

MORNINGSTAR®

Market Outlook Q4 2008

December 29, 2008

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Our Outlook for the Market

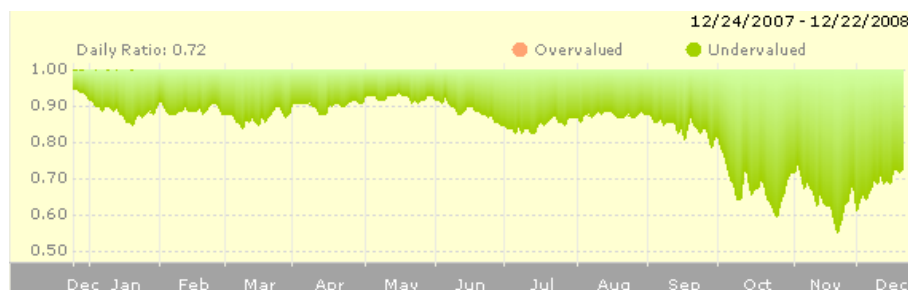
Broken record, or a consistent message? The market still looks cheap to us.

By Bill Bergman, Senior Stock Strategist

Economic weakness intensified in recent months, and the downturn in stock prices gathered greater steam—at least until recent weeks. After a brutal September, October, and November, the S&P 500 hit its low for 2008 during the day on Nov. 21. At 741.02, the S&P had been cut in half from year-end 2007.

Aggregating our bottom-up research on individual companies and adding those takes together, our bottom line has been pretty consistent all year—the market has been and still looks cheap.

Morningstar.com's Market Valuation Graph (see snapshot below) computes the median ratio of stock price to fair value across our coverage universe. As the economic downturn intensified during 2008, we've been reducing our revenue and cash flow expectations for many of the 2,000-plus companies we follow, leading to lower fair value estimates. But stock prices raced downward even faster, leading to lower price/fair value ratios. Our discounted cash flow models are more sensitive to changes in longer-term expectations than in near-term expected corporate performance—one reason our fair value estimates have held up relative to the market.



A Bottom-Up Perspective

For related reasons, recessions can provide some of the best opportunities for patient, long-term investors to buy into moaty companies, and even to buy into the market generally. Since World War II, investing in the S&P 500 only during recessions, even only at the beginning of recessions, has beaten putting money into the market continuously.

However, the current recession and associated stock market activity have underscored the mantra that "past performance does not guarantee future success," at least so far. Even if you had waited until June, six months after the recession started (and after a 12% decline in the S&P 500), a fresh investment in the market would have shriveled 40% by Nov. 21.

At Morningstar, we emphasize bottom-up, fundamental research on individual firms, not market calls. In turn, we recommend stocks only after their price falls below a "margin of safety"—namely, a discount to our estimate of their fair value that is commensurate with our estimate

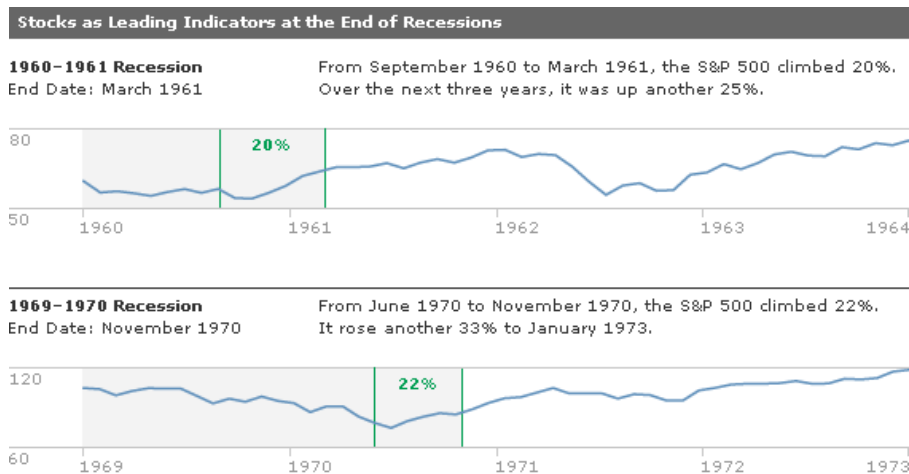
of their fair value uncertainty. We've put more firms in higher uncertainty categories this year, especially in the financial-services area. And we've widened the margins of safety to boot. But the generalized hailstorm has left a lot of firms looking individually cheap, if not on fire sale, these days. For example, we've assigned our highest 5-star (consider buy) ratings to over half of the Dow 30 industrial stocks, with only one firm rated below the neutral 3-star rating.

The Market vs. the Economy

What will it take to get stock prices and our fair value estimates more in line with one another? The depressed economy and financial markets have been walking down the aisle together, at least until recent weeks. If generalized economic improvement is needed to spark more cash flow into the stock market, it may not make sense to wait for the economic data to improve before investing money in the market. The market will likely improve well before evidence arrives that the economy has. In fact, if you are looking for evidence of an upturn in the economy, one good place to look is in the stock market.

Even when economic data are published regularly, they cover time periods a month or two in the past. On the other hand, stock prices are timely reads, available almost continuously. Economic data can be materially revised, especially around turning points, but stock prices are unrevised. Stocks can be subject volatile day-to-day mood swings, to be sure, but in reflecting investor and business confidence, they also provide a read on expectations in a timely manner.

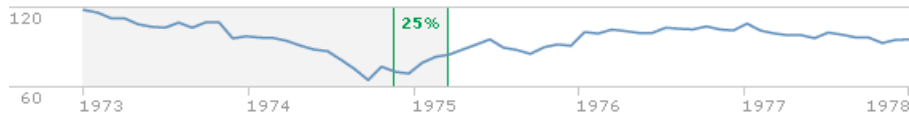
Since that Nov. 21 low point, the market has been behaving better, and there may be more than meets the eye on that score. The stock market is included in the index of leading economic indicators, and its improved performance before the end of past recessions has been very consistent (see associated table). In turn, within overall market indexes, insights can be gleaned from firms and industries that are especially sensitive to the economy, such as staffing services firms, homebuilders, and heavy machinery manufacturers.



Stocks as Leading Indicators at the End of Recessions

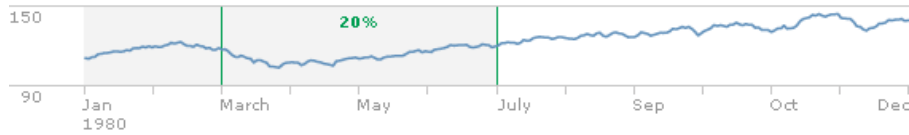
1973-1975 Recession
End Date: March 1975

From December 1974 to March 1975, the S&P 500 climbed 25%.
It had climbed another 20% by July 1977, then stagflation hit.



1980 Recession
End Date: July 1980

From March 1980 to July 1980, the S&P 500 rose 20%.
The S&P 500 rose another 15% by November 1980.



1981-1982 Recession
End Date: November 1982

The S&P 500 rose 35% from August 1982 to November 1982.
It climbed another 40% to November 1985.



1990-1991 Recession
End Date: March 1991

The S&P 500 rose 20% from November 1990 to March 1991.
It continued to climb another 25% to March 1994.



2001 Recession
End Date: November 2001

From September to November 2001, the S&P 500 rose 20%.
Stocks fell 25% to March 2003 in a cranky market.



We don't focus on stock prices too closely at Morningstar. We focus on fundamentals in individual companies and our assessments of their competitive advantages. But expectations of generalized conditions and business confidence are fundamentals worth respecting, especially in the financial-services sector, and the stock market provides good input on that score.

We have not yet seen a declared end to our current recession, which the NBER Business Cycle Dating Committee recently determined we entered in December 2007. In turn, we haven't had much yet in the way of several months of improving stock performance, like we had before the end of previous recessions. The S&P has risen about 15% since Nov. 21, however. Time will tell if we are getting into the early stages of an "end-of-recession" bull market.

Sector and Industry Insights

In a poll we recently conducted, most Morningstar stock analysts expected significant further economic deterioration. But our discounted cash-flow models include projections for stronger revenue gains and positive earnings growth for many industries in the 2010-12 time frame, and those expectations look very reasonable, if not conservative.

Banks

We see little reason for cheer in the new year, as we expect loan losses to rise further and bank earnings to remain significantly depressed. At the same time, we see the downturn as an opportunity to purchase shares of some high-quality, lower-risk banks.

Basic Materials

Weak demand, falling prices, and production curtailments were the norm for basic materials companies in the latter part of 2008. Dynamics in the copper, chemicals, and fertilizer markets provide salient examples of the trends affecting basic materials companies.

Business and Property Services

On aggregate, all of the segments within the business and property services sector are trading below their fair value. That doesn't mean that every stock is cheap, but it does mean that as a whole we think the sector is on sale.

Consumer

Given that the U.S. could be headed toward an extended economic downturn, we are focusing on a combination of lower-risk firms that lean more toward consumer staples and that have dominant brands, and slightly higher-risk firms with better long-term growth opportunities.

Energy

The credit crisis and a lower commodity price environment continued to rip through the energy industry in the fourth quarter—and oil & gas producers are scaling back.

Financial Services

We outline the good (data processing), the bad (insurance), and the ugly (money management) based on opportunity and performance, and offer some stocks that deserve consideration.

Health Care

The market has challenged the defensive nature of health care, and we believe the punishment of these sectors in response to near-term weakness in demand has been too severe.

Industrials

Slowing demand and dollar strength will hurt in 2009, but values remain, and we're actually quite bullish on the share prices for many of our names.

Media and Telecom

This sector is a tale of two extremes. Telecom offers relative stability, but old media is in big trouble.

Tech

Unless and until the credit markets thaw, we do not expect technology spending to rebound in a material way. Get our take on the developments in the major tech sectors.

Utilities

Financing, demand, and fuel price concerns have besieged the utilities sector. But despite these challenges, we see long-term value.

Our Outlook on Bank Stocks

Loan losses are likely to increase as economic activity slows.

By Erin Davis, Stock Analyst

Bank stocks continued to tumble in the fourth quarter, as economic indicators worsened and credit markets ground to a halt. We see little reason for cheer in the new year, as we expect loan losses to rise further and bank earnings to remain significantly depressed. At the same time, we see the downturn as an opportunity to purchase shares of some high-quality, lower-risk banks.

For years, banks rapidly grew their loan portfolios and allowed lending to increase much faster than deposits—banks' traditional and safest form of funding. Instead, banks increasingly depended on debt markets and securitization to fund their lending operations. This system, which had shown signs of stress throughout 2007 and 2008, crumbled on the eve of the fourth quarter when the 158-year-old investment bank Lehman Brothers declared bankruptcy and sent both equity and debt markets into disarray. Investors fled risky assets, causing prices to tumble and liquidity to dry up, and took shelter in U.S. Treasuries. Banks around the world prepared to take billions in write-downs, forcing many to seek out new sources of equity capital. A week later, as the crisis deepened, Goldman Sachs GS and Morgan Stanley MS, the last two large independent investment banks, declared that they would raise capital and become bank holding companies in order to restore their access to funding, thus confirming that the global banking system was undergoing sweeping changes.

As the fourth quarter dawned, the financial crisis was threatening to become a disastrous vicious cycle in which banks conserved capital by refusing to lend either to each other or to the private sector. This sudden loss of funding threatened to sharply increase bankruptcies, which would cause bank losses to increase and encourage the banks to further hoard capital. In response to this growing threat, Congress enacted the Emergency Economic Stabilization Act in early October, which created the Troubled Asset Relief Program (TARP). This program was initially intended buy up many of the risky assets that set off the financial crisis, but was soon converted to a plan in which the Treasury would buy stakes in U.S. banks in the form of preferred shares and warrants for common shares. Of the 74 domestic banks we cover, 54 have received at least preliminary approval to get a collective \$178 billion of new capital, which increased their Tier 1 capital ratios—a critical measure of bank health—by an average of 3 percentage points and alleviated most near-term capital worries. Seven of the healthiest banks we cover, including Hudson City HCBK and Commerce CBSH, have said that they do not intend to apply. We're most worried about three banks—E*Trade ETFC, BankAtlantic BBX, and Hanmi HAFC—that have applied but have not yet been approved. We already had concerns about these banks' long-term viability and think that if the Treasury does not approve their applications they may soon be forced to shut down.

