

Morningstar Market Commentary

4th Quarter and Year-End 2004

Morningstar Market Barometer™



Optimism Triumphs over Uncertainty

Investors grappled with uncertainty for most of the year, but the U.S. stock market closed out 2004 with a decent showing after all. For the first three quarters of the year, a litany of doubts seemed destined to keep returns in a holding pattern: the threat of higher inflation driven by surging oil and natural gas prices, steadily rising interest rates, questions about the outcome of the presidential election, a slumping U.S. dollar, and mixed news about the strength of the economic recovery. By the end of the third quarter, Morningstar's US Market Index had gained only about 2% for the year to date.

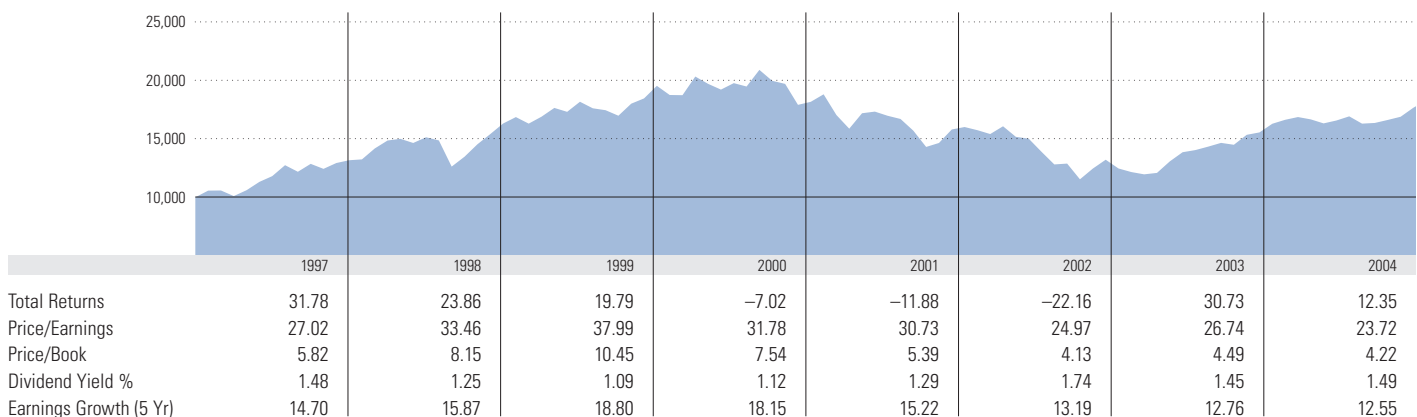
But optimism ultimately won out, as the market quickly shook off its doubts following decisive Republican wins in the November election. Thanks to a 10.1% gain for the fourth quarter, the US Market Index finished the year up 12.4%. Investors not only took comfort in the firmer political landscape, but also seemed reassured by the Federal Reserve's slow-and-steady policy of gradual interest-rate hikes, which have so far kept inflation in check without choking borrowers accustomed to easy, low-cost money. A spate of merger news late in the year—including Sears/Kmart, Johnson & Johnson/Guidant, Sprint/Nextel, Oracle/Peoplesoft, and Symantec/Veritas, to name a few—also gave the market a shot in the arm.

Reversing the trend shown in 2003, growth stocks lagged behind their value counterparts by a huge margin. In 2004, Morningstar's US Growth Index gained just 4.4%, compared with a 16.9% runup for the US Value Index. There was also a gaping span in returns for the size-based indexes. With beleaguered blue chips weighing heavily on the benchmark, Morningstar's Large Cap Index gained 9.5% for the year, compared with a 20.4% gain for the Small Cap Index.

On the individual stock level, stocks such as General Electric, Exxon Mobil, Johnson & Johnson, and Bank of America were among the biggest positive contributors to the US Market Index for the year. Selected tech stocks, including Apple Computer, eBay, Qualcomm, and Yahoo! also fared well as investors sought out companies with visible earnings growth. Formerly distressed Texas utility TXU Corp. was another major positive contributor to the benchmark. On the negative side, pharmaceutical giants Pfizer, Merck, and Eli Lilly posted deep market losses for the year. Tech bellwethers Intel Corp and Cisco Systems also offset some of the market's gains.

But with the damage from these stocks relatively limited, by the end of the year the market had made back most—but not all—of the losses it suffered during the bear market from 2000 through 2002.

