
Wide Moat Investing



Heather Brilliant, CFA

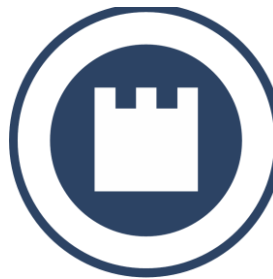
May 2016

Morningstar Equity Research
Morningstar[®] Economic Moat[™] Rating

Sustainable competitive advantages that allow a company to generate positive economic profits for the benefit of its owners for an extended period of time.



Wide
15%



Narrow
45%

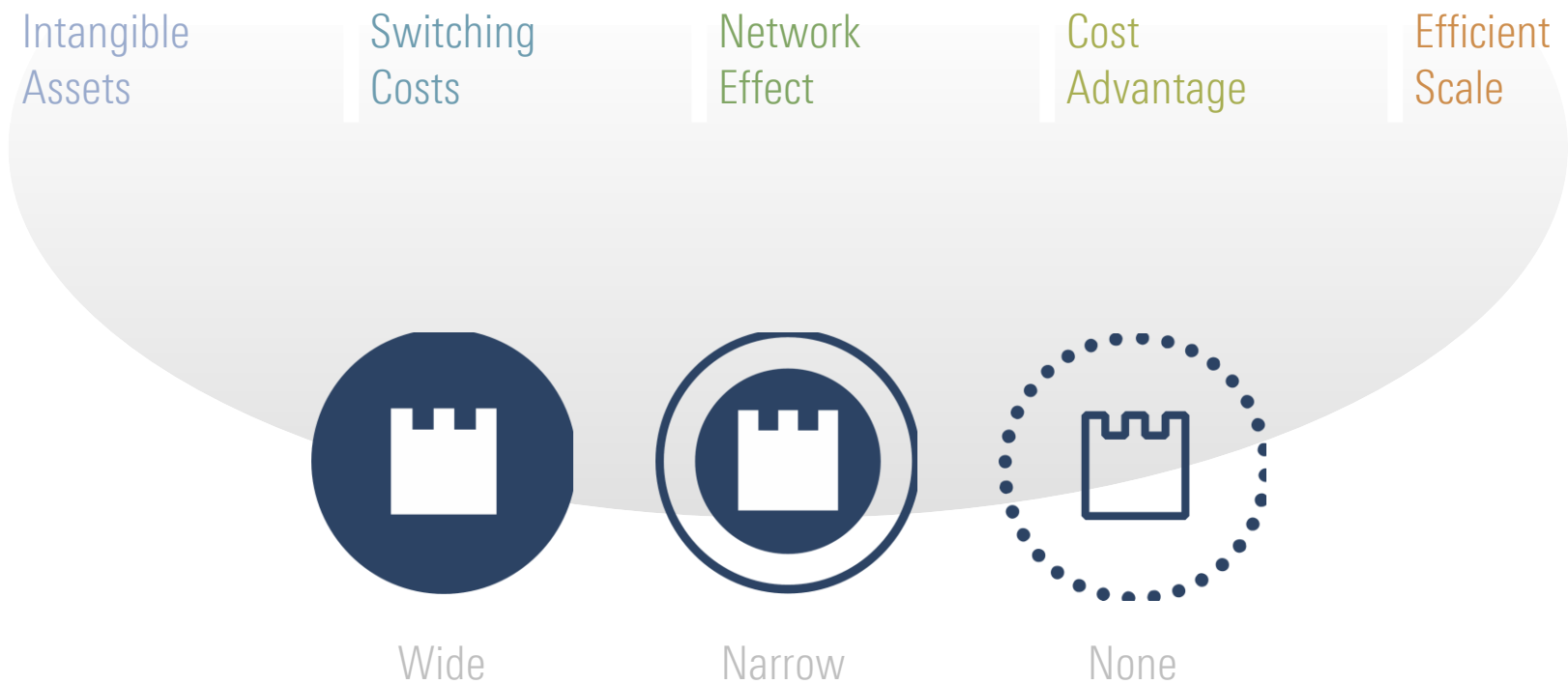


None
40%

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Sources of Economic Moat

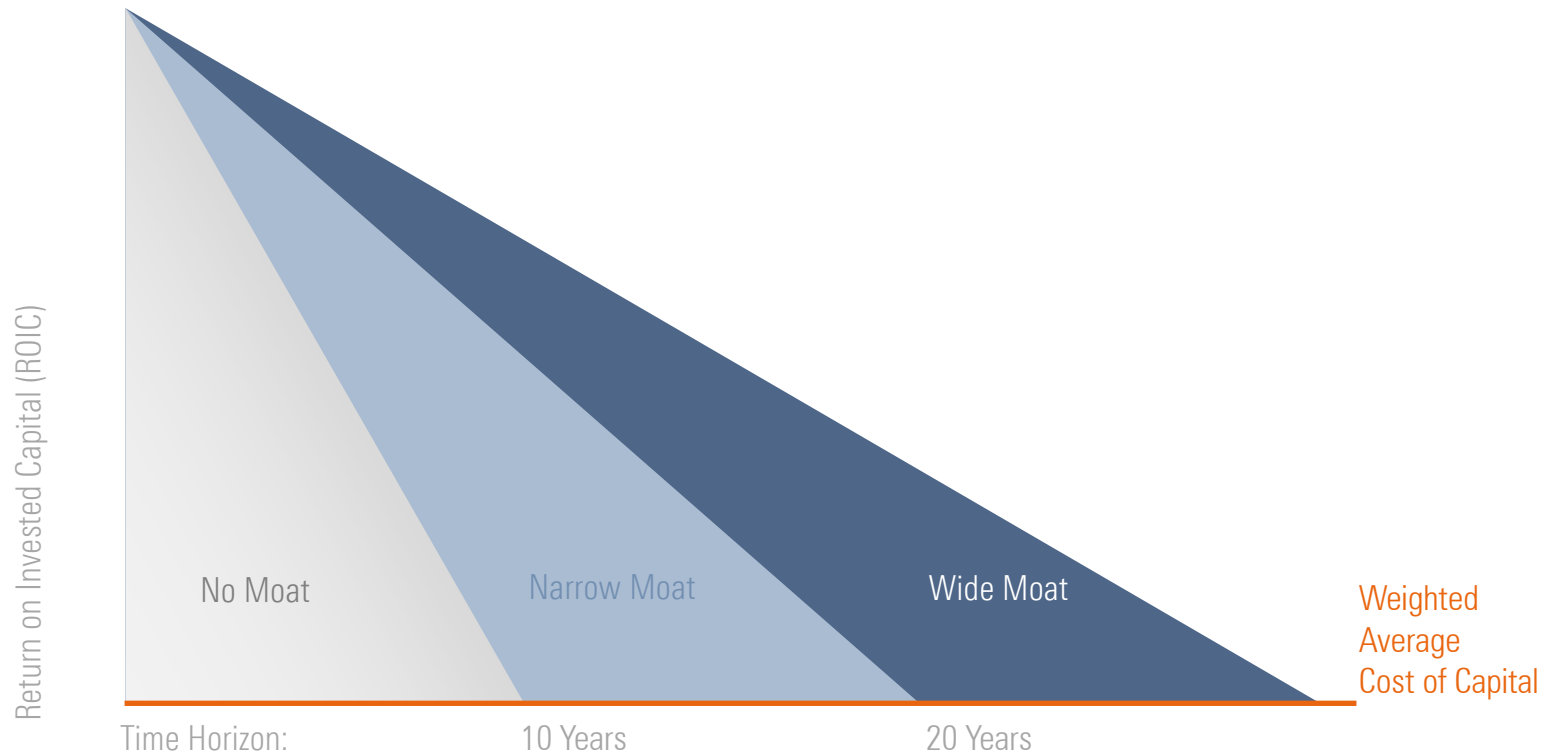
There are five sources of economic moats.



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Measuring an Economic Moat

Duration of excess returns is far more important than absolute magnitude.