While the TARP program appears to have staved off the worst outcomes, we see the financial downturn as far from over. The news that the TARP program would not buy up risky assets after all sent prices plummeting, and we expect many banks to take large write-downs again in

the fourth quarter. Moreover, we anticipate that bank loan losses will increase sharply in 2009 and to remain very high through at least 2010. So far, most of banks' loan losses have been related to residential real estate, but we expect losses to spill over into other categories, such as commercial and unsecured consumer lending, over the coming quarters as economic activity declines and unemployment increases. In our opinion, bank stock prices are likely to remain volatile for some time.

Valuations by Industry

Bank Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Finance	0.52	0.70	-26
International Banks	0.55	0.72	-24
Regional Banks	0.63	0.82	-23
Savings & Loans	0.86	1.04	-17
Securities	0.73	0.94	-22
Super Regional Banks	0.69	0.79	-13

Data as of 12-15-08. *Market-Weighted Harmonic Mean

In spite of all of this gloom and doom, we think the current environment offers an opportunity for investors to pick up shares of good companies at attractive prices. On average, finance companies and international banks offer the most attractive discounts to our fair values, but many of these are among the more risky companies we cover. We recommend that investors be alert for attractive discounts on the strongest of these companies, like HSBC HBC and American Express AXP. Regional banks also have attractive price/fair value ratios, although some are fairly valued in our opinion, and do not offer investors a large margin of safety. For example, Cullen/Frost CFR is rarely priced at a significant discount to our fair value, but we see value in BB&T BBT.

Bank Stocks for Your Radar

Stocks to Watch—Banks

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
American Express AXP	★★★★★	\$58	Wide	Medium	\$40.60
BB&T BBT	★★★★★	\$43	Narrow	Medium	\$30.10
HSBC HBC	★★★★	\$84	Wide	High	\$42.00
Trustmark TRMK	★★★★	\$25	Narrow	Medium	\$17.50
US Bancorp USB	★★★★★	\$35	Wide	Medium	\$24.50

Data as of 12-16-08.

American Express AXP is temporarily suffering from increased loan losses but we expect its long-term return on equity to be near 30%, thanks to its lucrative payment network and the strong fee-income stream it garners.

BB&T BBT is an efficient Southeastern bank that is gaining deposits, the best source of bank funding, at a time when others are losing them.

HSBC HBC is the only global bank that has come through the financial crisis in reasonably good shape. It is likely to gain market share as competitors like Citigroup C and UBS UBS are forced to scale back.

Trustmark's TRMK conservative strategy during the boom years has allowed it to maintain very low loan losses in its home market of Mississippi, despite the downturn.

US Bancorp's USB prudent underwriting and steady fee income stream are allowing it to take advantage of the credit crisis by buying up deposits and branches from less-successful rivals.

Erin Davis does not own shares in any of the securities mentioned above.

Our Outlook for Basic Materials Stocks

By Elizabeth Collins, Associate Director of Stock Analysis

Weak demand, falling prices, and production curtailments were the norm for basic materials companies in the latter part of 2008. The credit crisis and weak global economy are crimping demand for basic materials. This, in part, is leading to lower prices. In response, companies are curtailing operations and shelving expansion projects. And in some cases, malignant credit conditions and weak balance sheets are forcing producers to delay expansions. Dynamics in the copper, chemicals, fertilizer, and coal markets provide salient examples of the trends affecting basic materials companies.

Copper prices fell nearly 70% to \$1.30 per pound from their peak in March as the outlook for copper demand dimmed. In response, Freeport-McMoRan FCX recently announced one of the most aggressive cost- and production-reduction plans of any of the major mining companies so far this year. If copper prices remain depressed, more production cuts are likely, as Freeport estimates that two thirds of its North American mines will operate at net cash costs between \$1.40 and \$1.60 per pound in 2009.

Rapid deterioration in the global economy in general and the construction and automotive sectors in particular have severely dented demand for chemicals. In addition, we believe inventory destocking at the customer level in anticipation of lower prices and seasonal slowness in construction- and agriculture-related business are a further drag on current demand. In response, major chemical producers are taking measures such as workforce reductions, output reductions, plant closures, and asset divestitures. The more-temporary or seasonal headwinds should abate in the next few quarters, but until global auto and construction markets stabilize, demand for chemicals is likely to remain weak.

The combination of a late fall harvest, falling farm commodity prices, and tight credit conditions for growers in certain corners of the globe has caused the global fertilizer market to slow considerably. In response, numerous fertilizer producers across the globe have outlined plans to curtail output heading into 2009. However, farmers can't defer their purchases of fertilizer inputs indefinitely. Soil nutrients must be replaced and any skimping could come at the cost of lower yields. Given the production cuts and significant amount of inventory in fertilizer channels, we believe the stage is set for a very back-end-weighted 2009 as depletion in channel inventories in the spring will probably be followed by strong order patterns in the fall.

The coal industry has been hit by the same macroeconomic forces as the rest of the basic materials sector. After holding up strongly since July, U.S. coal prices fell dramatically in the past two weeks. The outlook for the next year or so is dismal. Dramatically falling electricity output and industrial activity in China do not bode well for global coal demand. We are more concerned with the outlook for metallurgical coal—as demand for autos, appliances, and construction materials are all in a steep cyclical downturn. In contrast, we expect thermal coal, used to generate electricity, to hold up somewhat better, though it will not be immune to price

pressures. That said, we think high-quality, lower-production-cost U.S. miners will weather the storm, as they generally have strong balance sheets and have locked in substantial long-term contracts.

Valuations by Industry

Mining and coal companies are trading at the steepest discounts to their fair value estimates, and we have a handful of 5-star stocks in these segments, such as Compass Minerals CMP, Potash Corp. POT, Arch Coal ACI, Peabody Energy BTU, Foundation Coal FCL, and Massey Energy MEE. The engineering and construction segment is the most fairly valued in the basic materials sector.

Basic Materials Valuations

Segment	Price/Fair Value*	Three Months Prior	Change
Building Materials	0.62	0.64	-3%
Chemicals	0.66	0.81	-18%
Coal	0.55	0.71	-23%
Engineering/Construction	0.91	0.84	8%
Forestry/Wood	0.76	0.91	-16%
Gold & Silver	0.60	0.57	6%
Metal Products	0.62	0.83	-26%
Mining (Nonferrous/Nonmetals)	0.52	0.63	-17%
Steel/Iron	0.62	0.52	19%
Paper	0.67	0.88	-24%

Data as of 12-15-08. *Market-Weighted Harmonic Mean

Basic Materials Stocks for Your Radar

We've picked five stocks from our coverage list to keep on your radar. Ecolab ECL produces and sells cleaning products and services, and its customer base includes hospitals, food and beverage plants, and schools. Two of our picks are agricultural: Compass Minerals CMP and Monsanto MON. We're also highlighting two Powder River Basin coal producers: Peabody Energy BTU and Arch Coal ACI.

Stocks to Watch—Basic Materials

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Ecolab ECL	★★★★★	\$47	Narrow	Low	0.74
Compass Minerals CMP	★★★★★	\$83	Wide	Medium	0.68
Monsanto Company MON	★★★★★	\$145	Wide	Medium	0.49
Peabody Energy BTU	★★★★★	\$54	Narrow	High	0.43
Arch Coal ACI	★★★★★	\$38	Narrow	High	0.41

Data as of 12-19-08.

Ecolab ECL

Ecolab produces and sells cleaning products and services to institutional, hospitality, and industrial customers. Its offerings include textile and ware washing systems, detergent, and vehicle-care and pest-elimination products. Ecolab's major customers are restaurants, hotels, hospitals, food and beverage plants, and schools. It aims to become a one-stop shop for its clients' cleaning and sanitizing needs. To this effect, the company has made substantial strides toward increasing sales and improving operating performance in its kitchen equipment repair service and expanding its presence in the health-care market. Although the hospitality and food service industries are facing softer demand from consumers, Ecolab should be able to make up for some slower revenue growth by gaining additional market share.

Compass Minerals CMP

Compass Minerals is a wide-moat producer of highway deicing salt and sulfate of potash specialty fertilizer and has unique, world-class, low-cost resources. We think the current stock price discounts the lower end of likely outcomes for long-term specialty fertilizer profitability (holding all other factors constant). In contrast, we think many powerful trends should support higher long-term prices and profitability, such as declining arable land per person, changing diets, and biofuel production. On the highway deicing salt side, we think the fundamentals are strong and getting stronger. Supplies in the Great Lakes region are tight assuming normal winter weather, and Compass is a dominant player able to expand low-cost production capacity.

Monsanto Company MON

Monsanto is a wide-moat producer of agricultural seed and associated biotechnology traits. We think that the market is overestimating the effects that falling commodity grain prices could have on the firm. We believe that Monsanto's entrenched position at step-one in the global food chain along with the incremental value its products create for growers through reducing their input costs and boosting their yields will ultimately serve to preserve the firm's pricing power—even in the face of falling grain prices.

Peabody Energy BTU

Peabody Energy is the largest private sector coal miner in the world, possessing a gargantuan reserve base and some of the best coal assets in the U.S. Its Wyoming Powder River Basin (PRB) mines, in particular, have some of the lowest marginal costs in the world. Unlike in the eastern U.S., with its thousands of small mines, the western U.S. is dominated by a few huge ones; the top five companies account for almost all PRB production. As the biggest of these, Peabody has established a near-unchallengeable scale advantage and reserve position. Moreover, PRB's geology is so advantageous that per-ton extraction costs are a fifth of Appalachian mines'. However, the PRB is far removed from markets, and shipping costs far outweigh extraction costs. Consequently, PRB coal sells for a large discount to Eastern coals, after adjusting for heat, ash, and sulfur content. Nevertheless, the transportation disadvantage hasn't been enough to dissuade utilities from gradually switching to plentiful, cheap PRB coal. The enormous extraction cost advantage should eventually make itself felt, producing huge value for Peabody.

Arch Coal ACI

Arch Coal is the second-largest coal producer in the United States, concentrating on the Powder River Basin (PRB). As part of the oligarchy that rules this vital coalfield, we think Arch will create value for shareholders in the years ahead. Arch's incumbent status in the PRB confers many advantages. Unlike Appalachia, with hundreds of competitors, the PRB is controlled by five producers, with Arch as the second largest. Barriers to entry are high—existing producers already invested billions of dollars and achieved massive economies of scale. Furthermore, most of the coal is controlled by the government, and obtaining leases and developing new mines requires many years and hundreds of millions of dollars.

Elizabeth Collins has a position in the following securities mentioned above: BTU POT

Our Outlook for Business and Property Services Stocks

The stock market downturn has created potential buying opportunities.

By Todd Young, Stock Analyst

Our business and property services sector includes various industries that are affected by many different factors. Over the last quarter as the equity markets have taken a beating, most of the segments in the business and property services sector have had similar results.

Although no segment was completely safe from the market sell-off, potential buying opportunities have been created. On aggregate, all of the segments within the business and property services sector are trading below their fair value. That doesn't mean that every stock is cheap, but it does mean that as a whole we think the sector is on sale, although not necessarily a fire sale. Some segments are cheap because shares have been taken too far down with the rest of the market, while others have stayed stagnant while growth remains healthy.

Valuations by Industry

Business and Property Services Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Business Applications	0.63	0.79	-20%
Business Support	0.61	0.76	-20%
Business/Online Services	0.58	0.72	-19%
Consultants	0.76	1.04	-27%
Education	0.81	0.93	-13%
Employment	0.70	0.97	-28%
Gambling/Hotel Casinos	0.86	0.72	19%
Hotels	0.73	0.97	-25%
Personal Services	0.75	0.88	-15%
Real Estate	0.56	0.70	-20%
Recreation	0.75	0.90	-17%
REITs	0.78	0.96	-19%
Waste Management	0.76	0.81	-6%

Data as of 12-15-08. *Market-Weighted Harmonic Mean

The education industry should benefit from the economic slowdown. As the economy slows and the job market deteriorates, out of work individuals turn toward education to better their employment marketability. While there currently aren't any 5-star stocks, this segment is still trading below its aggregate fair value with a price to fair value of 0.81. We think the market has yet to capture the upside potential of these firms during a downturn.