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



Surveying the Sectors

With a gain of 33%, the energy sector was far and away the best performer of Morningstar's 12 economic sectors for 2004. Oil services stocks, such as Tesoro, Ultra Petroleum, and Valero Energy, posted the most eye-catching gains. But shares of the major integrated oil companies, such as Exxon Mobil, Total, and Chevron-Texaco also generally enjoyed solid gains.

decline in Hardware sector led to a drop in Information super sector's share of the US Market Index from 23.5% to 21%. Service, which contributed 47.4% at the beginning of the year, was almost unchanged.

Industry Returns

Drilling down to the industry level, the Oil/Gas Products industry hit the top of the charts, generating a 71.3% return for 2004. The water-transport industry came in second, posting a 61.4% return for the year thanks to strong gains on shipping stocks such as Teekay Shipping, Overseas Shipholding Group, OMI, and General Maritime. The steel/iron industry was another top performer thanks to soaring demand from China and other emerging markets. Industry conditions were so strong that every stock in the industry, except one, finished the year with solid gains. The coal, gambling/hotel casinos, and security services industries also generated well above-average returns for 2004.

Despite the generally strong market, 15 of Morningstar's 129 industry groups finished the year with negative returns. Chip stocks were particularly painful; the semiconductor and semiconductor equipment industries both dropped about 20% for the year. Other industries related to hardware equipment—including data networking, contract manufacturers, and optical equipment—also suffered deep losses for the year. With negative returns on stocks like Clear Channel Communications, Westwood One, Univision Communications, and Sinclair Broadcast Group, the radio and broadcast TV industries also finished the year significantly in the red.

Morningstar Sectors: 2004 Return %

| | 3 Month | 1 Year | 3 Year |
|----------------------|--------------|--------------|--------------|
| Information | 13.83 | 3.62 | -2.91 |
| Software | 15.29 | 10.68 | -2.51 |
| Hardware | 14.57 | -3.65 | -2.12 |
| Media | 14.73 | 4.81 | -1.87 |
| Telecommunication | 8.54 | 17.96 | -5.86 |
| Service | 9.29 | 11.84 | 5.65 |
| Health Care | 6.02 | 3.76 | -0.86 |
| Consumer Services | 12.67 | 17.71 | 8.04 |
| Business Services | 13.03 | 14.95 | 3.22 |
| Financial Services | 9.10 | 13.99 | 9.84 |
| Manufacturing | 8.98 | 20.15 | 9.39 |
| Consumer Goods | 10.10 | 11.75 | 9.60 |
| Industrial Materials | 9.85 | 18.71 | 7.67 |
| Energy | 5.05 | 32.99 | 13.88 |
| Utilities | 12.12 | 23.40 | 5.64 |

The utilities sector was another strong performer for the year, generating total returns of 23.4%. Exelon, Southern, and Duke Energy led the sector with spectacular gains.

With a -3.7% return, the hardware sector brought up the rear in 2004. Chip equipment makers remained deeply out of favor because of rising inventory levels and weak pricing power. Network equipment maker Cisco Systems was another major drag on returns.

The health-care sector remained in its slump for most of 2004, finishing the year with a paltry 3.8% gain. Health-care services stocks fared relatively well, but that was far outweighed by deep losses on major pharmaceutical stocks. First, Merck lost close to 30% of its market value after it pulled its pain and arthritis drug Vioxx from pharmacy shelves. Pfizer also suffered deep losses during the year; after much speculation, the company finally announced that its arthritis drug Celebrex was found to have similar—though less severe—cardiovascular side effects to Vioxx.

The sector makeup of the Morningstar US Market Index underwent some changes over the past 12 months as well. Thanks to a surge in Energy and Utilities sector, the Manufacturing super sector, increased its share of the US Market Index from 29.1% to 31.4%. While a

Top and Bottom Five Industries: 2004 Return %

| | |
|-------------------------|--------|
| Oil/Gas Products | 71.31 |
| Water Transport | 61.37 |
| Steel/Iron | 56.77 |
| Real Estate | 52.64 |
| Agriculture | 48.89 |
| Broadcast TV | -14.71 |
| Data Networking | -16.70 |
| Contract Manufacturers | -16.92 |
| Semiconductors | -19.47 |
| Semiconductor Equipment | -22.09 |

Value Stocks Continue to Dominate

Morningstar US Value Index +16.9%

The US Value Index dominated the style-box map for most of 2004 as cautious investors shied away from pricier growth stocks. A 15% stake in the buoyant energy sector was a definite plus. Top holding Exxon Mobil, for example, gained 28% for the year. Formerly troubled TXU Corp. was another major positive contributor to returns. The stock surged more than 170% as it continued to make significant operational improvements and pay down debt. Kmart Holding Corp. was another huge gainer.

