

# Morningstar<sup>®</sup> Market Commentary

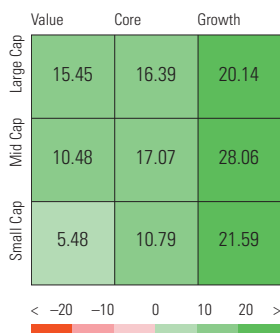
3rd Quarter 2007

## Morningstar Market Barometer™

3rd Quarter, 2007 Return %



1-Year Return %



Markets survived a battery of crises in the third quarter of 2007. Mounting defaults in subprime mortgage loans had caused concerns towards the end of the second quarter, but investors were still taken by surprise at the sudden escalation of the problem into a full-blown credit crunch. As conditions in the housing market worsened, financial institutions grew reluctant to lend money on asset-backed collateral, and uncertainty also grew about which institutions and investment funds were harboring big losses on subprime loans. This led to the near paralysis of debt markets, as well as a sell-off in stocks and other assets as investors scrambled to raise cash or shed risk. The U.S. Federal Reserve moved on Sept. 18 to slash its key interest rate by 0.5% to prevent the financial markets' problems from affecting the real economy. This greater-than-expected rate cut finally boosted confidence, causing markets to stage an impressive quarter-end rally. The rally brought the Morningstar US Market Index back from the red into positive territory. Thus, the index had a 1.7% gain to show for the eventful and turbulent quarter. The Morningstar Core Bond Index, a proxy for investment grade debt, gained 3.4%, with virtually all the gains coming before the Federal Reserve action, when investors flocked to the safety of top-rated bonds.

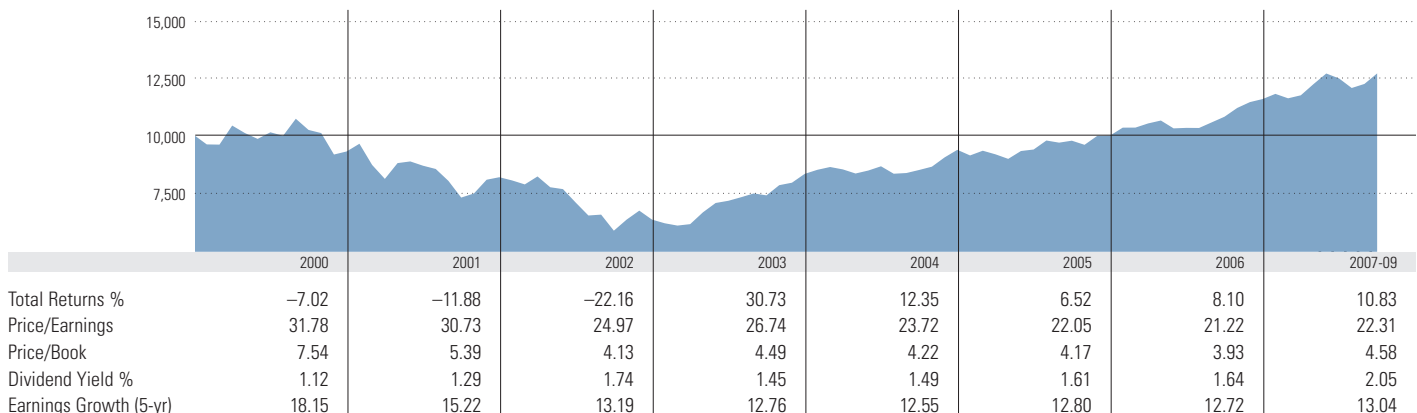
The current situation is a far cry indeed from the debt-fueled buyout and takeover boom during the first half of the year. Also, the housing market is in a deep slump with sales and prices tumbling at rates not seen in nearly

two decades. Without the longstanding support of home equity and easy credit, consumer demand could falter, calling for a subdued outlook for equities.

That is not to say good investment ideas have disappeared. Indeed, according to Morningstar's equity analyst team, stocks are currently trading at reasonable valuations overall. Moreover, some of the best buys are to be found in sectors that took the worst beating during last quarter's turmoil. For example, Morningstar's financial services analysts' research shows several prominent banks and other financial firms that are trading significantly below fair value. Generally, large-cap stocks and growth stocks had a far better quarter than small-cap and value rivals, and uncertain economic conditions ahead could continue to favor that trend.

