

# Morningstar Index Quarterly

Second Quarter 2003

## Morningstar Market Barometer<sup>SM</sup>

	Value	Core	Growth
Large Cap	18.16	15.05	12.05
Mid Cap	18.61	16.95	19.71
Small Cap	25.85	19.99	25.51

### 2nd Quarter (% Return)

-3.83	2.16	3.14
-1.02	0.63	7.44
1.58	0.49	4.49

### 1-Year (% Return)

## Morningstar Earnings Barometer

40Y 31A	40Y 41A	23Y 33A
110Y 48A	129Y 103A	71Y 105A
154Y 86A	180Y 144A	120Y 159A

Number of companies with  
 ▼ downward revisions  
 ▲ upward revisions

Cumulative changes in consensus earnings estimates for FY 2003 were based on change in estimates between March 31 and June 30, 2003.

## Overview: A Broad-Based Rally

For stock investors, it was a quarter to remember.

The Morningstar US Market Index rose 16% for the quarter, its best quarterly showing since the last hurrah of the stock-market bubble in the fourth quarter of 1999. Although the quarter held some nasty surprises—most notably, the turnover in Freddie Mac's management team—the positives outweighed the negatives.

First of all, while the economy remained sluggish, the outlook for corporate earnings stabilized—at least according to Wall Street analysts. Back in the first quarter, downward revisions vastly outnumbered upward revisions, and the stock market (not surprisingly) was down. In the second quarter, as you can see from the Morningstar Earnings Barometer, upward and downward revisions were about equal.

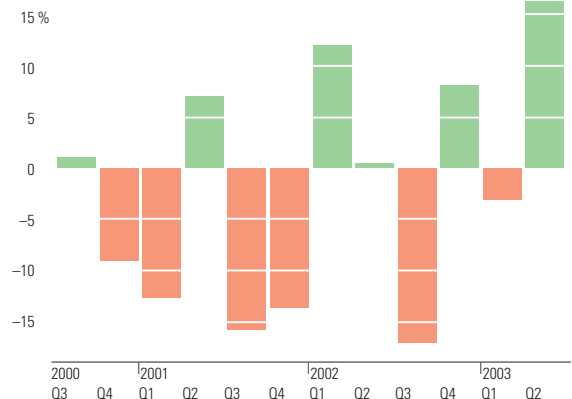
Also, investors liked what they saw coming out of Washington. In May, President Bush signed into law tax reforms that lowered taxes on corporate dividends to 15%, down from the personal income tax rate of as high as 38.6% before the tax bill. The government also cut taxes on long-term capital gains to 15% from 20%.

Finally, the market had been beaten down over the past three years, and many of the riskier stocks were poised to jump on any whiff of good news. The Morningstar US Market Index started the quarter 40% below its highs reached three years before.

The most speculative areas of the market enjoyed the biggest rebound. For example, the best-performing of Morningstar's 12 sectors was Hardware, the sector most brutalized by the three-year bear market. We also saw many financially troubled companies that the market had shunned—stocks like AMR, Capital One, Americredit, and Ford Motor—rebound strongly in the second quarter. When the stock market rises and interest rates fall—both of which improve access to capital for cash-strapped companies—speculative stocks such as these can rise in a hurry.

While speculative stocks did the best in the second quarter, the rally was broad-based. As the Morningstar Market Barometer illustrates, all nine of Morningstar's style indexes rose during the quarter. Of the 1,800 stocks in the Morningstar US Market Index, 92% had gains. Of the stocks that rose during the quarter, the average gain was 26%. Of those that were down, the average drop was only 9%.

## Morningstar US Market Index (% Quarterly Returns)



With the market in rally mode, smaller-cap stocks led the charge. The Morningstar Small Cap Index rose 22% during the quarter, versus a 12% increase for the Large Cap Index.

Looking ahead, most fund managers we've talked to recently are fairly optimistic, pointing to the salutary effects of the recently passed tax package, continued low interest rates, and better corporate earnings on the horizon. Yet, caution is still warranted. Most stocks can't be considered cheap, particularly after the dramatic market rebound of the past three months. Only about 7% of the stocks in Morningstar's rating universe currently earn 4 or 5 stars, suggesting that bargain-priced shares are few and far between.