Morningstar US Core Index +15.6%

Thanks to a strong showing late in the year, the US Core Index—which includes stocks that demonstrate a mix of value and growth characteristics—finished the year just slightly behind the US Value Index. Top holding General Electric, which makes up about 7% of the index's value, was the biggest positive contributor to index returns for the year. Shares in the stock rose about 20% in 2004, as the company has made numerous

acquisitions in an effort to boost future top-line growth. Consumer stalwarts such as Johnson & Johnson, Procter & Gamble, Target, and Home Depot were also strong contributors to the US Core Index for the year.

On the negative side, insurer Marsh & McLennan was a drag on returns; the shares dropped about 30% following news that New York Attorney General Eliot Spitzer had filed civil charges against the company for charging contingent commissions to insurance companies in exchange for getting more business.

Morningstar US Growth Index +4.4%

After a brief moment in the sun in 2003's market rebound, the US Growth Index fell behind by a country mile again in 2004. The index finished the year up just over 4%—more than 10 percentage points behind the Value and Core Indexes. Index returns were plagued mainly by losses on blue-chip growth stocks, such as Pfizer, Intel, Cisco Systems, and Coca-Cola. Aggressive growth stocks, such as Apple Computer, eBay, Qualcomm, Starbucks, and Yahoo!, kicked in impressive gains in 2004, but those returns were generally overshadowed by lackluster results among several of the top holdings in the index.

Following this year's disappointing showing, the US Growth Index has generated an annualized loss of 2.2% for the trailing three years, and is still nursing deep losses for the trailing five-year period.

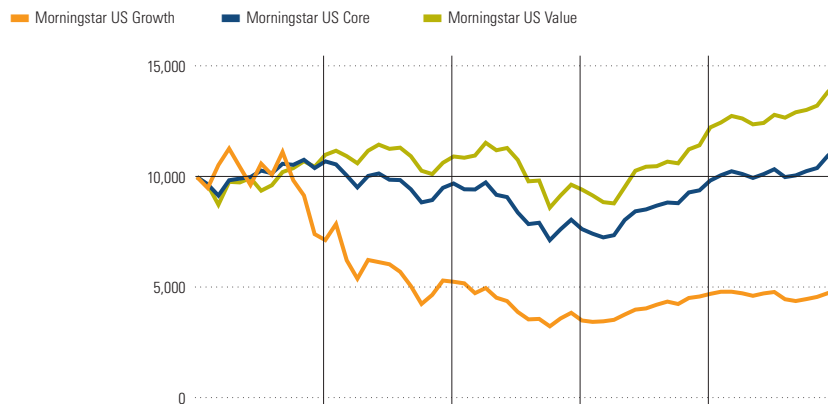
Best-Performing Style Index: Mid Value +24.3%

Morningstar's Mid Value Index beat out the Small Value Index by a hair in 2004. The index is light on health-care and hardware stocks, so it sidestepped most of the damage from those areas. At the same time, it has a 36% weighting in financial services stocks, which generally performed well despite the Fed's interest rate hikes during the year.

Worst-Performing Style Index: Large Growth +0.2%

The Large Growth Index just barely finished the year in positive territory. That's probably cold comfort to anyone who had hoped to take refuge from market uncertainty in classic growth stocks. Hardware and health-care stocks—which make up a combined 41% of the benchmark's value—were the main culprits.