Another third-quarter highlight is the stellar performance by natural resources and commodities stocks. The newly launched Morningstar Long-Only Commodities Index was up 12.6% for the quarter, far surpassing all our equity and fixed-income indexes. Even the Morningstar Long/Short Commodity Index, which takes short positions in commodities that have displayed downward momentum in recent months, fared better than stocks, gaining 7.4%. Looking under the hood, grains such as soybean and wheat scored spectacular gains in the quarter—wheat surged more than 50% in the quarter alone—and contributed heavily to the indexes' performance.
















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



### Surveying the Sectors

Our Super Sector Indexes divide the overall market into three convenient and economically coherent slices, allowing them to capture important investing themes as well as provide performance attribution. The Morningstar Manufacturing Super Sector Index emerged as the clear leader in the third quarter, followed by the Morningstar Information Super Sector Index, while the Morningstar Services Super Sector Index finished in the red. Below we discuss the highlights in each.

#### Morningstar Sectors: 3rd Quarter 2007 Return %

	Quarter	1 Year	3 Year
 <b>Information</b>	3.40	21.12	13.83
 Software	0.93	11.24	11.72
 Hardware	8.42	27.80	15.69
 Media	-5.96	8.48	6.19
 Telecommunication	1.98	27.07	19.09
 <b>Service</b>	-1.98	6.81	10.81
 Healthcare	1.91	10.05	10.23
 Consumer Services	-2.90	7.28	8.63
 Business Services	-0.89	20.65	18.21
 Financial Services	-4.15	1.44	10.27
 <b>Manufacturing</b>	5.56	30.20	20.28
 Consumer Goods	3.01	17.31	13.25
 Industrial Materials	5.75	31.92	17.41
 Energy	8.86	43.34	30.97
 Utilities	1.16	20.33	20.83

#### Manufacturing Super Sector +5.6%

The energy and industrial materials sectors again powered the Manufacturing Super Sector this quarter, opening a yawning lead over its two rivals for the year so far. Oil prices rose to record nominal levels as demand remained strong and geopolitical fears about supply disruptions persisted. Oil drilling services remained the hottest corner in the sector due to the frenzied search for oil resources in emerging markets and offshore locations. For example, FMC Technologies Inc. rose 46%, and Oceaneering International Inc. jumped 44%. Basic materials and heavy industrial companies also benefited from continued strong demand from booming emerging markets. Utility stocks lagged behind, despite the reversal of the spike in long-term Treasury rates that had pulled the sector down in the second quarter. This break from the strong historical negative correlation between Treasury yields and utility returns could be a sign that negative sentiments may be overdone in the sector.

#### Information Super Sector +3.4%

Hardware was clearly the star sector here. These companies are enjoying fast growth in sales and earnings

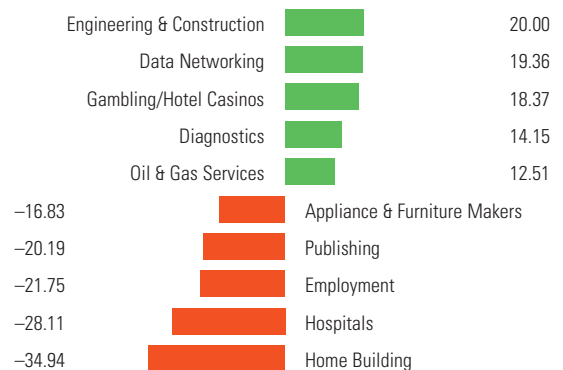
stemming from a surge in orders from emerging markets, which leaves them less vulnerable to a slowdown in the U.S. Also, major equipment suppliers such as IBM and Cisco Systems Inc. have taken impressive steps to run their businesses more efficiently by better managing their costs and inventories. By contrast, media stocks were the sore spot in the Information Super Sector. The sector has felt the pain from subdued advertising spending, as well as from the migration of ad dollars from traditional to digital media. This unpopular sector could well have good bargains, however, especially among large conglomerates such as Time Warner Inc. that boast stable cash flows and valuable brands.