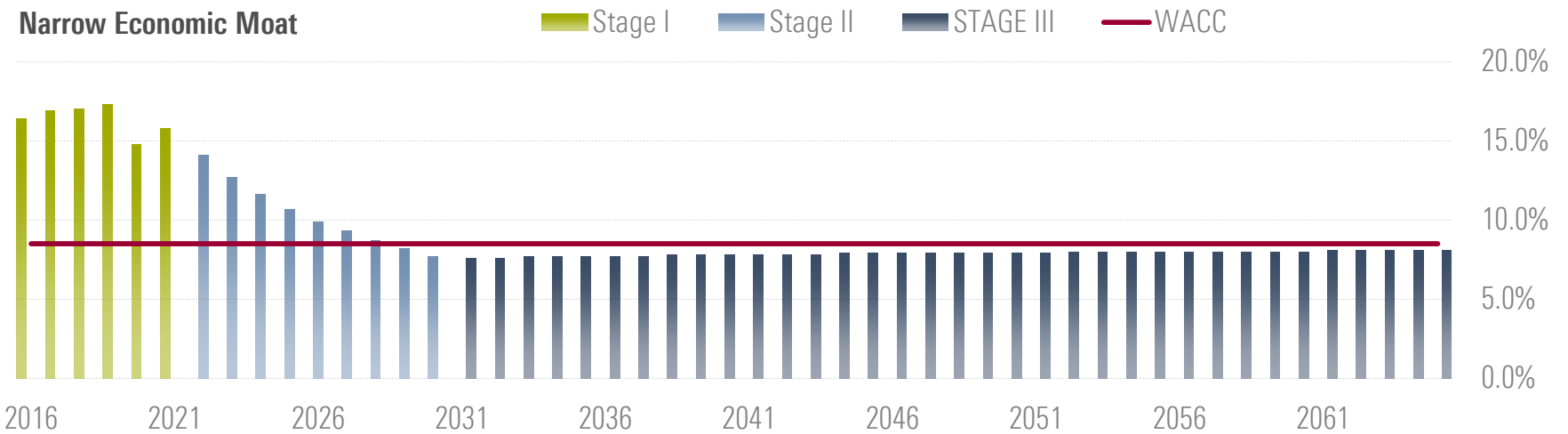
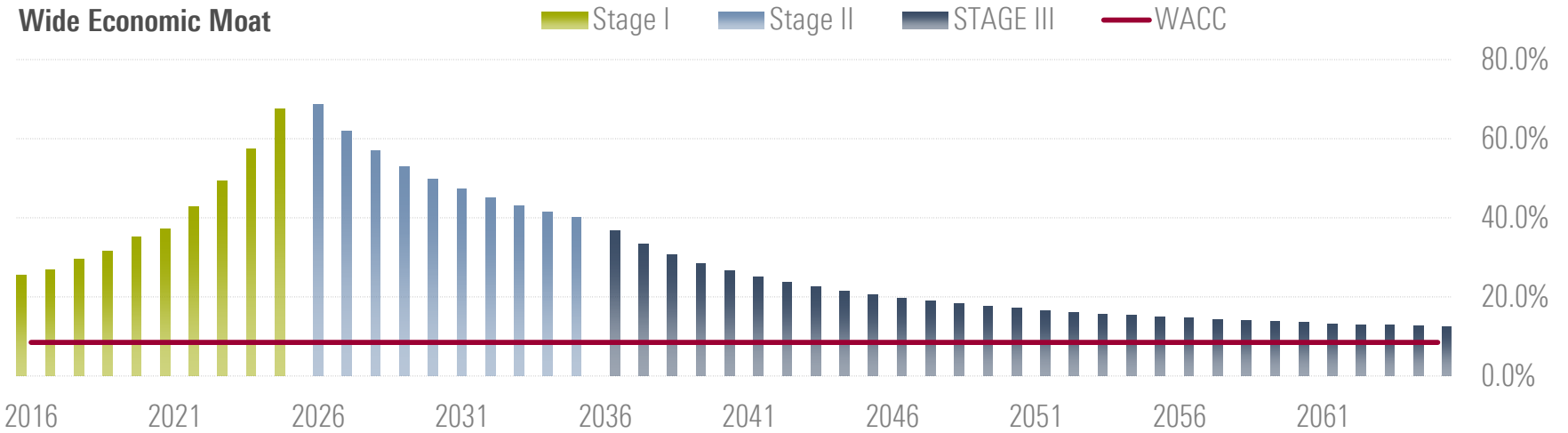


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Why Moats Matter

Sustainable competitive advantage drives value creation.