## Surveying the Sectors

All 12 Morningstar sectors rose sharply in the second quarter. Three of the best-performing stock sectors in the second quarter were among those beaten up the worst over the past few years: Hardware, Utilities, and Telecommunications.

Business/online services, which includes many dot-com firms, was another hot industry in the second quarter, up more than 40%. Stocks like Amazon, eBay, Priceline.com, and Expedia—all part of the Consumer Services sector—enjoyed another great quarter, which helped the growth indexes.

### Morningstar US Market Index (% Sector Composition 6-30-03 Versus 12-31-02)

	6-30-03	12-31-02		6-30-03	12-31-02		6-30-03	12-31-02
<b>Information</b>	<b>22.04</b>	<b>20.99</b>	<b>Service</b>	<b>49.87</b>	<b>49.63</b>	<b>Manufacturing</b>	<b>28.09</b>	<b>29.37</b>
Software	4.55	4.72	Healthcare	14.69	14.57	Consumer Goods	8.99	9.69
Hardware	9.46	8.45	Consumer Services	9.42	9.13	Industrial Materials	10.16	10.60
Media	4.60	4.18	Business Services	4.41	4.48	Energy	5.93	6.19
Telecom	3.42	3.64	Financial Services	21.36	21.46	Utilities	3.01	2.90

The sharp rebound in Hardware—the sector was up almost 25%—helped the Morningstar Growth Index. The index has almost a 20% weighting in that one sector. Many of the largest Hardware stocks rose 30% or more during the quarter, including Intel, Cisco, Hewlett-Packard, EMC, and Sun Microsystems. Given how cyclical the profits are for these firms, their stocks will tend to jump the farthest when the overall market rebounds.

The surge in both Utilities and Telecom stocks, by contrast, helped the Large Value Index. The index has a 13% weighting in the telecom sector—the highest among Morningstar indexes. Among telecom stocks, both wireline and wireless providers rose sharply. The three big Baby Bells—Verizon, SBC Communications, and BellSouth—each posted double-digit gains. AT&T Wireless and Nextel on the wireless side also posted sharp gains. Despite their increases this year, though, telecom stocks are still far underwater over the trailing 3- and 5-year periods.

Biotechnology also vastly outperformed—yet another example of a speculative group of companies that found favor during the period. The biotech rally helped the Small Growth Index, which has a 23% stake in the healthcare sector.

The worst-performing sectors of the second quarter were Energy and Consumer Goods. (Even the worst performers were still up double digits for the quarter.) This marks the second straight quarter in which consumer-goods stocks were at the bottom of the performance heap. This may have been because investors preferred more speculative securities instead of the steadier companies that populate the consumer-goods sector, or it could have been because the sector had fewer companies with near-death experiences that have come roaring back.

### Morningstar Sectors (% Return)

	Qtr	1 Yr	3Yr		Qtr	1 Yr	3Yr		Qtr	1 Yr	3Yr
<b>Information</b>				<b>Service</b>				<b>Manufacturing</b>			
Software	16.29	3.60	-21.17	Healthcare	14.51	6.57	-23.60	Consumer Goods	12.63	-7.39	4.94
Hardware	24.59	4.83	-1.68	Consumer Services	17.75	-5.11	-2.58	Industrial Materials	16.81	-7.31	1.50
Media	21.40	11.93	-31.55	Business Services	18.66	-4.92	4.50	Energy	12.99	-3.12	0.21
Telecom	20.62	5.28	-15.67	Financial Services	19.90	-0.77	0.01	Utilities	21.05	-3.75	5.13

## Fund Categories Versus the Benchmarks

Nearly every domestic-stock fund category Morningstar tracks was in the black during the second quarter of 2003. On a relative basis, though, six out of the nine Style Box categories failed to beat their respective indexes.