#### Service Super Sector -2.0%

The travails of the financial services sector (which makes up 44% of the Service Super Sector) dictated the course of markets in the third quarter. The cheap debt and private equity buyouts that had fueled the sector during the first half of the year faded abruptly while a credit crisis took hold, and financial services stocks experienced heavy losses. Though the sector staged a dramatic rebound following the Federal Reserve rate cut, the sector still finished the quarter well in the red. The consumer services sector also suffered losses, with homebuilders contributing prominently. Major homebuilders have recently resorted to marking prices down by as much as half in some markets. With the widespread slump in housing and the threat of more mortgage default losses for financial institutions, the foreseeable future looks murky for these sectors. Healthcare was the only sector here to finish in positive territory, with biotech stocks doing especially well.

#### Top and Bottom Five Industries:

##### 3rd Quarter 2007 Return %



### Style and Market Cap Indexes

The third quarter firmly established a couple of budding trends from earlier in the year. The first is the switch in market leadership from mid- and small-cap stocks to large-caps. Smaller-cap stocks have held sway virtually since the start of this decade, causing long-term returns for large-cap stocks to appear decidedly pale by comparison. That trend started to reverse in 2007, and after a third quarter that saw small-cap stocks as a group finish in the red, large-caps have taken a convincing year-to-date lead. Mid-cap stocks have remained a close second. The other case of trend reversal has occurred in the growth versus value match-up. While value stocks tanked in the third quarter and core stocks held on, growth stocks finished with strong positive gains and cemented a wide year-to-date lead. This again represents an impressive turnaround for growth stocks after years of lagging core and value stocks.

These new trends could have a ways to go. The diversified and relatively stable earnings streams of large

companies made them a haven for investors during the third quarter's market uncertainties. Also, growth stocks were seen as relatively immune from the damages seen in credit markets. Those points would remain in favor if economic weakness persists in the U.S. Even from a valuation standpoint, however, large-caps and growth stocks make a plausible case. Years of neglect from investors and strong underlying business prospects at these companies mean their stocks are trading at attractive price multiples.