Why Moats Matter: Moats Increase Intrinsic Value



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Research Methodology




Our award-winning analysts rely on a proven methodology.



Fundamental Research and Analysis

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Examples of Wide, Narrow, and No Moat Companies

	Intangible Assets	Switching Costs	Network Effect	Cost Advantage	Efficient Scale
	<p>Coca Cola</p> <p>It's just sugar water, but consumers pay a premium</p>	<p>Oracle</p> <p>Switching from Oracle's tightly integrated databases could cause massive disruptions</p>	<p>MasterCard</p> <p>Each additional user of the MasterCard brand increases its value to others.</p>	<p>Novo Nordisk</p> <p>Entering insulin market requires significant upfront costs, and Novo controls more than 1/4 of the market.</p>	<p>Canadian National</p> <p>Cost advantages, efficient scale, and network effect form a steep barrier to entry</p>
	<p>Adidas</p> <p>Has strong and well-recognized brand in athletic footwear.</p>	<p>Workday</p> <p>Switching costs with initial product set, but still need to see success integrating a large number of products.</p>	<p>United Health</p> <p>Sizable membership and solid provider network allows firm to scale its fixed costs</p>	<p>FedEx</p> <p>The high fixed-cost air express segment is still a large portion of revenue</p>	<p>Southern Company</p> <p>Utilities have natural geographic monopolies, but regulations restrain returns</p>
	<p>United Continental</p> <p>Name recognition doesn't result in sufficient pricing power</p>	<p>Macy's</p> <p>Consumers easily pick and choose among many retailers</p>	<p>Deutsche Telekom</p> <p>Despite its scale, it has not been able to generate returns above its cost of capital</p>	<p>Alcoa</p> <p>Low-cost bauxite resources can't offset industry oversupply</p>	<p>Sprint</p> <p>Lacking scale versus AT&T and Verizon eliminates economic profit</p>

Morningstar[®] Economic Moat[™] Trend

Morningstar Equity Research

Morningstar[®] Economic Moat[™] Trend

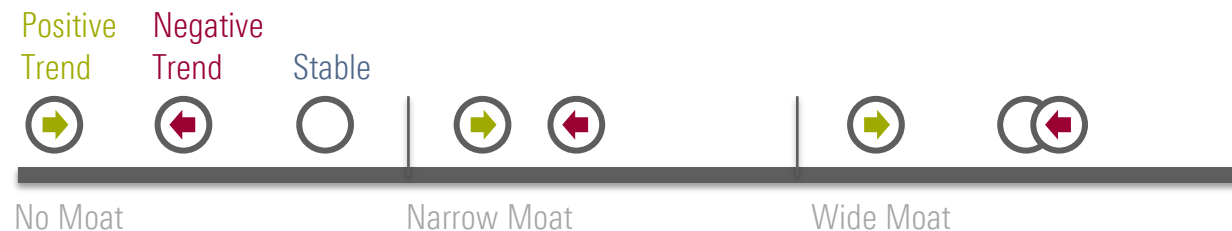
Moat Trend is a detectable direction of change in the competitive position of a company's businesses.

▶ **Positive Trend**

The underlying sources (or potential sources) of an economic moat must be materially strengthening for an identifiable reason