In the large-growth area, three quarters of fund managers beat the index. Not coincidentally, the Morningstar Large Growth Index was the worst-performing index in the second quarter—up just 12% versus the market's 16% rise.

Top 10 Value Stocks			
US Value Index	Weight %	Mutual Funds	Number of Funds
ExxonMobil	8.05	Citigroup	296
Bank of America	3.97	ExxonMobil	253
Verizon Comm	3.61	Bank of America	250
Altria Group	3.09	J.P. Morgan Chase	223
SBC Comm	2.85	Verizon Comm	259
Chevron Texaco	2.59	Chevron Texaco	217
J.P. Morgan Chase	2.33	Fannie Mae	178
Fannie Mae	2.22	American Intl Group	197
Hewlett-Packard	1.96	Altria Group	184
Wachovia	1.80	Bristol-Myers Squibb	213

Top 10 value stocks held by mutual funds are ranked by aggregate assets held by all value mutual funds

The toughest benchmarks to beat proved to be the red-hot Small Value and Small Growth Indexes. Less than 20% of managers in those two categories managed to beat their respective indexes. We see two reasons for the underperformance.

First, many of the best-performing stocks in the second-quarter were former large- and mid-cap companies that have tumbled down into small-cap territory. Think AMR, AES, Calpine, and Americredit. Many of the funds that own these names are large-cap funds, not small-cap funds.

Top 10 Growth Stocks			
US Growth Index	Weight %	Mutual Funds	Number of Funds
Pfizer	8.97	Microsoft	452
Microsoft	7.86	Pfizer	405
Johnson & Johnson	5.11	Johnson & Johnson	369
Wal-Mart Stores	4.84	General Electric	297
Intel	4.52	Amgen	411
Cisco Systems	3.90	Cisco Systems	410
Amgen	2.60	Viacom B	264
Dell Computers	2.41	Wal-Mart Stores	333
Viacom Cl B	2.21	American Intl Group	291
Medtronic	1.94	Dell Computers	379

Top 10 growth stocks held by mutual funds are ranked by aggregate assets held by all growth mutual funds

25.2	40.9	72.8
18.2	15.0	12.0
37.1	60.9	28.0
18.6	17.0	19.7
15.3	57.2	20.8
25.9	20.0	25.5

### Active vs. Passive, 2nd Quarter, 2003

- Percent of actively managed mutual funds outperforming their respective benchmark
- Index (%) Returns for 2nd Quarter, 2003

Because Morningstar's indexes are style pure—meaning an index like Large Growth contains large-growth stocks exclusively—their performance can differ substantially from funds in the equivalent category. Unlike the indexes, almost all fund managers own stocks in more than one square of the Style Box. That tends to mute their performance versus the index. When the index swings up, managers tend not to swing as far. Likewise when the index heads down.

Just look at the first quarter of 2003, when we saw the exact opposite of the second quarter. Then, the Large Growth Index was the best-performing index, and only 9% of large-growth managers kept pace with it.

By contrast, in the second quarter it was large-value managers who had a tough time keeping pace with the index. Only 25% of large-value funds beat the index. Because telecom and utilities stocks had such a great quarter, any manager lacking exposure to those two sectors faced a strong headwind.

Second, the smaller the stock, the better it tended to perform in the second quarter. For mutual funds, though, it gets tougher to establish significant positions as you move down the market-cap spectrum. While the Morningstar Small Cap Index excludes the bottom 3% of stocks by market cap—thus eliminating most microcaps—it's still going to have a pure small-cap focus, whereas many small-cap funds have a smattering of mid caps as well as small caps.

## Value Outpaces Growth

### Morningstar US Growth Index: +14.5%

The three largest contributors to the performance of the Morningstar US Growth Index were Cisco, Pfizer, and Intel. Hardware stocks overall had a great quarter, as the market continued to price in a yet-to-be-seen recovery in earnings. Cisco gained 33% for the quarter, and Intel was up 30%.

Despite a much smaller market cap than these companies—its weight in the index is just half a percent—Genentech was among the top-10 contributors to the index's second-quarter return. The stock of the biotech giant more than doubled in the quarter, in large part due to positive news about its cancer drug, Avastin.