Morningstar Style Indexes: 5 Year Growth of \$10,000



| | 2000 | 2001 | 2002 | 2003 | 2004 |
|------------------------------|--------|--------|--------|-------|-------|
| Morningstar US Value | | | | | |
| Total Returns | 10.06 | -0.68 | -13.68 | 29.75 | 16.85 |
| Price/Earnings | 20.19 | 21.85 | 20.53 | 18.58 | 16.79 |
| Price/Book | 4.15 | 3.00 | 2.17 | 2.83 | 2.58 |
| Dividend Yield % | 2.30 | 2.74 | 3.40 | 2.69 | 2.68 |
| Earnings Growth (5yr) | 11.52 | 10.21 | 9.08 | 8.48 | 8.68 |
| Morningstar US Core | | | | | |
| Total Returns | 7.10 | -9.31 | -21.18 | 28.63 | 15.62 |
| Price/Earnings | 33.53 | 28.24 | 21.46 | 23.75 | 21.93 |
| Price/Book | 8.12 | 6.03 | 4.24 | 4.64 | 4.34 |
| Dividend Yield % | 0.86 | 1.04 | 1.59 | 1.27 | 1.30 |
| Earnings Growth (5yr) | 14.94 | 14.35 | 12.46 | 12.11 | 11.85 |
| Morningstar US Growth | | | | | |
| Total Returns | -28.45 | -26.32 | -33.20 | 34.12 | 4.37 |
| Price/Earnings | 44.60 | 47.43 | 32.89 | 38.45 | 33.50 |
| Price/Book | 10.56 | 6.92 | 5.61 | 5.93 | 5.91 |
| Dividend Yield % | 0.13 | 0.17 | 0.50 | 0.43 | 0.40 |
| Earnings Growth (5yr) | 28.12 | 21.75 | 17.52 | 17.26 | 17.58 |

The Smaller the Better

Morningstar Large Cap Index +9.5%

Despite finishing the year with positive returns, the Large Cap Index again fell behind its small- and mid-cap counterparts by a big margin in 2004. Returns on blue-chip stocks were particularly disappointing because they should have had a headwind from the weak dollar. Indeed, most multinational companies enjoyed at least a couple of percentage points in extra sales growth thanks to currency movements. But many blue-chip firms have been struggling to generate organic growth, and investors have been more interested in smaller stocks that are better poised to benefit from the ongoing economic recovery.

Hardware stocks, including Intel Corp., Cisco Systems, Texas Instruments, and Applied Materials, were among the biggest negative contributors to index returns during the year. Major drug makers, including Merck, Pfizer, and Eli Lilly, also contributed deep losses to the index in 2004.

Morningstar Mid Cap Index +19.7%

Mid-cap stocks didn't fare quite as well as small-cap issues in 2004, but they still finished the year well ahead of lagging large-cap names. The Mid Cap Index has close to one third of its assets in Morningstar's manufacturing supersector, which allowed it to benefit from stronger economic growth and healthy commodity prices. An additional 22% of index assets are in the financial services sector, which generally fared well despite rising interest rates.

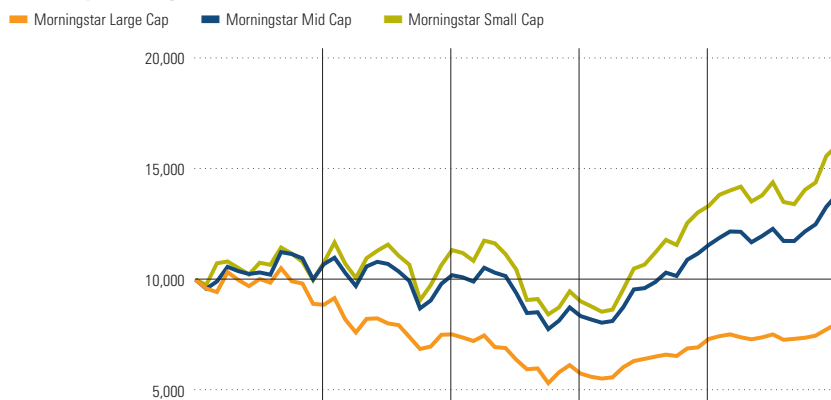
Apple Computer, which now ranks as the top holding by market capitalization in the Mid Cap Index, was by far the biggest positive contributor to returns, as soaring iPod sales helped drive the stock to a 200% gain (following December 2004 index reconstitution, Apple is now a member of the Large Growth Index). TXU Corp., Autodesk, and Chicago Mercantile Exchange Holdings also contributed triple-digit gains for the year. On the negative side, a number of mid-cap growth stocks, such as Univision Communications, Sanmina-SCI, Tiffany & Co., and Mylan Laboratories, suffered sharp losses for the year. But because these stocks generally occupied smaller positions in the index, the damage was relatively limited.