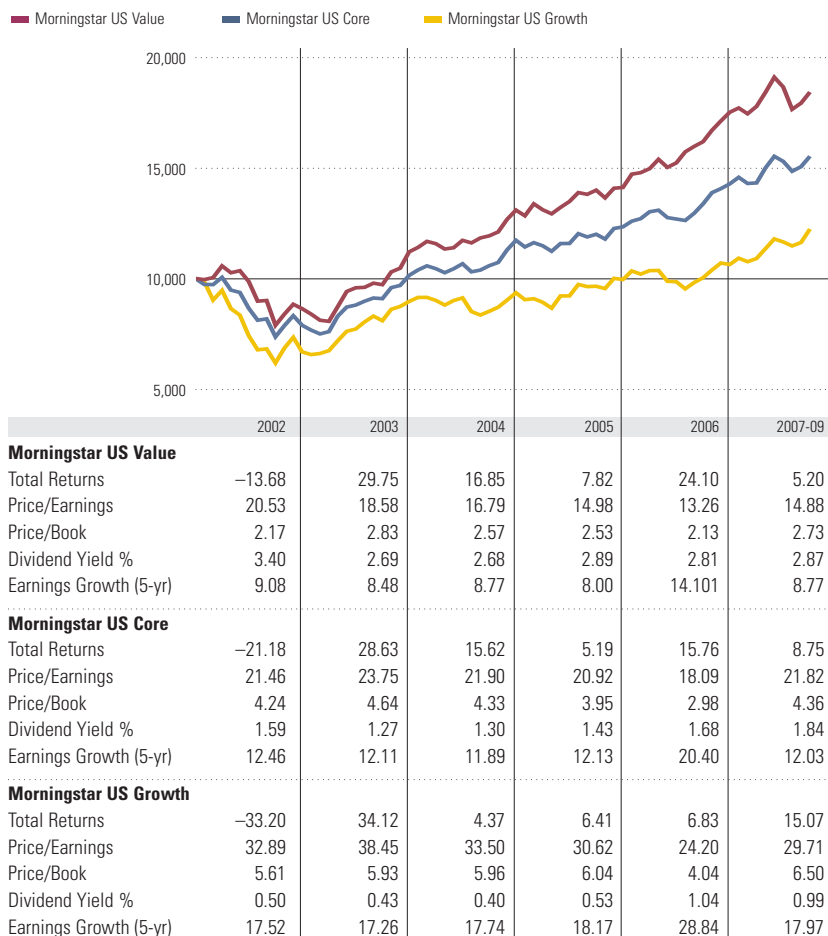
### Morningstar US Value Index -1.2%

Energy stocks thrived during the quarter, but the Morningstar US Value Index was dragged underwater by financial services and housing-related stocks. Countrywide Financial Corp., which fell a dizzying 47% during the quarter, captures the plight in that sector. One of the nation's largest mortgage lenders, Countrywide ran into trouble when it couldn't sell the mortgage loans on its books to its usual clients due to the credit squeeze. Large banks such as Washington Mutual Inc. and National City Corp. that have significant mortgage businesses also felt the blow from the crisis, with their stocks suffering large double-digit losses. Even mega-financial institutions like Citigroup Inc. and JPMorgan & Co., for which the mortgage business is only a tiny part of the equation, didn't escape unscathed. The fear in the marketplace is that due to the much-altered credit landscape, these financial giants would have to retain loans (such as those made to finance private equity deals, for example) in their books that they otherwise would have sold off to investors. This could, at the very least, result in a period of lower earnings for financial companies. Homebuilder stocks also share the same gloomy outlook as prices fall and inventories pile up to levels not seen in decades. Beazer Homes USA Inc., the nation's sixth largest homebuilder, fell 66% in the quarter.

### Morningstar US Core Index +1.5%

Stalwart core stocks PepsiCo Inc. and Coca-Cola Co. gained 14% and 11% respectively, benefiting from the bout of risk aversion during the quarter. In a similar vein, diversified conglomerates such as General Electric Co. and United Technologies Corp. also pulled their weight as investors gravitated towards stable, ample cash-generating companies. However, the Morningstar US Core Index was disappointed by large retailers like Wal-Mart Stores Inc. (which fell almost 9%) and Home Depot Inc. (which plunged 17%), which were hurt by warnings of an impending slowdown in consumer

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



demand. The index also had a brush with the troubled financial services sector due to the presence of companies such as Merrill Lynch & Co. Inc. and Lehman Brothers Holdings Inc.

#### Morningstar US Growth Index +5.0%

Growth stocks scored a thumping victory during the quarter. The rally was led from the front by technology giants Cisco Systems Inc., which gained 19%, and Apple Inc., which enjoyed a 26% surge. Apple introduced the iPhone during the quarter, and announced several upgrades to its iconic iPod lineup of music players. As many observers believe, the recent run-up in technology stocks could have legs if economies abroad pick up the slack from a slowdown in the U.S. The global reach of technology companies would make them ideal for playing that angle. The Morningstar US Growth Index also got a boost from the online retailing industry, as Amazon.com Inc. and eBay Inc. advanced 36% and 21% respectively. Monsanto Co., the world's leading producer of seeds, was also among the top contributors with a 27% surge. Monsanto raised its earnings guidance for

the year, citing strong demand for its corn seeds in Brazil and Argentina.

#### Morningstar Large Cap Index +3.0%

Large-cap stocks mopped up funds fleeing riskier corners of the market, and also benefited from trends in certain favorable sectors and industries. Diversified multinational conglomerates, integrated energy giants, and leading technology companies were the major contributors to the Morningstar Large Cap Index's strong showing.