While REITs became cheaper on average over the last quarter, our coverage universe displays a wide range of valuations. Certain property types such as hotels appear substantially undervalued, in aggregate, while retail and apartment REITs are fairly or even slightly overvalued. Overall, we still have plenty of concerns about commercial real estate values and the cash flow declines REITs will experience over the next few years. In addition, persistent credit market turmoil is compounding the situation. However, after sorting through how the head winds will

affect each of these firms, we've been able to find a select few REITs that are cheap, such as Sunstone SHO discussed below.

Hotels are getting hit hard by the economic slowdown. Fewer people are traveling in the face of economic uncertainty and rising unemployment. This is sending occupancy rates downward and putting pressure on nightly rates. Timeshare sales, which have been a key earnings driver for hotel managers, fell sharply in the quarter as consumer financing for purchases disappeared. We believe that the next few years will be extremely challenging for the industry, but that much of this pain is already priced into the stocks. Our industry price/fair value ratio is 0.73.

Watching the employment market over the last few months has been like watching a Detroit Lions football game; ugly and cringe-worthy. Unemployment is at a 15-year high and the U.S. has lost 1.8 million jobs since the start of the year. The temporary employment market, a leading indicator of the overall employment market, has seen job losses accelerate. Thus, the stocks of employment-related firms have also experienced large moves downward, bringing some more in line and others slightly below our fair value estimates. Not all employment-related firms are as sensitive to the overall employment market, and we believe some, such as Paychex PAYX, Automatic Data Processing ADP, and Cintas CTAS, are attractively priced. These firms have a few things in common: high customer switching costs and the ability to leverage scale through superior infrastructures.

We expect the recreation industry to continue to suffer in the ongoing economic slowdown. Declining discretionary consumer spending and rising unemployment have weighed heavily on demand for recreation activities. However, not all recreation companies are alike and we believe Ticketmaster TKTM, Regal Entertainment RGC, International Speedway ISCA, and Expedia EXPE are significantly undervalued given their potential to succeed once consumers again open their wallets, although that may still be more than just a couple of quarters from now.

Business and Property Services Stocks for Your Radar

Below are five stocks that are worth considering in today's market. Some of these stocks have been unjustly beaten down with the rest of the market, others will be positioned well once the economy starts to pick up, and others may see limited impact from a slowing economy or actually benefit from today's economic conditions.

Stocks to Watch—Business and Property Services

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/FV
Jackson Hewitt JTX	★★★★★	\$30	Narrow	Medium	0.53
Sunstone Hotel Inv SHO	★★★★★	\$17	None	Very High	0.37
Convergys CVG	★★★★★	\$18	Narrow	Medium	0.35
Expedia EXPE	★★★★★	\$26	Narrow	High	0.33
Paychex PAYX	★★★★★	\$51	Wide	Medium	0.53

Data as of 12-17-2008

Jackson Hewitt JTX

Even in weak economic times, individuals must still pay taxes, making tax preparation firms a defensive investment. Jackson Hewitt is a tax return preparer that focuses on lower-income individuals. These customers typically make use of refund anticipation loans (RALs) in order to receive a faster tax refund. With a weakening economy, we expect the demand for RALs to increase as cash-strapped consumers look for ways to gain access to capital as soon as possible. Jackson Hewitt was hurt last year by a lack of a pre-season product. With a new pre-season product this year and increased demand for RALs, Jackson Hewitt should do well when the tax season kicks off in January.

Sunstone Hotel Investors SHO

Sunstone Hotel Investors' upscale, West Coast-focused hotel portfolio is feeling the strain of the faltering economy, but the firm's financial strength should carry it through the downturn. Demand for hotel rooms is falling as both business and leisure travelers cut back in the face of lower corporate profits and an uncertain economy. At the same time new hotel supply is increasing at the fastest rate in years, putting further pressure on nightly rates and occupancy. In the short term, these trends will put tremendous pressure on the firm, but Sunstone has a strong enough balance sheet to ride out the storm and emerge on the other side ready to take advantage of the recovery.

Convergys CVG

Convergys is one of the leading providers of third-party billing and customer care solutions to clients in the communications industry. The company benefits from economies of scale and high switching costs. Its business model is based on a fairly stable and recurring revenue base and most of its contracts are long-term in nature (three to seven years). These long-term contracts, combined with expensive service implementations, tend to keep Convergys' client turnover low. Though an unexpected non-cash write down in the third quarter has weighed heavily on the stock, we believe that Convergys' fundamentals remain intact, and we expect revenue growth and profitability to improve over time.

Expedia EXPE

Expedia is the largest online travel agency. Of the approximately \$250 billion of gross online worldwide travel bookings in 2007, Expedia booked the most, with \$20 billion. The company's size fuels its competitive advantage via a network effect. Potential travelers visit Expedia's Web sites because they know they can find good, cheap travel options, including hotels, cruises, car rentals, and flights. In turn, travel suppliers continue to use Expedia as an outlet for their inventory because Expedia attracts the greatest number of visitors to its Web sites. While weak consumer spending and slowing travel volumes have weighed heavily on the stock and fundamental performance recently, we think the company will excel once economic conditions improve. In addition we believe Expedia will continue to capitalize on the significant growth opportunities in more profitable international markets.

Paychex PAYX

High customer switching costs, inherent scalability, and a respected brand image are the main drivers for Paychex's wide economic moat. However, the firm has felt and will continue to feel some mild near-term pressure as the economy slows and small business closures pick up. Lower average employee headcount for its clients also adds to current near-term headwinds as this translates into lower per-check processing fees. We strongly believe, however, that the extreme difficulty customers face with switching payroll processing services, the scale Paychex is able to leverage from its servicing infrastructure, and its strong cash position will continue to provide the firm with long-term profits that few companies can match.

Todd Young does not own shares in any of the securities mentioned above.

Our Outlook for Consumer Stocks

Performance in this sector ranged from merely poor to truly horrific.

By Joseph Beaulieu, Associate Director of Stock Analysis

The fourth calendar quarter of 2008 was a terrible one for the consumer sector. Economic fundamentals, including rising unemployment, tightening credit standards, ongoing weakness in home sales, and a relentless stream of downbeat headlines kept consumers out of stores, and when they did shop they tended to buy less and to trade down.

Additionally, consumer products companies, having battled higher commodity costs throughout the year, now face a more tight-fisted consumer just as many were pushing through a new round of price increases. These companies were up against an unattractive choice; either take a hit to gross margins or sell fewer products. And although commodity prices actually fell in the second half of 2008, consumer product firms hedge a good portion of their input costs and have locked in higher prices that will pressure profitability into 2009.

Valuations by Industry

With the exception of alcoholic drinks, the performance of the industries that make up the consumer sector ranged from merely poor to truly horrific.

Consumer Goods/Services Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Alcoholic Drinks	0.78	0.76	3
Apparel Makers	0.64	0.90	-29
Appliance/Furniture	0.77	0.79	-3
Auto Retail	0.81	0.89	-9
Beverage Manufacturing	0.73	0.90	-19
Clothing Stores	0.55	0.86	-36
Dept Stores	0.49	0.74	-34
Discount Stores	0.85	0.99	-14
Food Manufacturing	0.73	0.89	-18
Groceries	0.70	0.72	-3
Household/Personal Prod	0.75	0.94	-20
Online Retail	0.57	0.77	-26
Recreation	0.75	0.90	-17
Restaurants	0.77	0.85	-9
Shoes	0.68	0.90	-24
Specialty Retail	0.71	0.80	-11
Tobacco	0.70	0.85	-18

Data as of 12-15-08. *Market-Weighted Harmonic Mean

Clothing store and department store stocks were slaughtered during the quarter. Mall traffic fell substantially, and despite retailers' efforts to prune back inventory levels to respond to falling demand, stores were still forced to resort to rampant discounting in order to move products off the shelves. Apparel makers suffered as well, due to their dependence on the department stores and tightening credit markets, which exacerbated the woes of the more leveraged players.

At first glance, restaurant and discount store valuations appear to have held up relatively well. However, that is somewhat of an illusion. The data in the associated table is market-cap weighted, and two strong performers—Wal-Mart WMT and McDonald's MCD—make the aggregate numbers look much better than they actually are.

Consumer Goods/Services Stocks for Your Radar

Given that the U.S. could be headed toward an extended economic downturn, we are focusing on a combination of lower-risk firms that lean more toward consumer staples and that have dominant brands, and slightly higher-risk firms with better long-term growth opportunities.

Stocks to Watch—Consumer

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	P/FV
Avon AVP	★★★★★	\$44	Wide	Medium	0.52
Colgate-Palmolive CL	★★★★	\$79	Wide	Low	0.83
PepsiCo PEP	★★★★★	\$74	Wide	Low	0.72
Procter & Gamble PG	★★★★★	\$77	Wide	Low	0.78
Yum Brands YUM	★★★★★	\$49	Narrow	Medium	0.61

Data as of 12-23-08.

Avon AVP

Given this firm's long history of managing through global economic disruptions, and the fact that it is more focused than ever on controlling costs and empowering its sales representatives around the world, we believe Avon will find a way to successfully navigate through the current crisis. With an infrastructure capable of supporting long-term growth, bright international prospects, and a business model that generates strong returns on invested capital, we believe that Avon will continue to reward investors over time. (For more on Avon, see our recent in-depth Stock Strategist Industry Report.)

Colgate Palmolive CL

This company is likely one of the best-positioned consumer products firms around. Not only is it less exposed to input cost inflation because of its product categories, but its core toothpaste category is less sensitive to private-label threats as consumers tend to be highly brand loyal in oral-care products.

PepsiCo PEP

Despite the head winds created by rising commodity costs and global economic weakness that PepsiCo is likely to face over the next couple of years, we continue to believe that the company will weather the storm much better than its peers. With a portfolio full of strong brands, a solid

track record of product innovation and differentiation, and a direct-store-delivery network that has few peers, PepsiCo remains the gold standard for the consumer products industry.

Procter & Gamble PG

P&G is the largest consumer products manufacturer in the world, with 24 brands that each earn more than \$1 billion in sales. Procter & Gamble built its moat with product development and marketing, but the firm's strengths go beyond skills in brand building. The company consistently reinvents itself and refocuses on improving its capabilities where it sees opportunity.

Yum Brands YUM

Narrow-moat rated Yum Brands (parent company of KFC, Pizza Hut, and Taco Bell) looks like an attractive investment to us. The stock is trading at about 60% of our fair value estimate. We believe the company is in the early innings of a tremendous growth story in China. Yum also has a strong presence in Japan, Great Britain, Canada, and Australia and is expanding further in continental Europe, India, and Russia. Yum should ultimately be able to turn around its U.S. business, as well. Altogether, Yum has the potential to deliver double-digit earnings growth for many years to come.

Joseph Beaulieu does not own shares in any of the securities mentioned above.

Our Outlook for Energy Stocks

Oil and gas producers scale back in the face of tight credit and weak pricing.

By Eric Chenoweth, CFA, Associate Director of Stock Analysis

The credit crisis and lower commodity price environment continued to rip through the energy industry in the fourth quarter. Last quarter, the carnage was largely contained to the equity and debt values of energy companies, as hedge funds and investment banks engaged in coordinated forced selling of these securities. Although still present from time to time, these bouts of forced selling began to ease in December. The credit crisis entered new territory this quarter, directly impacting companies' present operations and next year's budgets.