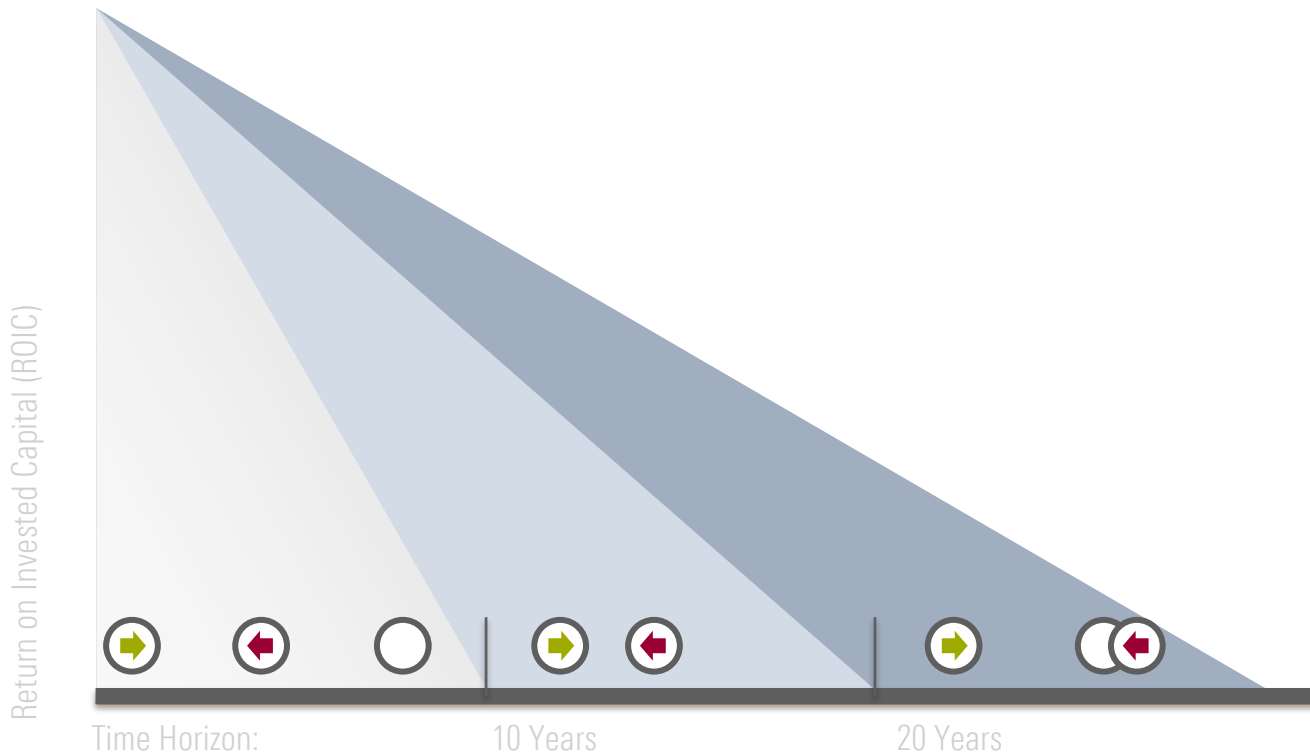
▶ **Negative Trend**

The underlying sources (or potential sources) of an economic moat must be materially weakening or face a substantial and identifiable threat that is growing



Morningstar Equity Research
Morningstar[®] Economic Moat[™] Trend

A change in moat trend doesn't indicate a change in moat rating. It's an alert that competitive advantages could extend further into the future, or dissipate sooner than we initially forecast.



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Examples of Positive, Stable, and Negative Moat Trend Companies

	Wide Moat	Narrow Moat	No Moat
	<p>Salesforce.com Switching costs continue to grow, as companies increase their spending with the firm faster than other vendors.</p>	<p>FedEx Enjoying a strengthening network effect, driving by growth, better margins, and market share gains.</p>	<p>Panera Bread Increasing pricing power evidence of an improving intangible asset.</p>
	<p>3M Ongoing investment in support of intangible assets perpetuates a self-sustaining new product development cycle.</p>	<p>Ross Stores Competition likely to increase, but continued growing scale at Ross should offset major threats.</p>	<p>Marathon Oil High-quality U.S. portfolio increasing in contribution, but the company's overall relative competitive position is likely to remain unchanged.</p>
	<p>Wal-Mart Shift to e-commerce will likely take share and make large Wal-Mart stores less productive at the margin.</p>	<p>Nasdaq Still a major player, but competition in the trading space remains fierce.</p>	<p>Ford Motor Co Excess capacity will probably become even worse going forward given minimal barriers to entry.</p>