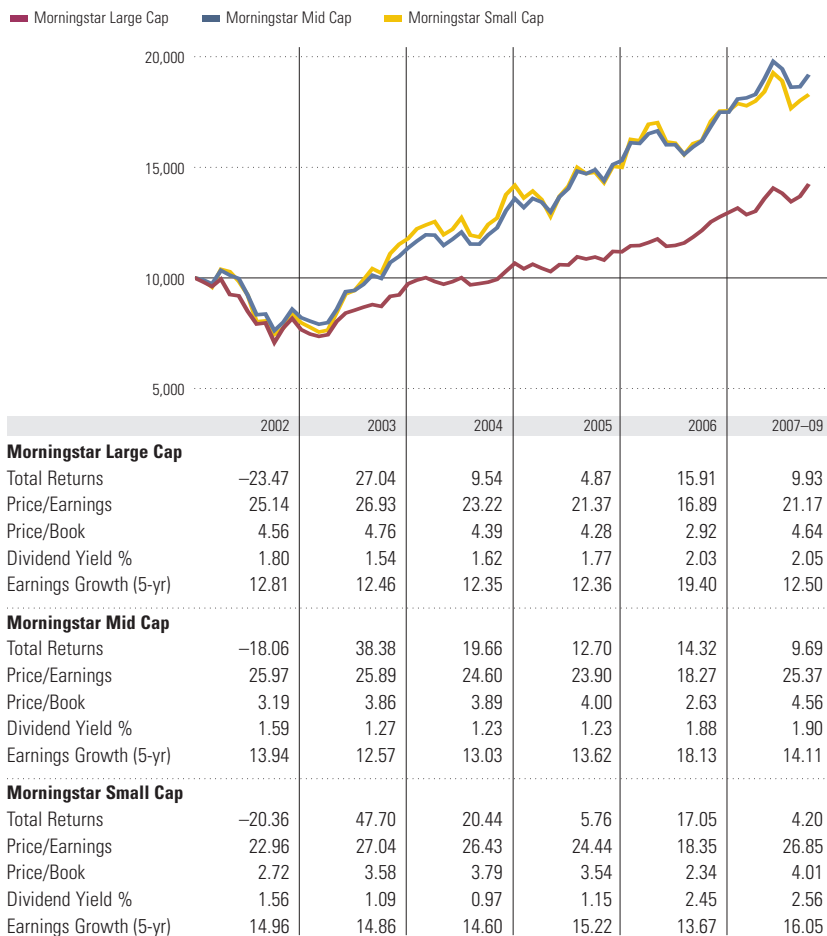
#### Morningstar Mid Cap Index –1.3%

Navigation devices maker NAVTEQ was the best performing stock in the Morningstar Mid Cap Index, surging 84% in the quarter ahead of the Oct. 1 announcement of its acquisition by mobile handset giant Nokia. The index lost its shine, however, as the buyout boom of the first half of 2007 went bust. Mid-cap stocks also had their detractors in the financial services sector. E\*TRADE Financial Corp. lost 41% in the quarter after announcing increases in its loss reserves and the elimination of its mortgage business.

#### Morningstar Small Cap Index –3.3%

Small-cap stocks caught the worst of the market turmoil. Smaller companies often get squeezed the hardest in a credit crunch, which meant investors dumped small-caps as concerns mounted in debt markets. Homebuilder Standard Pacific Corp., which lost 68%, typifies the problem. Standard Pacific operates only in California—one of the worst-affected housing markets—and entered the downturn with a heavy debt burden and a bloated inventory. The company is currently fighting to stay afloat and can only acquire the financing it needs on very bad terms.

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



**Active vs. Passive, 3rd Qtr 2007**

	Value	Core	Growth
Large Cap	32.98	18.47	51.46
Mid Cap	89.34	60.13	41.40
Small Cap	63.04	80.30	30.50
	0.56	3.35	5.30
	-6.25	-2.75	4.87
	-6.81	-5.95	2.46

○ Percent of actively managed mutual funds outperforming their respective benchmark. Includes the oldest share class for all U.S. diversified mutual funds with at least a one-year history. As of Sept. 28, 2007 there were 2,571 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 (%), 3rd Quarter, 2007

**Fund Categories vs. the Benchmarks**

The race between active managers and their respective benchmarks ended virtually in a dead heat for the quarter, though active managers had the edge. The average return of active funds exceeded the return of the relevant Morningstar Index in five out of nine style categories. Benchmarks in struggling corners of the market are usually easier to beat because active managers can choose to be less faithful to an out-of-favor style. As expected, the two worst-performing indexes, the Morningstar Small Value Index and Morningstar Mid Value Index, were beaten by a large proportion of managers. Surprisingly, however, active managers fared well against the Morningstar Large Growth Index, the quarter's best performing index. This could be due to the timely return of active large-growth managers to rallying technology stocks, which is an area many have underweighted in recent years in preference to "non-growth" sectors like energy.