Oil and gas producers big and small scaled back drilling plans for 2009. Bigger companies such as Chesapeake Energy CHK grabbed headlines—it scaled back its budget multiple times in the fourth quarter, not unlike many other exploration and production (E&P) companies. Mega oil projects were canceled or deferred across the globe—from the oil sands to the Manifa project in Saudi Arabia. Although some of these disruptions could be opportunistic on the part of resource owners—hoping to rebid projects to capture lower raw materials and engineering and construction (E&C) costs that have just recently emerged—some projects have been truly mothballed. Active rig counts began to fall over the course of the quarter—most notably onshore natural gas rig counts in North America—and rig rates and service costs have started to soften.

In the short run, oil prices are caught in the middle of a tug of war between falling demand due to global economic weakness and producers racing to cut back supply—falling demand has been the dominant force thus far, dragging oil prices much lower. Over the next few quarters, supply cuts from OPEC and reduced output from higher-cost non-OPEC suppliers should help oil markets find some balance. OPEC has announced cuts of 4.2 million barrels per day thus far. Combining OPEC cuts with non-OPEC declines could bring supply down from a high point of roughly 87 million barrels per day this past summer to 80 million to 82 million barrels per day in the first half of 2009, which matches up better with present demand.

Entering 2009, North American natural gas prices will be largely influenced by winter weather and related heating demand. Extended periods of extremely cold temperatures in the northeast would be bullish for demand. As we've discussed in previous industry reports, natural gas producers have been successful in finding and producing new shale gas resources in recent years, helping to boost overall supply. However, recent budget cuts are translating into reduced drilling activity. Lower drilling activity, combined with steep initial decline rates at newly drilled wells, should help moderate supply growth until a better credit and gas price environment spurs greater levels of activity.

Budget cuts and project delays have not been contained just to E&P companies; midstream players like pipelines and processors—especially those utilizing a master limited partner (MLP) structure, have also been affected. Reduced midstream investment will likely postpone projects critical to hauling natural gas out of emerging producing regions (i.e., shale plays

where large volumes of gas are expected to be produced over the next decade but where midstream infrastructure is still scarce) and delivering it to key consumer markets. This is likely to reduce the price producers will receive at the wellhead for their gas and ultimately slow the pace of supply growth in the intermediate term (two to three years out).

In light of rapidly deteriorating demand fundamentals for oil and natural gas related to the global economic slowdown, we reduced our long-term oil and natural gas price outlooks in October. In our individual company valuations we shifted our weighting more toward our low and base cases, putting less emphasis on our high case. These decisions reduced our fair value estimates for E&P companies, oil services firms, and drillers.

Valuations by Industry

Presently all of the subsectors in the energy sector appear undervalued. Drillers and service companies, refiners (oil and gas products), and pipelines are trading at the steepest discounts to their fair value estimates. However, drillers and service companies and refiners have far fewer 5-star rated stocks in their respective subsectors than the E&P (oil and gas) and pipelines subsectors do. This is due to the higher uncertainty ratings we assign to drillers, services, and refiners. In general, we require greater returns from companies in these subsectors to achieve equivalent risk-adjusted returns to pipelines and E&Ps.

Energy Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Oil & Gas	0.72	0.60	20
Oil & Gas Services	0.59	0.69	-14
Oil & Gas Products	0.61	0.82	-26
Pipelines	0.61	0.68	-10

Data as of 12-15-08. *Market-Weighted Harmonic Mean

Energy Stocks for Your Radar

We've picked five stocks from our 5-star list to keep on your radar. One of our picks is Chevron CVX, a large, integrated oil major that is a well positioned company for a turbulent operating and financing climate like the one we face today. Two picks are pipeline companies, Energy Transfer Equity ETE and Enterprise EPD. We've been especially impressed with the way Energy Transfer has assembled a great set of midstream assets within Texas, the Midcontinent and the Southwest—a position that adds a lot of value to its E&P customers in the region and one with a lot of potential for healthy growth. We're also highlighting two E&P companies, XTO Energy XTO and Ultra Petroleum UPL. Ultra's conservative financing strategy over the past few years gives it a relatively attractive financial footing compared with peers, and we think current market conditions offer investors a great way to get a stake in the company's low-cost natural gas resource in Wyoming. XTO may slow down a bit on the acquisition front in today's rough environment, but we think the share price is compelling given its high-quality U.S. natural gas properties. XTO's extensive hedging program should help the firm better weather low oil and gas prices in 2009.

Stocks to Watch—Energy

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Chevron CVX	★★★★★	\$109	Narrow	Medium	\$76.30
Energy Transfer ETE	★★★★★	\$51	Narrow	High	\$25.50
Enterprise EPD	★★★★★	\$39	Narrow	Medium	\$27.30
XTO Energy XTO	★★★★★	\$67	Narrow	High	\$33.50
Ultra Petroleum UPL	★★★★★	\$82	Narrow	High	\$41.00

Data as of 12-19-08.

Energy Transfer Equity ETE

We're big fans of Energy Transfer Partners ETP and think that its general partner, Energy Transfer Equity, presents an attractive opportunity for investors who are interested in natural gas pipeline plays and are looking more for growth than yield. We think unitholders of ETP will see distributions increase at an 8% average annual rate during the next decade, and because of the general partner MLP structure, ETE should be able to boost its distributions by at nearly twice that rate. In the past year Energy Transfer has demonstrated an ability to grow through partnerships, with joint ventures such as the Midcontinent Express Pipeline and Fayetteville Express Pipeline, both partnerships with Kinder Morgan KMP. Also, we note that ETE is currently yielding more than ETP, which makes little sense given that incentive distribution rights give ETE an increasing claim on ETP's growing cash flows. We think investors stand to see greater unit price appreciation from ETE than from ETP, and in the meantime, collect a slightly higher yield on a distribution that will increase more rapidly than ETP's.

Enterprise Products Partners EPD

By any metric, Enterprise Products Partners is one of the largest master limited partnerships, and to our eyes, one of the more attractive investment opportunities in midstream energy. Under the leadership of Dan Duncan, Enterprise has assembled a set of assets stretching from the Rockies into the Gulf of Mexico, providing midstream services for natural gas, natural gas liquids (NGLs), and crude oil. But because the majority of its revenues stem from fee-based contracts, Enterprise has relatively little commodity price exposure, and in our view the combination of its natural gas and its NGL businesses results in a bit of a natural hedge. We also think that Enterprise's solid liquidity position, with \$2.2 billion available, places this MLP in a great position to weather capital and commodity markets downturns or to pursue opportunistic acquisitions.

XTO Energy XTO

XTO possesses one of the best portfolios of natural gas producing properties in the United States. The firm has assembled this portfolio through hundreds of deals over the past two decades, many of which were negotiated deals. XTO's toehold positions in multiple high-quality producing regions in the United States give it a scale advantage over peers to bid competitively and add value through acquisitions in the future. Its organization is geared to this acquire-and-exploit strategy, giving it the ability to execute dozens of deals, or more, in a given year. Because it has been so successful over the years, XTO has developed a reputation as a preferred acquirer.

Ultra Petroleum UPL

Ultra's enviable position in the Pinedale Anticline in the Green River Basin in Wyoming gives it a formidable competitive advantage. Ultra built its position before economic production was proven, providing it a low-cost entry price. Over the past five years, the firm's unit costs have been among the lowest in the U.S. natural gas industry and well economics have been fantastic—costing about \$5 million to \$6 million to complete and accessing 7 billion to 8 billion cubic feet in reserves. We expect Ultra's unit cost structure will remain among the lowest in the industry over the next five years. Ultra has the potential to reinvest in its Pinedale assets for many years, reducing the reinvestment risk that many exploration and production companies regularly face. Of the approximately 125,000 Pinedale acres in which Ultra owns an interest, only 17,000 are developed.

Chevron CVX

Chevron's position as the second-largest oil company in the U.S. gives it the resources to explore for and produce hydrocarbons throughout the world. The majority of its portfolio of projects is located outside the United States and involves partnerships with national oil companies. Chevron presents itself as an expert in exploration and production, which makes it attractive to governments looking to capitalize on their resource base. Ongoing offshore drilling and natural gas infrastructure projects that require heavy investment are often out of the reach of smaller competitors, though they are readily available to Chevron. Chevron's recent investments in deep waters offshore should start to pay off through higher production volumes in upcoming years.

Eric Chenoweth, CFA, has a position in the following securities mentioned above: ETE CVX

Our Outlook for Financial Services Stocks

The good, the bad, and the ugly.

By Jim Ryan, Senior Stock Analyst

The Good

Data-processing companies have been unfairly beaten up in the third quarter, in our view. We think most processors have some nice qualities like solid and fairly stable free cash flow, asset-light business models, clean balance sheets, and recurring revenue streams. But by Dec. 15, the segment was punished with the rest of the market as the price of the stocks in the sector went down, on average, about 26%, slightly more than the entire S&P 500. When the tide goes out all ships fall in proportion, it seems.

The Bad

Insurance—70% of the financial services stocks in Morningstar's coverage universe—continued on a downward spiral this quarter. One by one, insurance industry subsectors have experienced the domino effect initially caused by toxic housing-related derivatives and further compounded by frozen credit markets. Beginning in 2007, we observed the first signs of weakness with the mortgage insurance companies followed by bond insurers and, this year, title insurers. Life insurers have now caught the contagion as their investment portfolios have fallen prey to markdowns; shrinking equity and leaving balance sheets vulnerable to rating agency actions. And property and casualty (P&C) companies, further burdened by elevated catastrophic events, have followed suit, though not to the same extent as the life insurers.

The Ugly

Money management firms are on track for a horrific quarter, down over 50% by the middle of December. Money management fees are tied to the level of assets under management, so when the market falls, revenue for these companies falls proportionally. Magnifying this effect are record levels of fund outflows, as investors have retreated to safer ground. Most money management companies are scrambling to reduce their cost bases through layoffs, but cost reductions are unlikely to be sufficient to avoid margin compression.

Valuations by Industry

On a price/fair value basis the data processing industry currently has the most attractive valuations. Life insurers, on the other hand, are near fair value due to our reassessment of the industry.

Financial Services Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Data Processing	0.62	0.81	-23%
Insurance (Gen & Prop)	0.71	0.78	-9%
Insurance (Life)	0.94	0.76	24%
Insurance (Title)	0.74	0.71	4%
Money Management	0.73	0.88	-17%

Data as of 12-15-2008 *Market-Weighted Harmonic Mean

We think the valuations on many data processing companies are attractive and that these firms will survive the downturn in relatively good shape. However, for those processors serving the financial sector, struggling customers will put a damper on growth in the near term. For instance, the core processors we cover saw growth slow across the board as banks deferred technology purchases, although none of them experienced a revenue decline. In other cases, secular trends still outweighed the decline in the economy. Small merchant credit card processor Heartland Payments HPY, for instance, achieved 14% organic revenue growth in the third quarter, despite a 2% decline in same-store sales, as it continued to sign up new merchants. Other business services companies whose revenue is tied to the volume of credit applications, such as Equifax EFX and Fair Isaac FIC, saw revenue declines of 2% and 10%, respectively. Results are unlikely to improve until the credit markets settle and we expect similar performance in the fourth quarter and into 2009.

Life insurers are of concern to us as the level of equity to investments threatens to further constrict capital if more write-downs occur. We undertook another review of the industry in November, which concluded with many of the larger life insurers receiving our extreme fair value uncertainty rating. We think there are more investment write-downs to come this quarter, which may cause some of the larger life insurers to have to raise additional capital, resulting in shareholder dilution. However, in our extended review of the industry we concluded that Aflac AFL and Torchmark TMK are in the best position to survive the carnage due to the quality of their respective investment portfolios as well as a greater percentage of equity to investments. These factors strike us as the most important metric as more conservative assets stand up better in troubled times and companies with more equity can take all but the most extreme write-downs in stride.

Compared with the life insurers, the P&C companies look much safer. Having to manage and invest to a shorter tail of insurance risk helps as the degree of equity to tangible assets is much greater than with the life insurers. We continue to like Allstate ALL but we also recommend well-managed, low-cost providers such as Mercury General MCY and Progressive PGR. Insurance investment companies such as Alleghany Y and White Mountains WTM seem very attractive at recent bargain-basement prices. Both of these companies have long histories of creating shareholder value through patient, well-timed acquisitions and divestitures.