### Morningstar US Core Index: +15.8%

The story in the US Core Index was pharmaceuticals and financials. Both groups enjoyed solid returns in the second quarter, and the bulk of these stocks fall into the core group. Their growth rates tend to be solid, but they tend not to be among the market's priciest stocks. Many of them offer good dividend yields, for example. Among the financial stocks that contributed most to the index's performance were Citigroup, American International Group, American Express, and Wells Fargo. Among pharmaceutical stocks, Merck, Bristol-Myers, Wyeth, and Eli Lilly all numbered among the top-10 contributors.

Rounding out the top 10 were General Electric, with a 10% gain, and AOL-Time Warner. AOL rebounded sharply in the second quarter—the stock rose more than 40%—after a poor first quarter.

### Morningstar US Value Index: +18.8%

The performance of telecom and utilities stocks helped the value indexes. The US Value Index has a 10% weighting in utilities and a 10% weighting in telecom, as compared to the US Core and US Growth Indexes which have almost no exposure to those two sectors.

In case you're wondering, Freddie Mac falls into the Large Value Index. Given all the negative news coming out of the mortgage powerhouse, you might think the stock would have helped drag down the index. But the stock actually finished the quarter with only about a 5% loss. So while Freddie did hold back the value group's performance a tad, it wasn't much of a factor.

### Best-Performing Morningstar Style Index

#### Small Value: +25.8%

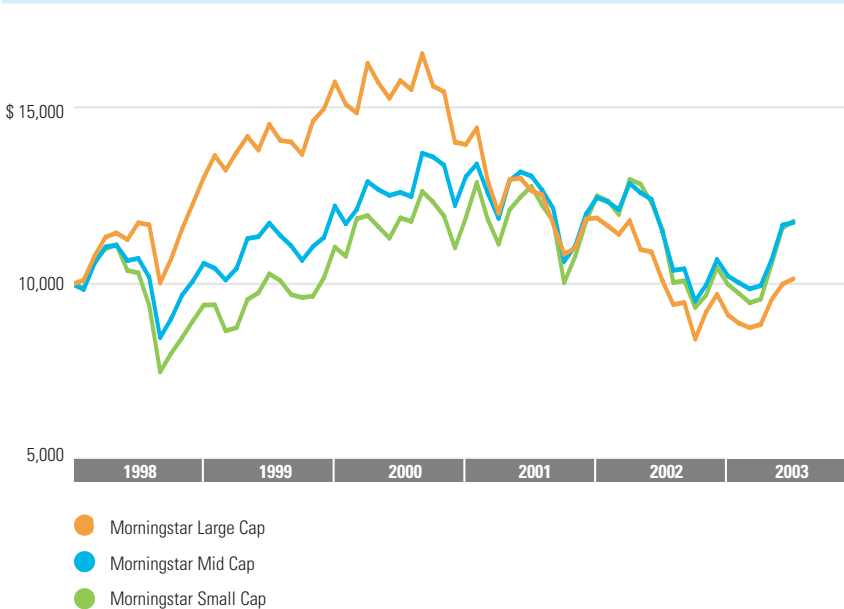
The best-performing Morningstar index for the quarter was Small Value, up 26%, but Small Growth was only 34 basis points behind.

### Worst-Performing Morningstar Style Index

#### Large Growth: +12.0%

Despite a 26% return from bellwether Cisco, the Large Growth Index was the worst performing for the quarter. Several mega-cap names had ho-hum stock-market performances during the quarter, including the two largest stocks in the group: Wal-Mart and Microsoft. Other big names like Qualcomm and Walgreen also had lackluster showings.