Morningstar Small Cap Index: +20.4%

The much-heralded "small-cap effect" was alive and well in 2004, as small cap stocks continued to dominate the index landscape for most of the year. Smaller-cap stocks normally outperform during periods of economic recovery; in addition, smaller-cap issues (which Morningstar defines as the bottom 7% of outstanding market capitalization of the Morningstar US Market Index) have continued to generate both revenue growth and bottom-line profits while many blue-chip firms have struggled to sustain growth.

Drilling down to the individual stock level, the Small Cap Index also benefited from triple-digit gains in numerous gaming and retail stocks, including Wynn Resorts Ltd, Boyd Gaming Corp., American Eagle Outfitters, and Urban Outfitters. Winning stocks like these were more than enough to offset losses on downtrodden tech names like Conexant Systems, Electronics for Imaging, and Integrated Device Technology.

Morningstar Cap Indexes: 5 Year Growth of \$10,000



| | 2000 | 2001 | 2002 | 2003 | 2004 |
|------------------------------|--------|--------|--------|-------|-------|
| Morningstar Large Cap | | | | | |
| Total Returns | -11.38 | -15.10 | -23.47 | 27.04 | 9.54 |
| Price/Earnings | 33.75 | 32.03 | 25.14 | 26.93 | 23.23 |
| Price/Book | 8.49 | 5.98 | 4.56 | 4.76 | 4.37 |
| Dividend Yield % | 1.02 | 1.29 | 1.80 | 1.54 | 1.62 |
| Earnings Growth (5yr) | 18.16 | 14.78 | 12.81 | 12.46 | 12.26 |
| Morningstar Mid Cap | | | | | |
| Total Returns | 6.94 | -4.63 | -18.06 | 38.38 | 19.66 |
| Price/Earnings | 27.01 | 26.96 | 25.97 | 25.89 | 24.64 |
| Price/Book | 5.35 | 3.96 | 3.19 | 3.86 | 3.87 |
| Dividend Yield % | 1.40 | 1.33 | 1.59 | 1.27 | 1.24 |
| Earnings Growth (5yr) | 17.74 | 16.14 | 13.94 | 12.57 | 12.90 |
| Morningstar Small Cap | | | | | |
| Total Returns | 7.66 | 5.26 | -20.36 | 47.70 | 20.44 |
| Price/Earnings | 21.28 | 25.22 | 22.96 | 27.04 | 26.45 |
| Price/Book | 3.68 | 3.11 | 2.72 | 3.58 | 3.77 |
| Dividend Yield % | 1.35 | 1.18 | 1.56 | 1.09 | 0.98 |
| Earnings Growth (5yr) | 19.65 | 17.57 | 14.96 | 14.86 | 14.45 |

Active vs. Passive, 2004

| | Value | Core | Growth |
|-----------|-------|------|--------|
| Large Cap | 37.8 | 10.9 | 92.5 |
| Mid Cap | 14.1 | 14.0 | 0.2 |
| Small Cap | 12.0 | 22.5 | 31.3 |
| | 24.0 | 19.1 | 15.5 |
| | 16.1 | 16.8 | 43.9 |
| | 24.3 | 23.6 | 13.5 |

○ 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 December 31, 2004, there were 2,427 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 (%) for 2004

Fund Categories vs. the Benchmarks

Once again, Morningstar’s market indexes were tough benchmarks to beat for the vast majority of active managers in 2004. In eight of the nine style-based categories, the average mutual fund had returns well below those of the appropriate index for the year. The large blend category—by far the largest Morningstar category with close to \$850 billion in investor assets—was particularly tough for active managers. The average mutual fund posted a 2004 return of 9.8%, falling about four percentage points behind the 14% return for the Large Core Index. Part of that is due to the drag of cash holdings in a generally rising market, but stock selection also had a negative impact on returns for many active managers.

Actively managed funds put in a better showing in the large growth category, where about 93% of funds were able to beat the Large Growth Index. Most funds were underweight in hardware and health-care stocks relative to the index, which allowed them to avoid some of the losses from these sectors. Moreover, Morningstar’s style indexes are designed to be style-pure, meaning that an index like the Large Growth Index only includes stocks that clearly demonstrate a large-growth style. But most fund managers have at least some degree of flexibility for buying stocks in other areas of the style box.