**Conclusion**

The recently concluded quarter has vividly displayed both the increasing sophistication of financial markets and the near-catastrophic flaws they still have. The wave of securitization in every conceivable asset, the packaging and repackaging of those securities into complex derivatives, and the free flow of capital across international borders have vastly enhanced global financial liquidity, and dispersed risk. The flip side, however, is that markets and asset classes have become more intertwined

than ever before. The same assets are bundled into a multitude of pooled investment vehicles, which are then owned by a diverse group of investors across the globe. Thus, subprime defaults in the U.S., which otherwise would not be very large or damaging in dollar terms, was magnified and spread across the global financial system. Also, the enhanced liquidity in the financial system, coupled with benign global economic conditions, encouraged investors worldwide to take on more risk at prices they couldn't really afford.

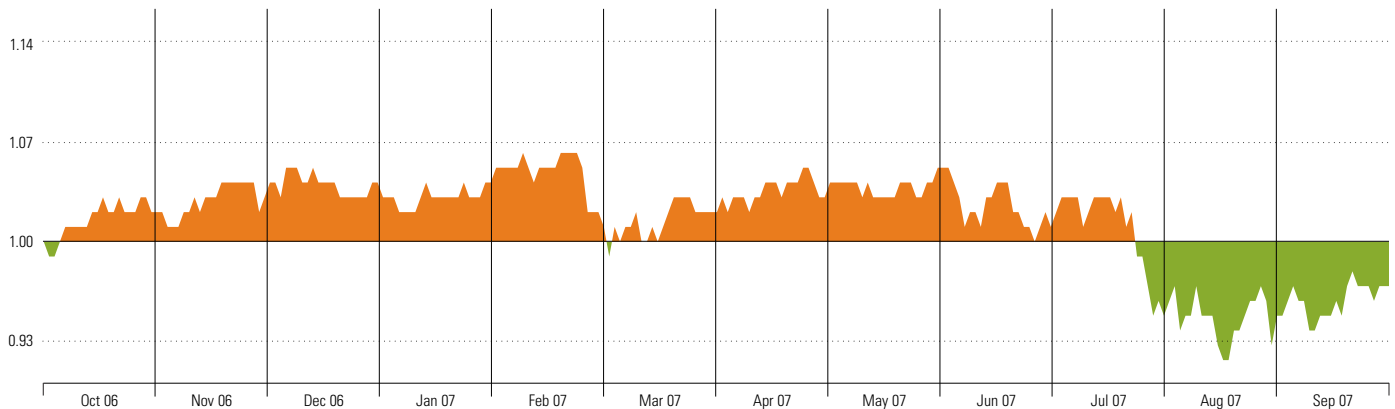
Now that the debt crisis has forced investors to price risk more prudently, and as major financial institutions shore up their balance sheets, the era of easy money could be absent for a while. Also, the recent turmoil shows that the task of building a diversified portfolio is more difficult now due to heightened correlation among different asset classes during crises. In this challenging environment, investors will need to think of more judicious mixes of asset classes in order to manage risk.