Growth of \$10,000



	Value	Core	Growth	Value	Core	Growth
Large Cap	17.07	21.66	31.97	3.14	1.56	0.62
Mid Cap	17.13	20.51	34.91	3.24	1.32	0.15
Small Cap	19.97	20.65	33.15	2.95	1.16	0.09

Price-to-Earnings 6-30-03

Dividend Yield % 6-30-03

## The Smaller the Better

### Morningstar Large Cap Index: 14.9%

The two largest contributors to the 14.9% return of the Large Cap Index were Citigroup and General Electric, which gained 24% and 10% respectively. Combined, those two stocks increased their market caps by an incredible \$80 billion during the quarter. Also helping the performance of the Large Cap Index were stocks in the hardware and telecom sectors: Cisco, Intel, and SBC Communications. Each of those three stocks numbered among the top-10 contributors to the Large Cap Index's returns during the quarter.

As with other indexes, a big driver of second-quarter returns was a rebound of down-and-out stocks. Among the largest contributors to the Large Cap Index's returns

was Altria (formerly Philip Morris), which gained more than 60% during the second quarter. McDonald's and Ford Motor also had great quarters but are still way below their five-year highs.

### Morningstar Mid Cap Index: 18.3%

It was high-risk, high-return for the Mid Cap Index in the second quarter. The main contributors to the index's 18.3% increase were stocks of hardware, software, and finance firms that the market had earlier shunned.

The single largest contributor to the performance of the Mid Cap Index: Veritas Software, which has more than doubled from its 52-week low, but still remains a fraction of its all-time high. After getting creamed in 2002 because of worries over consumer lending, Capital One surged in the second quarter, rising more than 50%. Best Buy, which shed 50% of its value in 2002, rebounded in the second quarter, gaining 60%. Among the other top contributors: Amazon.com, Broadcom, and Concord EFS.

### Morningstar Small Cap Index: 23.5%

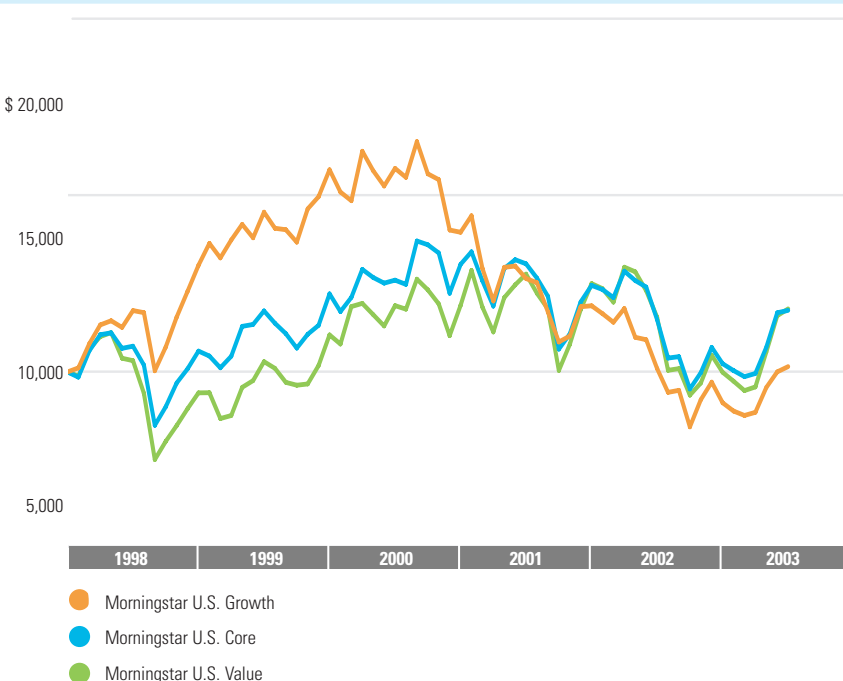
The biggest contributors to the small-cap resurgence in the second quarter were a rag-tag group of former mid- and large-cap companies. When the market does well, these kind of volatile stocks often shoot up. With the stock market rising and interest rates falling, raising capital got a bit easier for these firms during the quarter. With their chances of survival improving, these companies were richly rewarded by the market.

Scanning the list of top-10 contributors you find names like AMR, the struggling airline that just barely managed to avoid bankruptcy in the second quarter. Its stock shot up more than 300%. AES and Calpine, the independent power producers, gained 80% or more during the quarter. They're two companies that have also skirted with bankruptcy in the recent past.