As a result, the Morningstar style indexes tend to show more extreme performance characteristics, with higher returns in up markets and deeper losses in down markets than those experienced by actively managed funds.

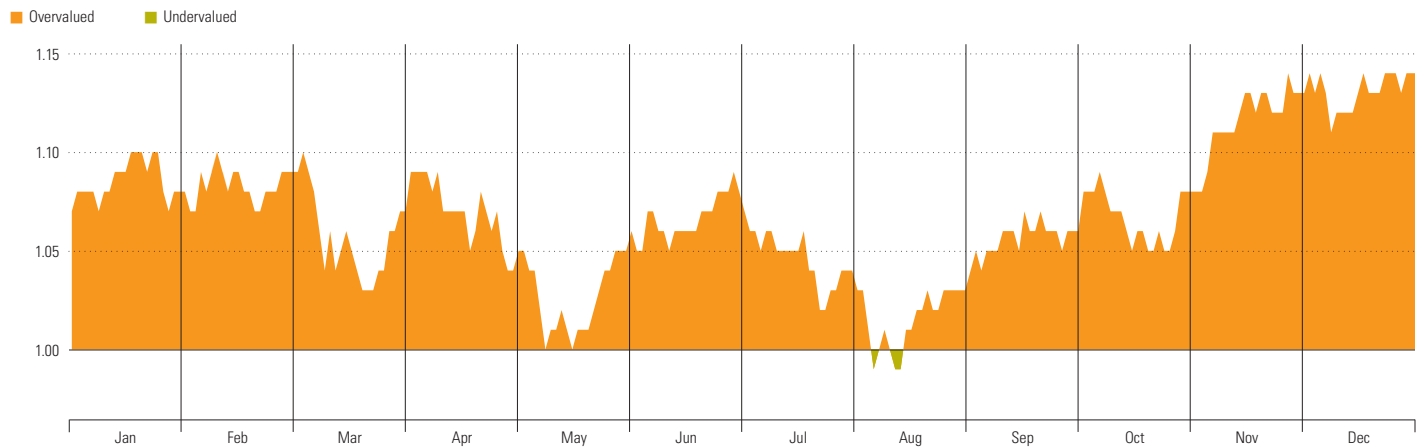
Conclusion

Despite the market’s generally optimistic mood, we think investors should avoid getting too carried away by end-of-year market euphoria. Market valuations have dropped slightly from the nosebleed levels reached at the end of 2003, but stocks still aren’t exactly cheap. Morningstar’s US Market Index now trades at about 24 times trailing earnings, down only slightly from 26.7 at the end of 2003. The median stock in our coverage universe now trades at a 14% premium to the analyst-generated fair value estimate. That ratio is higher than it’s been since we began tracking this statistic for our coverage universe at the beginning of 2001.

Morningstar’s star rating for stocks also suggests that overall market valuations are still on the high side. Currently, only 31 out of 1476 stocks rated by Morningstar earn 5-star ratings, while 525 stocks have 1-star ratings. (Generally speaking, stocks that trade at large discounts to our analysts’ fair value estimates receive higher star ratings and stocks trading at large premiums to their fair value estimates receive lower star ratings.) So while it’s possible to find stocks that are priced low enough to offer investors a margin of safety, those opportunities seem to be few and far between. ■■

Amy C. Arnott
Director of Securities Analysis

Market Valuation



52-Week High
1.14 (12-28-04)

52-Week Low
0.98 (08-06-04)

All-Time High
1.14 (12-28-04)