Most of the reinsurance world is still standing and we've been generally impressed with the performance and regulatory environment in Bermuda given how bad things might have been. We are expecting higher rates in reinsurance generally, given the hit to capital and other factors damping industry supply. But all firms will not behave the same. Some firms now have stronger incentives to try to gather premium inflow irrespective of price. Others with stronger balance sheets can pick and choose their spots more carefully. We see firms such as Berkshire Hathaway BRK.B, Wesco Financial Corporation WSC, Odyssey Re ORH, RenaissanceRe RNR, and IPC Holdings IPCR among the latter group, and currently Berkshire and Wesco are rated at 5 stars.

Money management stocks are tied to the direction of the market and we are loath to predict near-term market swings. Assets under management (AUM) have contracted at record levels as investors flee the heart-pounding collapse of the stock market. Worse yet, recent fraudulent

events with funds may provoke even more selling in the near term as investors lose confidence and demand redemptions from asset managers. That said, there are a couple firms that may be worth a look. Federated Investors FII has actually been able to increase its AUM due to its focus on money market funds. Federated has increased its money market AUM nearly 70% in the past 12 months. Legg Mason LM has hundreds of millions of dollars of AUM diversified among equities, fixed income, and money markets, providing a measure of stability as investors switch from one asset class to another.

Finally, we note that our coverage of title insurance stocks has now shrunk to two companies. LandAmerica LFGRO has filed for bankruptcy protection and Fidelity National Financial FNF has offered to purchase the main title underwriting subsidiaries Commonwealth Title and Lawyers Title as well as smaller United Capital Title. If this deal goes through Fidelity will control close to 50% of the title insurance market and will be able to significantly combine operations resulting in large cost savings. We don't think the title insurance market is on the verge of any return to glory in the near term, but Fidelity is positioned to rule this cash-rich industry when it does.

Financial Services Stocks for Your Radar

Despite all the gloom and doom we think the following companies deserve consideration as long-term investment opportunities.

Stocks to Watch—Media & Telecom

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Market Cap (\$Bil)
Fiserv FISV	★★★★★	\$61	Wide	Medium	6
Equifax EFX	★★★★★	\$39	Wide	Medium	3
Berkshire Hathaway BRK.B	★★★★★	\$4,800	Wide	Medium	154

Data as of 12-16-08

Fiserv FISV

Fiserv faces a number of head winds in the near term, but we think its shares are very attractively priced for the long haul. A struggling bank customer base, lower interest rates (which reduce float income), and a drop-off in the company's HELOC business, combined to keep revenue flat on an organic basis in the third quarter and we don't expect this to change soon. However, these factors are at the margin and with 85% of the company's revenue generated under long-term contracts, we think Fiserv will hold up well through tough times. The company should generate close to \$600 million in free cash flow in 2008 and the long-term trend toward increased technology needs for banks remains intact in our opinion, which should allow this industry leader to ultimately return to the mid- to high-single-digit organic growth rates it has historically enjoyed.

Equifax EFX

Credit bureau company Equifax enjoys a wide moat. Its database of credit information on 300 million consumers would be almost impossible to replicate and limited competition allows the company to maintain fat profit margins. The turmoil in the financial markets has led to a drop

in demand for credit information and we think a loose credit environment is unlikely to return anytime soon. But international growth has helped to offset this decline, and adoption of consumer credit scores in emerging markets could provide opportunities for long-term growth. In the meantime, while domestic revenue may continue to fall a bit in the near term, Equifax should remain highly profitable. Despite the difficulties it has faced, through the first nine months of 2008, the company produced \$236 million in free cash flow.

Berkshire Hathaway BRK.B

Berkshire Hathaway has long had a lot of fans here at Morningstar. Berkshire's core competitive advantages flow from its financial strength and conservative capital position, attributes that have become only more valuable with the developing financial crisis. After some recent and, we believe, unwarranted concern about its equity derivative positions, Berkshire's share price has fallen to create an attractive buying opportunity. Berkshire built up an extraordinarily liquid balance sheet in recent years, while many other financial firms pursued a quest for yield they now painfully regret. Berkshire has recently been deploying its cash hoard in selective investment opportunities at attractive prices. We're anticipating some hardening in the reinsurance markets in coming years, after several years of weaker rates, and higher-quality reinsurers like those in the Berkshire stable are likely to benefit most.

Marsh & McLennan MMC

Marsh & McLennan's economies of scale and scope, long-standing valuable relationships in attractive international markets, and ability to attract and retain topnotch insurance brokerage talent led to an outstanding historical financial record. The firm's moat was tested by a regulatory crisis in 2004 and 2005, and recent market conditions have been challenging for other reasons. We believe MMC's underlying recovery remains on track, however. The firm's performance several years out is likely to be well ahead of what its share price would suggest today. Soft insurance pricing and uncertainty about the structure of brokerage compensation have been weighing on MMC's commission revenue. But the insurance industry has long been subject to cycles of hardening and softening markets, and the next upturn in pricing is likely to come sooner than later. We think the industry and its regulators are making progress on rationalizing brokerage compensation practices, which will likely allow greater returns for valuable intermediaries. We don't expect economic weakness to weigh on MMC's consulting businesses forever, either. Down the road, we see MMC as an improving firm in improving markets.

Mercury General MCY

Mercury's underwriting performance this year has suffered from downward pricing pressure and increased catastrophe claims. And the adoption of SFAS 159 has taken a toll on the income statement as the investment portfolio has suffered from write-downs. But we think these are temporary issues. P&C pricing is now on the rise as companies raise premiums to increase capital. Almost 95% of the \$276 million third-quarter write-down is from mark-to-market of municipal bonds—70% of Mercury's investment portfolio. Mercury benefits from being a low-cost provider in an industry that has government-backed mandates for purchase (almost all states require the purchase of at least minimum liability auto insurance coverage). The California-based insurer is in the midst of a national expansion, which presents opportunity for growth. Debt/capital is under 10% and Mercury pays a \$2.32 per share annual dividend, which

yields over 5% at today's price. We think the growth opportunities, outsized dividend, and pristine balance sheet make Mercury a compelling buy at the right price.

Jim Ryan does not own shares in any of the securities mentioned above.

Our Outlook for Health-Care Stocks

Market challenges the defensive nature of health care.

By Alex Morozov, CFA, Associate Director of Stock Analysis

The fourth quarter of 2008 saw market turbulence of historic proportions, and the near-collapse of the global financial system left the U.S. economy reeling. In the face of this challenging economic environment, the relative resistance of the health-care sector to market woes has once again validated the notion of health care as a “safe haven.”

While not entirely immune to the financial and economic crisis, health-care stocks in general have held up: The year-to-date return of the Health Care Select Sector SPDR XLV trails only the return of the consumer staples indicator, outperforming returns of every other major economic sector. Such resilience can be explained in part by the traditionally defensive nature of health-care expenditures. However, the solid financial health of many health-care companies has also been a key factor in this relatively strong performance. Many established drug, device, and service companies generate robust cash flows to finance their business growth and aren't relying on the currently frozen capital markets for their financing needs.

Nonetheless, the difficult economic landscape that is likely to persist in the near term has forced many firms in the health-care space to scale back on their 2009 forecasts, which in turn has shaken investor confidence in this area. Growing concerns of a prolonged recession, coupled with both rising unemployment levels and decreasing affordability of private insurance, are challenging the traditional view that health expenditures are immune to the broad state of the economy. Anecdotal evidence of consumers skipping medications and foregoing treatments is starting to trickle in, and numerous health-care firms have warned of a tough year ahead. Hospitals in particular have been affected by this malaise; not only have most hospital operators seen an increase in the number of uninsured and underinsured patients they are mandated to treat, but the number of “quality” patients (those with private insurance) has also shown signs of a decline. Hospitals, research laboratories, and drugmakers have responded by tightening their capital budget belts to reflect the uncertainty of the current environment, producing a wave of projection cuts from medical equipment makers, contract research firms, and other auxiliary service providers.

The uncertain regulatory and legal environment is also causing headaches for the health-care sector. As President-Elect Obama is about to be sworn in to office, the probability of sweeping health-care reform that encompasses many campaign promises is rapidly increasing. To our surprise, the breadth of proposed changes has not been whittled down, despite the economic challenges associated with implementing plans that could cost \$50-\$60 billion per year. The impact of reform would likely be felt across the entire sector. However, if Obama is able to slow the growth of health-care expenditures by legalizing drug reimportation and allowing Medicare to negotiate drug prices, the consequences for the pharmaceutical industry could be negative. On the flip side, Obama's proposal to drastically reduce the number of uninsured Americans would likely result in a massive influx of new patients into the system, which could provide an offsetting—if not a net positive—effect on overall health spending. We analyzed

Obama's plan in detail in the September issue of Morningstar HealthcareObserver, our monthly publication that provides an in-depth look at trends in health care.

Valuations by Industry

Not surprisingly, the segments that depend on capital expenditures by hospitals and drugmakers have fared the worst in the fourth quarter, with price/fair value estimate ratios collapsing for research and medical service providers, as well as medical equipment manufacturers.

Health-Care Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Biotechnology	0.79	0.93	-15
Diagnostics	0.73	0.85	-14
Drugs	0.68	0.79	-14
Hospitals	0.62	0.96	-35
Managed Care	0.54	0.73	-26
Medical Equipment	0.59	0.88	-33
Medical Goods & Services	0.60	0.90	-33
Physicians	0.67	0.80	-16
Research Services	0.55	1.05	-48

Data as of 12-15-08 *Market-Weighted Harmonic Mean

Although these industries—particularly equipment makers—have elements of cyclicity to them, we believe the market's punishment of them in response to near-term demand weakness has been too severe. In fact, only a portion of most instrument makers' revenue streams depend on the high-ticket items that are particularly sensitive to tightened capital budgets, and recurring revenue from low-priced consumables and services frequently constitutes more than half of total sales. Even if purchasing delays persist over the next few quarters, it is unlikely that this cycle will extend for a prolonged period; scientists' demands for newer and better instrumentation are unlikely to fall on deaf ears for too long, given the increasing complexity of new drug research. With an average price/fair value now under 60%, we think this segment is significantly undervalued.

We are also becoming bullish on the research services industry, composed primarily of contract research organizations (CROs), which provide clinical development services for pharmaceutical and biotechnology firms. CRO stocks rose meteorically when times were good (from 2004 to mid-2008) only to collapse precipitously when key growth drivers showed some signs of near-term moderation. The clinical trials outsourcing growth story propelled CROs to the top, but has recently come under threat, as research activities are suddenly drying up. Small biotechnology firms that rely on capital markets for their financing needs are delaying trials to preserve cash, which is leaving CROs scrambling to fill capacity. We don't anticipate this clinical-trials vacuum can be sustained for more than a few quarters as the advancement of drug candidates through clinical trials is the only bloodline for many of these biotechnology companies. Pent-up demand will most likely result in explosive growth for CROs once capital markets thaw out, and now is the time to consider investing in this industry, which is seeing many of its stocks trading at 10 times or less their forward earnings estimates.

Health-Care Stocks for Your Radar

Here are some of our favorite picks from the medical equipment and research services sectors, along with two health-care stalwarts that are presently trading at a substantial discount to our fair value estimates.

Stocks to Watch—Health-Care

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Recent Price
Thermo Fisher TMO	★★★★★	\$73	Narrow	Medium	\$33
Convivial Ltd. COV	★★★★★	\$65	Narrow	Medium	\$38
Charles River CRL	★★★★★	\$60	Narrow	High	\$22
Stryker SYK	★★★★★	\$72	Wide	Low	\$40
Novartis AG NVS	★★★★★	\$73	Wide	Low	\$49

Data as of 12-18-08

Thermo Fisher Scientific TMO

Similar to other instrument manufacturers, Thermo Fisher recently noted a rampant pullback in large-ticket purchases, coinciding with the credit crisis hitting the broad economy. The pullback will likely cascade well into 2009, but we believe our long-term bullish stance on Thermo Fisher has not been affected. First, nearly half of the company's revenue is recurring, and its instrument consumables and catalog business are by and large unaffected by the souring economy. Thermo Fisher enjoys pricing power over its consumers in this area evidenced by the history of successful annual price hike implementations. Second, although recessionary fears have resulted in tightening belts all across the research and industrial sectors, capital expenditure delays can't be extended for a prolonged period. We have seen several pullbacks in capital spending over the past years, and the troughs rarely extend for more than a few quarters. Certainly, this tight budget environment could be different, but a growing complexity of drug research and increasing demand for air- and food-quality testing, should propel the uptick in instrument sales toward the latter part of 2009. Thermo is also very adept at swiftly managing its cost structure, evidenced by its ability to grow its bottom line even despite some top-line pullbacks.