You also find Williams (the struggling energy company), Americredit (the firm that makes auto loans whose stock blew up in January), and PMC-Sierra (the chip maker whose shares had fallen from \$255 a share in the bubble years to \$3).

—Haywood Kelly, Director of Securities Analysis

Growth of \$10,000



# Morningstar Index Quarterly

Trailing Returns %						
	Qtr	6-Month	1-Yr	3-Yr	5-Yr	10-Yr
Morningstar Indexes						
US Market	16.18	12.65	1.06	-10.79	-1.50	9.49
Large Cap						
Large Cap	14.91	11.45	0.57	-13.82	-2.90	9.48
Mid Cap	18.25	15.01	2.32	-2.35	1.85	9.05
Small Cap	23.50	18.28	2.11	-0.26	2.74	9.03
US Value						
US Value	18.80	10.94	-2.87	3.70	1.42	NA
US Core	15.78	11.60	1.68	-6.03	0.33	NA
US Growth	14.50	15.48	4.11	-27.36	-7.46	NA
Large Value						
Large Value	18.16	9.67	-3.83	0.73	0.32	NA
Large Core	15.05	10.92	2.16	-10.06	-1.12	NA
Large Growth	12.05	13.71	3.14	-29.84	-9.25	NA
Mid Value						
Mid Value	18.61	13.11	-1.02	11.53	4.09	NA
Mid Core	16.95	12.98	0.63	7.08	3.40	NA
Mid Growth	19.71	19.41	7.44	-20.81	-2.78	NA
Small Value						
Small Value	25.85	18.53	1.58	16.62	5.92	NA
Small Core	19.99	14.54	0.49	8.16	7.38	NA
Small Growth	25.51	22.48	4.49	-20.64	-4.15	NA



## 3rd Quarter 2002

-20.83	-13.64	-16.40
-17.19	-16.85	-18.12
-16.90	-19.70	-25.24

## 4th Quarter 2002

10.80	7.02	7.42
6.45	7.18	9.26
2.62	6.33	11.78

## 1st Quarter 2003

-7.18	-3.59	1.48
-4.64	-3.40	-0.25
-5.82	-4.54	-2.41

## 2nd Quarter 2003

18.16	15.05	12.05
18.61	16.95	19.71
25.85	19.99	25.51

## Portfolio Analysis

Morningstar Indexes	Median Market Cap (\$Mil)	Price/Earning	Price/Book	Price/Sales	Price/Cash Flow	Dividend Yield	1-Yr Revenue Growth	1-Yr Book Value Growth	1-Yr Historical Earnings Growth	1-Yr Projected Earnings Growth
US Market	1,501	23.73	4.30	3.07	15.17	1.59	4.29	7.67	15.40	13.22
Large Cap										
Large Cap	19,082	23.58	4.65	3.24	15.70	1.68	4.29	7.67	14.09	13.31
Mid Cap										
Mid Cap	3,123	24.20	3.59	2.57	13.92	1.39	3.84	7.64	20.13	13.07
Small Cap										
Small Cap	808	24.05	2.84	2.79	13.24	1.28	3.67	6.44	14.63	12.67
US Value										
US Value	1,508	17.27	2.48	1.43	7.58	3.14	-3.89	3.61	0.00	8.41
US Core										
US Core	1,633	21.34	4.22	2.24	13.55	1.47	4.29	10.09	8.87	12.77
US Growth										
US Growth	1,269	32.64	5.95	5.47	20.96	0.48	11.53	10.59	19.67	18.05

Notes and Disclaimer: ©2003 Morningstar, Inc. All Rights Reserved. Unless otherwise noted, all data is as of June 30, 2003. Multi-year returns are annualized. NA: Not Available. All portfolio analysis data is as of the most recent month ending. Price/Earnings are based on trailing 12-month earnings. Earnings estimate data provided by Multex. The information contained herein is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. For information visit <http://indexes.morningstar.com> or call 800-698-5933.

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