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 %

| Index | Quarter | 6-Month | 1-Year | 3-Year | 5-Year | 10-Year |
|--------------|---------|---------|--------|--------|--------|---------|
| US Market | 10.14 | 8.14 | 12.35 | 4.56 | -1.30 | 11.83 |
| Large Cap | 8.71 | 6.54 | 9.54 | 2.12 | -4.33 | 11.35 |
| Mid Cap | 13.68 | 12.54 | 19.66 | 10.69 | 6.70 | 12.54 |
| Small Cap | 14.22 | 11.53 | 20.44 | 12.30 | 9.92 | 12.67 |
| US Value | 9.74 | 11.66 | 16.85 | 9.38 | 7.42 | NA |
| US Core | 10.83 | 9.91 | 15.62 | 5.43 | 2.63 | NA |
| US Growth | 9.81 | 2.52 | 4.37 | -2.21 | -13.18 | NA |
| Large Value | 8.79 | 10.56 | 14.05 | 6.94 | 4.54 | NA |
| Large Core | 9.74 | 9.07 | 13.99 | 2.69 | -0.67 | NA |
| Large Growth | 7.36 | -0.56 | 0.19 | -4.35 | -16.21 | NA |
| Mid Value | 11.74 | 14.16 | 24.30 | 14.98 | 14.74 | NA |
| Mid Core | 13.89 | 11.87 | 19.05 | 13.07 | 11.96 | NA |
| Mid Growth | 15.54 | 11.49 | 15.45 | 2.93 | -5.33 | NA |
| Small Value | 13.32 | 15.27 | 24.03 | 19.19 | 18.95 | NA |
| Small Core | 13.82 | 13.41 | 23.61 | 14.79 | 16.38 | NA |
| Small Growth | 15.73 | 5.71 | 13.48 | 3.02 | -3.49 | NA |

Morningstar Market Barometer 4th Quarter Return %**Morningstar Market Barometer Trailing 4 Quarters Return %****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 |

4th Quarter 2004

| | | |
|-------|-------|-------|
| 8.79 | 9.74 | 7.36 |
| 11.74 | 13.89 | 15.54 |
| 13.32 | 13.82 | 15.73 |

Biggest Positive Influence on Morningstar US Market Index

| | Style | Contribution % | 1 Year | 3 Year | 5 Year |
|-------------------------|-------|----------------|--------|--------|--------|
| Exxon Mobil Corp. | ■ | 0.71 | 27.61 | 11.31 | 6.81 |
| General Electric Co. | ■ | 0.61 | 20.47 | -1.06 | -4.93 |
| Apple Computer Inc. | ■ | 0.38 | 201.36 | 43.22 | 4.60 |
| Johnson & Johnson | ■ | 0.36 | 24.88 | 3.87 | 7.69 |
| eBay Inc. | ■ | 0.36 | 80.07 | 51.45 | 29.99 |
| Bank of America Corp. | ■ | 0.31 | 21.07 | 17.70 | 16.34 |
| Qualcomm Inc. | ■ | 0.31 | 58.08 | 19.16 | -13.45 |
| TXU Corp. | ■ | 0.26 | 176.13 | 12.93 | 15.36 |
| UnitedHealth Group Inc. | ■ | 0.23 | 51.36 | 35.49 | 45.94 |
| Yahoo! Inc. | ■ | 0.23 | 67.36 | 61.88 | -19.00 |

Biggest Negative Influence on Morningstar US Market Index

| | Style | Contribution % | 1 Year | 3 Year | 5 Year |
|----------------------------|-------|----------------|--------|--------|--------|
| Pfizer Inc. | ■ | -0.34 | -21.96 | -10.37 | -1.89 |
| Intel Corp. | ■ | -0.31 | -26.52 | -8.98 | -10.32 |
| Cisco Systems Inc. | ■ | -0.20 | -20.26 | 2.18 | -18.43 |
| Merck & Co. Inc. | ■ | -0.15 | -27.19 | -14.67 | -10.22 |
| Coca-Cola Co. | ■ | -0.12 | -15.98 | -2.04 | -4.72 |
| Eli Lilly & Co. | ■ | -0.07 | -17.29 | -8.20 | -1.10 |
| Viacom Inc. Cl B | ■ | -0.07 | -17.44 | -5.92 | -9.46 |
| Applied Materials Inc. | ■ | -0.05 | -23.80 | -5.16 | -11.59 |
| Texas Instruments Inc. | ■ | -0.05 | -15.90 | -3.86 | -12.30 |
| Clear Channel Cmctns. Inc. | ■ | -0.04 | -27.53 | -12.46 | -17.47 |

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 Announces Semi-Annual Reconstitution of Indexes

On December 20, 2004 Morningstar reconstituted its indexes to reflect the most current fundamental information, market capitalization and liquidity of the underlying securities. Ninety-seven new securities were added to the Morningstar US Market Index, of which 22 were initial public offerings. Seventy-three securities were dropped from the Index. For a complete list of securities in the Morningstar US Market Indexes visit <http://indexes.morningstar.com> or send an e-mail to indexes@morninstar.com.