Covidien COV

The company appears to have been thrown into a hospital discretionary spending bucket even though most of its instruments address anything but discretionary needs. The vast majority of the company's surgical device product lines have to be replenished on an ongoing basis, and even elective procedures, such as bariatric surgeries, are unlikely to be delayed given immediate health concerns for patients suffering from obesity and requiring surgery. The company has also made tremendous strides in new product development, sales efforts, and cost efficiency since its spin-off from Tyco International more than a year ago. As a result, it will likely see a remarkable double-digit earnings expansion in 2009 despite the challenging economic environment. Yet, Covidien's stock trades at the below post-spin-off level, which, in our opinion, is nearly 40% below its true worth.

Charles River Laboratories CRL

We think the market is too preoccupied with a recent uptick in study delays related to the

reorganization of pipelines at big pharmaceutical firms and a dry-up in funding for small biotechnology firms to see the great long-term story of Charles River. Recent delays are temporary in nature and growth prospects related to increasing outsourcing penetration should outweigh any near-term worries. Drugmakers cannot afford to put off preclinical work for too long, as this would lead to depleted pipelines (and revenue opportunities) down the road. The market also is not giving the company enough credit for its highly lucrative research model business, which generates more than 45% of the company's revenue. Charles River is the premier provider of laboratory animals with 50% of worldwide market share, and operating margins in this segment exceeds 30%.

Stryker SYK

We think Stryker has built one of the widest moats in the medical device industry, and recent share prices represent a compelling entry point for this growth company. Stryker excels in several niches. We especially like its top-tier position in the highly profitable orthopedic implant market, which typically possesses high barriers to entry and sticky surgeon relationships. We think this market should continue growing at a fast clip due to favorable demographic and lifestyle trends; including the aging of the developed world, higher expectations for activity levels throughout the aging process, and the obesity epidemic that is straining joints. In addition to its prowess in therapeutic devices, the firm also outfits surgical suites and regular hospital rooms with various tools and equipment. It is particularly prolific in operating room products, including cutting tools and irrigation devices, and it is even a top provider of medical beds and emergency equipment, such as stretchers. Given these market opportunities, we expect Stryker's sales to grow 12% compounded annually through 2012 and operating margins to expand slightly from 22% in 2007 to 23% in 2012. To reach recent share prices, we'd have to assume that Stryker's orthopedic segment growth falls well below our industry expectations and that its medical equipment business can't make up the difference, resulting in a 5% compound annual growth rate in total sales through 2012. We'd also have to assume operating margins contract to 19% in 2012 from 22% in 2007. We think those assumptions are too pessimistic, and the market appears to be giving investors an excellent opportunity to invest in this admirable firm.

Novartis AG NVS

Novartis offers a strong investment opportunity as the market has taken down the stock price based on recession fears and liquidity concerns. However, Novartis offers a diverse platform of economy-resistant products, including branded drugs, generic drugs, vaccines, and consumer products. Further, this range of products should reduce the company's relatively minor patent exposure in its branded drug space. Additionally, the company boasts a strong balance sheet and robust cash flows that should eventually remind the market that Novartis does not heavily depend on the capital markets to run its business. Lastly, Novartis offers one of the best collections of late-stage pipeline products and recently launched drugs that we believe will drive superior long-term growth.

Alex Morozov, CFA, does not own shares in any of the securities mentioned above.

Our Outlook for Industrials Stocks

Slowing demand and dollar strength will hurt 2009, but values remain.

By Eric Landry, Associate Director of Stock Analysis

Next year will be a tough one for the industrial companies we cover, there's no doubt about it. Both the number of announcements regarding 2009 earnings forecasts and their magnitude of downward adjustment suggest that the majority of companies in our coverage universe are bracing for conditions not seen in several years. Nobody will be spared, as companies throughout the value chain, from those who mine the raw materials to the shippers that deliver the goods, are all affected.

The reasons are myriad but can be summed up most succinctly in two areas: Demand is falling off a cliff, both domestically and abroad; and currency has reversed from a strong tail wind into a stiff head wind. Take 3M MMM, whose management team recently outlined conditions by stating that business was "soft but in line with guidance in October" but then suffered a "rapid volume slowdown" in November, with "organic local currency sales down 17%." Illinois Tool Works ITW suffered a similar trend, with base (internal) revenue up 1% in October, but falling 14% year over year in November and 15% year over year through the first week or so of December. Eaton ETN was also tripped up, as management had to recently lower a forecast it produced in late October. Finally, equityholders of FedEx FDX suffered their worst day since the 1987 crash in early December when management disclosed that the low end of its fiscal 2009 (ended in May) earnings forecast would be 26% lower than the company had thought as recently as September. The list goes on and on, such that our analysts are expecting those companies that haven't already warned about a significant slowdown to do so in the not-so-distant future. Quite simply, business has shut down this fall, and virtually every company in our industrial universe will be affected.

On top of that, the world's banking crisis and resulting global recession has had a beneficial effect on the dollar, which has become a destination in the flight to quality. The trade-weighted dollar index is up 11.6% as of Dec. 17 since bottoming in March (although this trend may be reversing as we write). Importantly, the move reverses a trend that left the dollar 39% lower than its 2002 high (according to that index). The happy situation that enhanced the top lines of many of our multinational industrial names during the years of dollar weakness has now reversed, and U.S.-based corporations will suffer the consequences of exchanging their foreign currencies for fewer dollars than at the last reporting date. In some instances, the effect will be severe. A case in point is Tyco International TYC, whose management indicated that if exchange rates remained where they were in early November, the company would need to overcome an 8%-10% currency head wind. Although the dollar has displayed some weakness since the latest Fed rate cut in mid-December, we're still taking a conservative view toward revenues for next year throughout our coverage universe.

Notwithstanding these problems, we're actually quite bullish on the share prices for many industrials stocks. Equities are long-dated assets, and therefore they should be evaluated not just on 2009's prospects but on an estimate of normalized results. On this basis, many of the

stocks we cover are downright cheap. For those firms that enjoy strong balance sheets and sustainable competitive advantages, one or two years of relatively weak earnings aren't the end of the world. On the contrary, the prices afforded in these times of stress offer excellent opportunities to those smart enough to properly evaluate what they're buying. Industrial stocks are no exception.

Valuations by Industry

Industries that looked cheap in September are now even more so, thanks to the October/November equity swoon. In particular, manufacturing, land transport, and agricultural machinery prices look attractive relative to our current intrinsic value estimates, while environmental control and diversified manufacturers look to be a bit more expensive than in September. No groups, however, are significantly overvalued according to our methodology.

Industrials Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Aerospace & Defense	0.73	0.91	-20
Agricultural Machinery	0.67	0.70	-4
Air Transport	0.95	1.28	-26
Automakers	0.57	0.76	-25
Auto Parts	0.61	0.86	-29
Auto Retail	0.81	0.89	-9
Building Materials	0.62	0.64	-3
Construction Machinery	0.59	0.77	-23
Distributors	0.67	0.83	-19
Diversified	0.66	0.64	3
Electric Equipment	0.59	0.72	-18
Environmental Control	0.74	0.58	28
Homebuilding	0.56	0.78	-28
Land Transport	0.58	0.88	-34
Machinery	0.60	0.76	-21
Manufacturing	0.50	0.97	-48
Metal Products	0.62	0.83	-25
Packaging	0.69	0.87	-21
Paints/Coatings	0.92	0.96	-4
Transportation-Misc	0.65	0.86	-24
Truck Makers	0.64	0.75	-15
Water Transport	0.53	0.72	-26

Data as of 12-16-08 *Market-Weighted Harmonic Mean

Industrial Stocks for Your Radar

For this quarterly review, we're going to point out some deep-value stocks. None enjoy quite the business quality of the more high-profile industrial companies we cover, but they nonetheless have attributes sufficient to get them through the current downturn in relatively good stead. All have strong balance sheets and operate in niches that will help insulate against competitive attacks. Importantly, all are extremely cheap.

Stocks to Watch—Industrials

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Terex TEX	★★★★★	\$45	None	High	0.39
Pacer PACR	★★★★★	\$28	Narrow	Medium	0.34
SPX Corp. SPW	★★★★★	\$100	None	Medium	0.37
Crane CR	★★★★★	\$34	Narrow	Medium	0.46

Data as of 12-17-08

Terex TEX

Although it's pitted against the likes of Caterpillar CAT, Deere DE, and Komatsu in the highly cyclical and competitive construction equipment industry, Terex has secured itself a sizable share of the capital equipment market. Instead of going head-to-head with the industry heavyweights, Terex has built share and competed in other equipment categories such as cranes and aerial work platforms. In fact, Terex boasts more product breadth and depth than any other firm in the industry, while trading at a cheaper multiple of sales, earnings, or cash flow.

Pacer PACR

Pacer profitably operates one of the largest intermodal shipping networks in North America by buying bulk space on all major rail lines. We expect margins to deteriorate some when the firm renews critical contracts with Union Pacific UNP and CSX CSX in 2011 and 2015. Current rates were established when rails were looking to fill excess capacity, which is no longer the case as rails now enjoy tremendous pricing power due to their cost advantage over competing modes of transport. Nonetheless, Pacer's margins aren't going to zero, and the company will likely have the ability to pass along at least some of the cost increase. We think the market is a bit pessimistic on this name, as fuel costs, labor costs, and environmental concerns will all favor rail transport over straight trucking. Pacer is a big beneficiary, as it is the largest player in intermodal marketing, a service integral to the ongoing rail renaissance.

SPX Corporation SPW

Perceived exposure to automotive markets, municipal spending, and emerging-markets infrastructure have crushed this name. Fortunately, its auto exposure is in the service area, as SPX sells the diagnostic equipment used in diagnosing and servicing an aging automotive fleet. Its cooling tower business is heavily levered to power plant spending in China, an area likely to receive at least some of the nearly \$600 billion stimulus likely to be unveiled next year. We think normalized cash flows support a price much higher than the current quote.

Crane CR

This company operates in several markets that have been ravaged by the current market downturn. Exposure to aerospace, recreational vehicles, and energy markets will likely make

2009 a tough one. Asbestos exposure is also inherent to the story. Nonetheless, at current prices, investors are paying a fraction of the price the company commanded last summer. We think Crane is capable of generating normalized earnings in the \$2 per share range, and we note that it posted over \$3 per share of EPS in 2007. Asbestos exposure is well contained, as claims are no longer growing. Fraudulent practices rampant among litigants several years ago have been exposed, which suggests that the company no longer faces an ever-expanding roster of claimants.

Eric Landry does not own shares in any of the securities mentioned above.

Our Outlook for Media & Telecom Stocks

Telecom offers relative stability, but old media is in big trouble.

By Michael Hodel, CFA, Associate Director of Stock Analysis

The media and telecom sector is a tale of two extremes. At one end, we've seen relative stability among telecom service providers and cable companies, especially in the U.S. and other developed markets. While growth for most telecom and cable firms has slowed modestly recently and will likely continue to do so into 2009, margins and cash flow have generally held up very well. At the other end, "old media" companies that depend heavily on advertising spending are falling deeper into despair, and telecom-equipment vendors face a bleak outlook for 2009.

