-20.17	-4.52	-3.07
Citigroup Inc.	■	-0.08	-4.26	0.35	5.29
Microsoft Corp.	■	-0.07	-2.91	0.32	3.01
Eli Lilly & Co.	■	-0.07	-13.60	3.45	-7.44
PepsiCo Inc.	■	-0.06	-9.28	7.86	1.45
Cardinal Health Inc.	■	-0.06	-37.47	-24.83	-15.81

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 Briefs: Morningstar Announces Quarterly Rebalancing of Indexes

On September 20, 2004 Morningstar rebalanced its Indexes to reflect the most current corporate structure, shares outstanding, and free float for each index constituent. At the time of rebalancing, four new IPOs were added to the Morningstar US Market Index: Adesa, Cabela's, Genworth, and Google. For a complete list of securities in Morningstar US Market Indexes, visit <http://indexes.morningstar.com> or send an email to indexes@morningstar.com.