**Arijit Dutta**

Research Analyst

**Market Valuation**

■ Overvalued ■ Undervalued



**52-Week High**

1.06 (02-23-07)

**52-Week Low**

0.92 (08-16-07)

**All-Time High**

1.14 (12-01-04)

**All-Time Low**

0.78 (10-09-02)

**3rd Quarter Close**

0.97 (09-28-07)

**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 US Market	1.72	8.01	17.21	14.13	16.46	6.75
Large Cap	3.02	9.47	17.26	13.25	15.03	5.81
Mid Cap	-1.35	4.88	18.49	17.12	20.30	9.06
Small Cap	-3.27	1.64	12.82	13.79	19.70	8.01
US Value	-1.23	3.65	13.86	15.60	18.51	8.91
US Core	1.52	8.42	16.11	13.64	16.09	7.86
US Growth	5.00	12.23	21.94	12.83	14.64	2.60
Large Value	0.56	6.01	15.45	16.12	18.10	8.19
Large Core	3.35	10.53	16.39	12.98	14.87	7.00
Large Growth	5.30	12.02	20.14	10.12	11.84	1.21
Mid Value	-6.25	-2.63	10.48	14.53	19.33	10.77
Mid Core	-2.75	3.62	17.07	15.85	19.30	9.71
Mid Growth	4.87	13.86	28.06	20.84	21.96	6.03
Small Value	-6.81	-4.44	5.48	11.44	18.29	10.47
Small Core	-5.95	-0.43	10.79	14.33	19.75	10.89
Small Growth	2.46	9.23	21.59	15.18	20.66	2.99

**Morningstar Market Barometer 3rd Quarter Return %****Morningstar Market Barometer Trailing 4 Quarters Return %****4th Quarter 2006**

7.47	6.55	3.34
2.65	2.34	-1.78
3.08	1.17	-1.94

**1st Quarter 2007**

0.82	-0.90	1.58
4.19	4.35	5.22
1.31	2.40	3.85

**2nd Quarter 2007**

5.42	6.95	6.38
3.87	6.54	8.57
2.55	5.87	6.62

**3rd Quarter 2007**

0.56	3.35	5.30
-6.25	-2.75	4.87
-6.81	-5.95	2.46

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

	Style	Contribution %	QTR	1-Year	3-Year
Exxon Mobil Corp.	■	0.32	10.81	40.33	11.98
General Electric Co.	■	0.22	8.80	20.67	6.47
Cisco Systems Inc.	■	0.20	18.88	44.08	12.97
Procter & Gamble Co.	■	0.19	15.53	15.80	5.02
Apple Inc.	■	0.17	25.68	99.25	25.89
Schlumberger Ltd.	■	0.15	23.84	70.73	19.56
Chevron Corp.	■	0.13	11.89	48.51	14.12
Intl Business Mach. Corp.	■	0.11	12.36	45.79	13.42
ConocoPhillips	■	0.09	12.38	50.83	14.71
PepsiCo Inc.	■	0.09	13.62	14.62	4.66

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

	Style	Contribution %	QTR	1-Year	3-Year
Citigroup Inc.	■	-0.13	-7.97	-2.11	-0.71
Wyeth	■	-0.10	-21.88	-10.55	-3.65
Home Depot Inc.	■	-0.08	-17.03	-8.39	-2.88
Tyco International Ltd.	■	-0.07	-16.26	2.43	0.80
Wal-Mart Stores Inc.	■	-0.07	-8.81	-9.87	-3.41
Countrywide Financial Corp.	■	-0.06	-47.41	-44.84	-18.02
Time Warner Inc.	■	-0.06	-12.40	1.90	0.63
Merrill Lynch & Co. Inc.	■	-0.06	-14.31	-7.48	-2.56
JPMorgan Chase & Co.	■	-0.05	-4.70	0.43	0.14
Comcast Corp. Cl A	■	-0.05	-14.32	-2.06	-0.69

Biggest influence on quarter performance is calculated by multiplying the stock returns for the quarter by their respective weight in the index as of the start of the quarter.

**News Briefs: Morningstar Launches Family of Commodity Indexes**

Morningstar Indexes recently introduced a family of commodity indexes—the Morningstar Long/Short, Long/Flat, Short/Flat, Long-Only, and Short-Only Commodity Indexes. Based on a transparent, rules-based methodology, the new family of indexes employs different strategic combinations of long futures, short futures, and cash. These indexes are designed for investors seeking appropriate benchmarks for commodities and can support the creation of passive investment products that may serve as alternatives to active commodity investing. To learn, more go to (<http://indexes.morningstar.com/commodity>)