Several telecom and cable companies have noted recently that consumers are opting for cheaper rate plans or subscribing to fewer premium services. But a weak economy won't likely push households to disconnect television, Internet access, or wireless phone services in droves. These services, if not viewed as necessities, are fairly inexpensive relative to the typical customer's usage. The success of Apple's AAPL latest iPhone also demonstrates that a significant number of consumers remain willing to pay up for compelling products. About 2.4 million iPhones were sold in the U.S. during the third quarter, with each customer committing to spend at least \$70 per month on AT&T T wireless service. Business customers have begun to pull back a bit on telecom spending and negotiate harder on price as contracts expire. But weaker industry players, such as PAETEC PAET, have taken the biggest hit thus far. AT&T and Verizon VZ, which dominate the business services industry, have seen growth slow, but we expect these giants to press their scale advantages to win back share that was lost over the last few years.

We do expect the fourth quarter and 2009 will be a bit more difficult for telecom and cable companies. Cable again dominated the high-speed Internet access market during the third quarter, claiming a far greater share of new customers. Comcast CMCSA alone added 40% more customers during the period than AT&T and Verizon combined. But we've seen the phone companies begin to fight back, using price as the primary weapon. Each of the major phone companies is currently offering basic Internet access service for around \$15 per month and the cable companies have responded in many cases by promoting "economy" tiers as well. Although we still expect most cable companies will outperform their telecom peers over the long run, we recently lowered our margin expectations for several firms in the industry. For Charter Communications CHTR, these changes, coupled with the firm's massive debt load, have pushed our fair value estimate near \$0.

The current state of the capital markets has rattled few industries—outside of financials—as much as media. Over the past three months, we've assigned a \$0 fair value estimate to 11 media firms, adding to the four zeros we had previously. We believe the combination of heavy debt loads, shifting consumer demands, and the cyclical drop in advertising spending is simply too much for several "old media" firms to overcome. In radio, we now believe the equity of seven of the nine firms we follow is worthless, including satellite pioneer Sirius XM SIRI. In the newspaper business, we now expect McClatchy MNI and Lee LEE to eventually follow privately

held peer Tribune into bankruptcy. Among television broadcasters, we've placed \$0 fair value estimates on Entravision EVC and Gray Television GTN. Finally, we've taken telephone directory publishers Idearc IDAR and R.H. Donnelley RHD to \$0. Although we've maintained positive fair value estimates on a handful of newspaper, radio, and television broadcast companies, we don't believe any of these firms are compelling investments right now. However, we continue to believe shares of diversified media firms—such as Disney DIS—have been punished too severely amid the media mess.

The telecom equipment industry hasn't fared much better over the past quarter, and we expect 2009 will be even worse. Legacy vendors Nortel NT and Alcatel-Lucent ALU have seen revenue start to decline, and both continue to burn cash. Alcatel CEO Ben Verwaayen believes the telecom equipment market will see revenue decline 8%-12% during 2009, and AT&T's plan to cut capital spending doesn't bode well for equipment vendors. We have slashed our fair value estimates for Nortel and Alcatel, as both face bloated cost structures and need healthy carrier spending to aid their turnaround efforts. Cisco CSCO and Juniper JNPR have held up far better, propelled by double-digit third-quarter growth in the router market. However, we think demand fell precipitously in October, and we would not be surprised to see weak results over the next several quarters at either firm.

Valuations by Industry

While the market has dropped sharply over the past quarter, the radio and wireline equipment industries have both jumped sharply relative to our fair value estimates. As mentioned, this primarily reflects our belief that the majority of the equities in the radio industry are now worthless and that a slowdown in telecom capital spending will severely hinder turnaround efforts at the large, legacy telecom equipment vendors. A similar dynamic is at work in the publishing industry, where the newspapers reside. But this industry is much more diverse and includes healthy companies such as John Wiley & Sons JW.A.

Media & Telecom Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Advertising	0.64	0.70	-9
Broadcast Television	0.59	0.89	-34
Business/Online Services	0.58	0.72	-19
Cable TV	0.63	0.75	-16
Data Networking	0.56	0.74	-24
Media Conglomerates	0.67	0.73	-8
Publishing	0.82	0.75	9
Radio	1.51	0.93	63
Telecom Services	0.74	0.75	-1
Wireless Equipment	0.61	0.77	-21
Wireless Service	0.69	0.65	6
Wireline Equipment	0.71	0.56	27

Data as of 12-15-08 *Market-Weighted Harmonic Mean

Communication Stocks for Your Radar

We continue to see compelling valuations across some of the strongest businesses in the media and telecom sector. Four of the five stocks listed below receive our wide moat rating and the remainder, NII Holdings NIHD, is one of our favorite international stocks. NII replaces America Movil AMX this quarter, as shares of the latter have moved out of 5-star territory. We've also dropped Time Warner TWX from the list, as that firm plans to spin off its wide moat cable business in the near future.

Stocks to Watch—Media & Telecom

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Walt Disney Co. DIS	★★★★★	\$34	Wide	Low	0.67
eBay, Inc. EBAY	★★★★★	\$40	Wide	Medium	0.37
Comcast Corp. CMCSA	★★★★★	\$25	Wide	Medium	0.63
Cisco Systems, Inc. CSCO	★★★★★	\$31	Wide	Medium	0.54
NII Holdings, Inc. NIHD	★★★★★	\$58	Narrow	High	0.32

Data as of 12-18-08

Walt Disney DIS

We recently trimmed our Disney fair value estimate to reflect reduced expectations as a result of the weak economy, but we still believe the firm's long-term competitive advantages remain intact. The strength of the Disney brand allows the company to exploit its characters and franchises through box office and home video sales, theme park and resort attendance, and merchandising. The company also owns ESPN and its portfolio of assets, which include cable networks, magazine, and a popular Web site. In addition, Disney's cable networks are more dependent on affiliate fees and less dependent on advertising, which should help buoy the firm's financial results during these challenging economic times.

eBay EBAY

Although the business line that made eBay famous (online auctions) appears to be in decline, eBay is no longer a one-trick pony, as online auctions represent only about 32% of revenue. PayPal now generates about 27% of total revenue and continues to grow rapidly. We think PayPal is eBay's best opportunity for future growth. The total payment volume from merchant services now exceeds PayPal's payment volume on eBay, a testament to the ubiquity of PayPal across the Web.

Comcast CMCSA

The volatility in Comcast's shares over the past quarter belies the relative stability of the firm's business. Since late September, the shares have seen daily declines of 10% or more on five occasions and a 25% gain on a single day in October. Against this backdrop, the company itself continues to perform pretty much as expected, with free cash flow jumping sharply thus far in 2008. Revenues continue to grow, albeit at a slowing pace, while margins have held steady and capital spending has dropped. Despite a small reduction in our fair value estimate recently, we continue to believe the shares are compelling at current prices.

Cisco Systems CSCO

Although current market conditions are tough, network convergence, data-center consolidation, and increased global communications needs should drive relatively solid demand for Cisco's equipment through a depressed spending environment. We also expect Cisco to gain share at the expense of certain of its smaller, resource-constrained competitors during this economic downturn. At current levels, we believe the market is offering investors the opportunity to pick up a great long-term holding at a reasonable price.

NII Holdings NIHD

NII Holdings is a niche player in the Latin America wireless market, offering postpaid wireless plans (on Motorola's MOT iDEN platform) in a region where about 90% of subscribers are prepaid users. Despite solid performance through the first nine months of the year (40% revenue growth, 33% subscriber growth), 2008 has been a tough year for NII's share as economic conditions have deteriorated. While growth will likely slow in the fourth quarter and into 2009—mainly as a result of the steep declines in its operating currencies against the U.S. dollar—we think the long-term story for NII remains intact. The firm has built an extremely valuable customer base in the region and should be able to continue expanding that base as it enters into new markets. The shares currently place the firm's enterprise value at about 3.3 times operating income, excluding depreciation and amortization, the lowest since 2003.

Michael Hodel, CFA, does not own shares in any of the securities mentioned above.

Our Outlook for Technology Stocks

The credit crunch hits technology in the fourth quarter.

By Toan Tran, Associate Director of Stock Analysis

In the last quarterly update, we wrote that technology would not be immune from the credit-starved and slowing economy. The fourth quarter bore out that prediction. So far in the fourth quarter, the technology-heavy Nasdaq Composite Index is down by roughly 25%. The common theme we are hearing is that customers are delaying orders because of a lack of access to credit. Unless and until the credit markets thaw, we do not expect technology spending to rebound in a material way. Let's review developments in the major technology sectors.

Hardware

After a robust third quarter, PC unit growth has slowed significantly in the fourth quarter. The good news is that unit growth is still in the midsingle digits. The bad news is that much of the growth is from low-end "netbooks," which are generally less profitable for the entire PC supply chain. Moreover, it is likely that unit growth will slow further. Michael Dell, the eponymous CEO of Dell DELL, warned in September that conditions had slowed and recently mentioned that conditions remained in a depressed state. One PC maker we like at these prices is Apple AAPL. The weak U.S. consumer will undoubtedly take its toll on Apple, but if you're a long-term investor (if such a person exists anymore in these markets) the Macintosh should continue take market share and the iPhone has all the markings of a blockbuster business.

Of course, the slowing PC market is terrible news for the hard disk drive makers like Seagate STX and Western Digital WDC. To add to their difficulties, the massive glut of flash memory is helping solid state drives to become price competitive. The ongoing migration toward flash memory in consumer electronic devices like the iPod is also a major head wind.

Moving further back in the supply chain, companies that manufacture electronic components such as Amphenol APH, Molex MOLX, and Tyco Electronics TEL all announced weak outlooks. These companies tend to be vanguards of demand trends as they serve a multitude of industries in and out of technology, so their announcements of an incremental 15%-20% fall in demand during the fourth quarter are not encouraging.

The one relatively bright spot in hardware is storage, but even this is starting to fade. Storage benefits from the natural demand growth as more information is created every day, so storage has tended to be easy high-return projects for IT departments that are looking to prioritize their budgets. However, as resilient as storage may be, it cannot sail untouched through the current economic storm. Industry giants like EMC EMC and NetApp NTAP have become much more cautious about 2009 in recent months. Much of this pessimism has already been baked in by the market, given that both EMC and NetApp now trade at single-digit multiples of free cash flow. Enterprises may be able to delay storage investments, but not indefinitely. The growth of data is simply inexorable.

Software

Software giant SAP sounded the alarm at the beginning of the fourth quarter with word that business conditions had deteriorated significantly at the end of the third quarter. The reason, of course, was the global credit crunch. While business with large enterprise customers held up, sales to small and medium-sized businesses were extremely weak as customers in this segment are generally more reliant on external financing to purchase SAP's products. As the quarter moved on, we saw many companies such as Autodesk ADSK begin to offer promotions and vendor financing in an attempt to alleviate the credit crunch and spur demand.

As we saw in the hardware space, IT departments are also prioritizing software spending toward small, quick, and high-return projects. Large, lengthy, and often unwieldy projects, such as enterprise resource planning implementations, will suffer disproportionately. In contrast to SAP's warning, Microsoft's enterprise software segment, which sells mostly stand-alone products, recorded 17% growth in the most recent quarter.

We expect the server virtualization trend to continue as it helps to cut costs by consolidating server capacity. VMWare VMW has been a leader in virtualization software, but there will be an onslaught of competition from the likes of Microsoft MSFT, Citrix CTXS, and Red Hat RHT. VMWare clearly recognizes the commodity nature of the core virtualization software and has set itself on course to make money from software that manages virtual servers in the data center. If VMWare is able to successfully leverage its dominant position in virtualization to sell server management tools, the company could be an interesting growth play.

Semiconductors

The news from semiconductor land this quarter was uniformly bleak. Unlike the last semiconductor bust in 2001, which was primarily caused by excess inventory, inventories are now fairly lean in semiconductor supply chain. This means that the downturn is driven by a significant drop-off in end demand and it is unlikely that demand will return anytime soon. The world's largest semiconductor firm, Intel INTC, warned that fourth-quarter revenue would fall by about 16% from last year. Another large chipmaker, Texas Instruments TXN, reported sharp order decline starting in September and that fourth-quarter revenues would decline by an eyebrow-raising 30% sequentially.