Moat Committee Members



Adam Fleck, CFA
Consumer
Chicago



Gareth James
Technology
Sydney



Michael Holt, CFA
Technology
Chicago



Allen Good, CFA
Energy
Amsterdam



Mathew Hodge
Materials
Sydney



Michael Waterhouse, CFA
Healthcare
Chicago



Alex Morozov, CFA
Healthcare
Amsterdam



Joel Bloomer
Consumer
Sydney



Phil Gorham, CFA
Consumer
Amsterdam



Dan Baker
Telecom
Hong Kong



Matthew Coffina, CFA
Healthcare
Chicago



Rick Summer, CFA, CPA
Technology
Chicago



Elizabeth Collins, CFA
Materials
Chicago



Michael Hodel, CFA
Telecom
Chicago



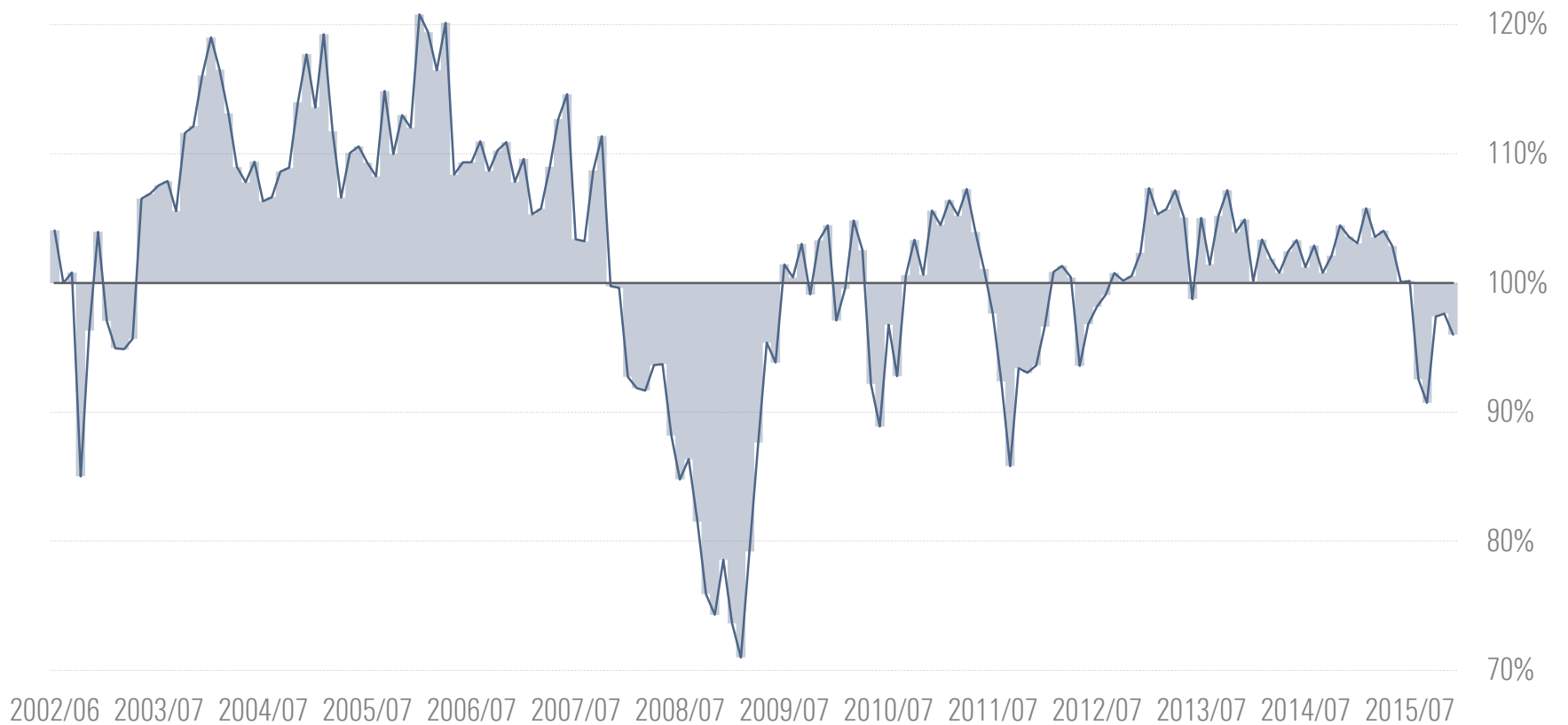
Stephen Ellis
Financials
Chicago

Valuation

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The Effectiveness of Our Ratings Over Time