As the outsourced manufacturers for much of the semiconductor industry, the two big chip foundries, TSMC TSM and UMC UMC, are a good barometer to track. Unfortunately, both firms are reporting massive drops in monthly revenue and capacity utilization. TSMC's November revenue dropped by nearly a third from the October figure. UMC expects capacity utilization to drop from 80% in the third quarter to about 50% in the fourth quarter. Utilization rates that low are the harbinger of doom for such capital-intensive and high-fixed-cost businesses.

The semiconductor equipment industry remains in free-fall. The core chip equipment business at Applied Materials shrank by 38% this year and the company expects sales to fall a further 25% in 2009. Other chip equipment makers like KLA-Tencor KLAC and Lam Research LRCX have echoed Applied's outlook. One of the primary causes of the industry's woes is the massive overhang of DRAM (computer memory) and flash manufacturing capacity. DRAM and flash prices have been driven so low that three major suppliers, SanDisk SNDK, Micron MU, and

Qimonda QI, actually reported negative gross margins. DRAM and flash is selling for less than it costs to manufacture. The overcapacity must be absorbed before there is to be any hope of an upturn.

Valuations by Industry

With the overall market off by such a large amount in the fourth quarter, it's not surprising that the price/fair value ratios came down significantly across all of the technology sector.

Technology Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Audio/Video Equipment	0.45	0.66	-31
Business Applications	0.63	0.79	-21
Business/Online Services	0.58	0.72	-19
Components	0.63	0.77	-19
Computer Equipment	0.58	0.77	-25
Contract Manufacturers	0.46	0.73	-37
Development Tools	0.78	0.93	-17
Distributors	0.67	0.83	-19
Electric Equipment	0.59	0.72	-18
Entertainment/Edu Media	0.48	0.83	-42
Photography & Imaging	0.54	0.70	-23
Semiconductor Equipment	0.52	0.74	-30
Semiconductors	0.62	0.73	-15
Systems & Security	0.65	0.87	-25

Data as of 12-15-08 *Market-Weighted Harmonic Mean

The economic picture is obviously bleak, but the key question to ask is how much despair is already baked into valuations. As you'll see below with our five picks for your radar screen, with many high-quality technology companies now trading at single-digit multiples, it's fair to say a lot of bad news has already been discounted. The problem, however, is there are few near-term catalysts to move stock prices up in technology.

Tech Stocks for Your Radar

Technology companies tend to hold mountains of cash and little to no debt on their balance sheets. When you look at a cash-heavy company, it makes sense to subtract the company's cash from its valuation. After all, if you were to pay \$100 for a company with \$50 of cash, your net outlay would be only \$50. We call this figure a company's enterprise value (EV), or its market capitalization minus cash plus debt. As you can see in the last column of the associated chart, many tech companies are now trading at single-digit EV/FCF (enterprise value/free cash flow) multiples.

Stocks to Watch—Technology

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	EV/FCF
EMC Corp. EMC	★★★★★	\$18	Narrow	Medium	7.0
Applied Materials AMAT	★★★★★	\$22	Wide	Medium	6.0
Intel INTC	★★★★★	\$23	Wide	Medium	8.0
Autodesk ADSK	★★★★★	\$44	Wide	Medium	5.0
Texas Instruments TXN	★★★★★	\$39	Narrow	Medium	6.0

Data as of 12-18-08

EMC Corporation EMC

As businesses continue to digitize everything from correspondence to confidential customer information, management of the underlying data has become a critical business processes. A leader in enterprise storage solutions, we believe EMC is positioned to capitalize on emerging technology trends and explosive data growth in corporate data centers around the globe.

Applied Materials AMAT

Applied Materials is the behemoth of the semiconductor equipment industry, with its unmatched scale and broad product portfolio. The firm has steadily been establishing its solar equipment business, which we think could turn into a key growth driver for Applied. However, a severe cyclical slowdown in the chip equipment market has been hampering the firm.

Intel INTC

Intel has reasserted its dominance over Advanced Micro Devices AMD and once again reigns supreme in the microprocessor industry. We believe Intel holds long-term advantages over its smaller rival, which should keep the firm in the driver's seat of the processor market over the long run.

Autodesk ADSK

Autodesk will continue dominating the market for computer-aided design (CAD) software. The company has more than 8 million CAD users, making its products the de facto standard in digital design. The firm benefits from its customers' high switching costs: It takes time to learn a new design software application, and operational disruption and downtime costs discourage companies from changing CAD providers.

Texas Instruments TXN

Texas Instruments is a smart, well-run company that has managed to reinvent itself over and over again during its 78-year history. During this time, it has undergone many changes, and while some of the recent changes have prompted jitters in the stock market, we believe TI's positives far outweigh its minuses. Risks still remain, but we believe that investors would be well served by taking a closer look at this innovative firm.

Toan Tran does not own shares in any of the securities mentioned above.

Our Outlook for Utilities Stocks

Financing, demand, and fuel price concerns have besieged the utilities sector.

By Ryan McLean, Stock Analyst

Three negative developments have seized the utilities sector, and there are no signs of relief on the immediate horizon. The first is the tightening of credit. While creditworthy utilities are still able to raise money, their cost of borrowing has risen by 300 to 500 basis points. Costlier credit is worrisome given utilities' reliance on debt to finance their capital-intensive operations. In theory, regulated utilities should be able to recover steeper financing costs through commensurately higher rates. But with consumers in a pinch and the number of pending rate cases already at a multidecade high, utilities may have a hard time convincing regulators of their woes. Inadequate rate increases could, in turn, lower utilities' credit standing—thereby raising their cost of financing and exacerbating the original problem.

Declining demand is a second head wind for most utilities. As the recession deepens, hard-hit industrial and commercial customers are dialing back their power consumption at double-digit rates. Households, particularly in weak real estate markets such as Florida, are also trimming their electricity use. Until the economy recovers, lower sales volumes will be a reality across the utilities sector. Because of their largely fixed cost structure, the corresponding decline in revenues will carry a leveraged impact on utilities' earnings.

Plummeting fuel prices are a third challenge. Following a sharp rise in the first half of 2008, oil and natural gas prices have sunk on weak demand. While lower fuel prices will benefit those regulated utilities, such as PNM Resources PNM, that had struggled to recover high fuel costs, their damping effect on power prices will lead to margin contraction at unregulated merchants. Unless we experience a cold winter or hot summer (which would boost gas prices), even the best merchants could face trouble.

In response to these head winds, utilities across the sector have revised their capital expenditure plans. FPL Group FPL—a large, A-rated utility—is a case in point. The Florida-based utility slashed its planned 2009 capital spending by a substantial 25%. While lower capital spending should help preserve returns at some utilities, a smaller earnings base will mean lower future profits. Renewable energy projects appear to be the first to have gotten nixed or delayed; declining demand means a less pressing need for new power sources, while limited access to capital has shackled companies' ability to get projects off the ground. The precipitous drop in oil prices, meanwhile, has dented the political urgency to develop alternative energy. And with Washington's finances so thinly stretched, subsidy-dependent technologies appear shakier ventures than before.

Despite these challenges, we see long-term value in the sector. Among the established base-load merchants we cover, we believe Mirant MIR, Exelon EXC, PPL PPL, and PSEG PEG are all underpriced. Our thesis for these firms centers on our long-term bullish outlook for natural gas. As gas prices recover, we expect power prices to rise and margins to expand. Prominent buyout offers for NRG NRG and Constellation CEG suggest other market participants also see value in

this subsector. Among regulated utilities, we continue to steer investors toward those utilities with stable rate structures, steady demand, and capital spending plans that regulators have already agreed to include in rates. NSTAR NST, Westar WR, and Southern SO stand out along these lines.

Valuations by Industry

The median price/fair value estimate for the electric and natural gas utilities sector now stands at about 0.85, which is relatively flat year to date. Although we view utilities as somewhat undervalued, we also consider it the most expensive sector (on a price/fair value basis) in our coverage universe.

Utilities Valuations

Segment	Price/Fair Value*	Three Months Prior	Change (%)
Electric Utilities	0.86	0.83	3.6
Natural-Gas Utilities	0.84	0.87	-3.4
Water Utilities	0.95	0.85	11.8

Data as of 12-15-08 *Market-Weighted Harmonic Mean

In addition to company-specific regulatory developments, at least four difficult-to-predict macro variables will impact utilities' earnings—and hence valuations—going forward. The first is interest rates. Until the second half of 2008, persistently lower interest rates made utilities' executives reluctant to ask for new rates for fear that regulators would cut allowed returns on equity. But falling equity prices and rising credit spreads now leave executives hoping for every opportunity possible to raise rates and allowed returns. In this environment, those utilities that are able to pursue rate cases will do better than their peers, in our view. A second variable is the availability of credit. If credit remains constrained, so too will utilities' capacity to expand their rate base and thus grow earnings. Third, continued commodity price volatility will impact utilities' margins, depending on their ability to recover input costs through regular rate adjustments. Fourth, general economic conditions will drive demand for power and therefore impact sales volumes and earnings.

Utilities Stocks for Your Radar

We continue to advise investors who are seeking exposure to a possible upswing in power prices to opt for those merchants with low-cost generation assets. Exelon EXC, Public Service Enterprise Group PEG, and PPL PPL are good examples. Those investors seeking the relative stability of regulated utilities should, as before, focus on companies that operate in supportive regulatory environments. These include Westar WR and NSTAR NST.

Although we believe the long-term fundamentals for the utilities industry are solid, we have assigned a 5-star rating to only two of the firms we cover. As credit markets stabilize and the economy recovers, however, we could see more-attractive opportunities emerge among some of our top merchant and regulated utilities. As such, we recommend keeping these stocks on your radar screen.

Stocks to Watch—Utilities

Company	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Dividend Yield (%)
PPL Corporation PPL	★★★★★	\$45	Narrow	Medium	4.6
Exelon EXC	★★★★	\$76	Wide	Medium	3.9
Westar WR	★★★★	\$27	Narrow	Medium	6.2
Southern Company SO	★★★	\$41	Narrow	Medium	4.7
NSTAR NST	★★★	\$36	Narrow	Medium	4.3

Data as of 12-16-08

PPL Corporation PPL

With one of the largest fleets of low-cost coal and nuclear generation in the U.S., PPL dominates the central Pennsylvania power markets. Falling Mid-Atlantic power prices and operating stumbles in late 2008 caused it to fall short of reaching its full profit potential this year. But strong forward hedges and changing Pennsylvania power market regulation still provide good earnings clarity through 2011. If coal prices retreat and natural gas prices rise, PPL should produce strong returns for investors.

Exelon EXC

Because of its low-cost nuclear power plants, Exelon is the only utility we cover that has earned a wide-moat rating. Despite a fall in power prices, we believe Exelon's long-term fundamentals remain intact. Management has demonstrated a long-standing commitment to creating shareholder value through stock repurchases and dividend hikes. As of November, Exelon had hedged substantially all of its power production and fuel costs for 2009 and 2010. This should lend stability to Exelon's earnings in today's turbulent market.

Westar WR

A stable, constructive regulatory environment in Kansas underpins a 10-year, \$3 billion capital investment plan Westar began in 2006. Two thirds of that build-out is either complete or fully approved and the company is only now beginning to collect the higher returns on those projects. As rates adjust higher in 2009 and 2010, we expect Westar will post industry-leading earnings growth and returns.

Southern Company SO

Southern has garnered envious regulatory relationships by providing comparatively cheap, reliable power to its customers. As a result, the firm enjoys industry-leading allowed returns on equity. Southern's strong earnings growth prospects, rock-solid financial condition, and appealing dividend yield justify its place as a core holding in most income investors' portfolios.

NSTAR NST

We think Boston-based NSTAR, a fully regulated transmission and distribution utility, will continue to outshine its peers. NSTAR's strength is its predictable, rising cash flow. Strong cash flows, in turn, have translated into an impressive record of dividend increases. We expect the firm will continue its dividend growth at a healthy 5%-6% pace for at least the next five years. For risk-averse, income-seeking investors, we think NSTAR is among the most attractive firms available.

Ryan McLean does not own shares in any of the securities mentioned above.