Aggregate Market Price to Fair Value

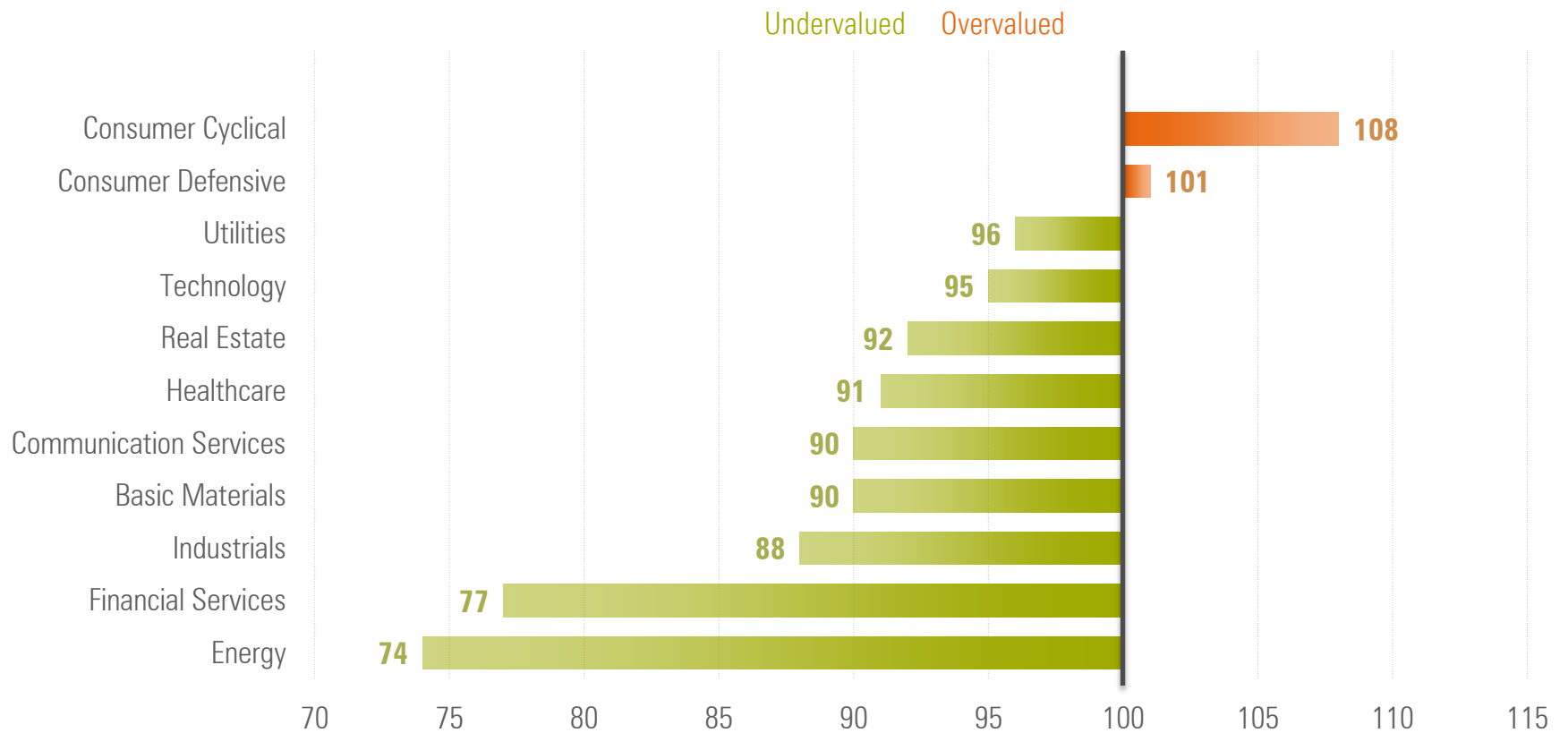


Data as of December 31, 2015

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Aggregate Price to Fair Value By Industry

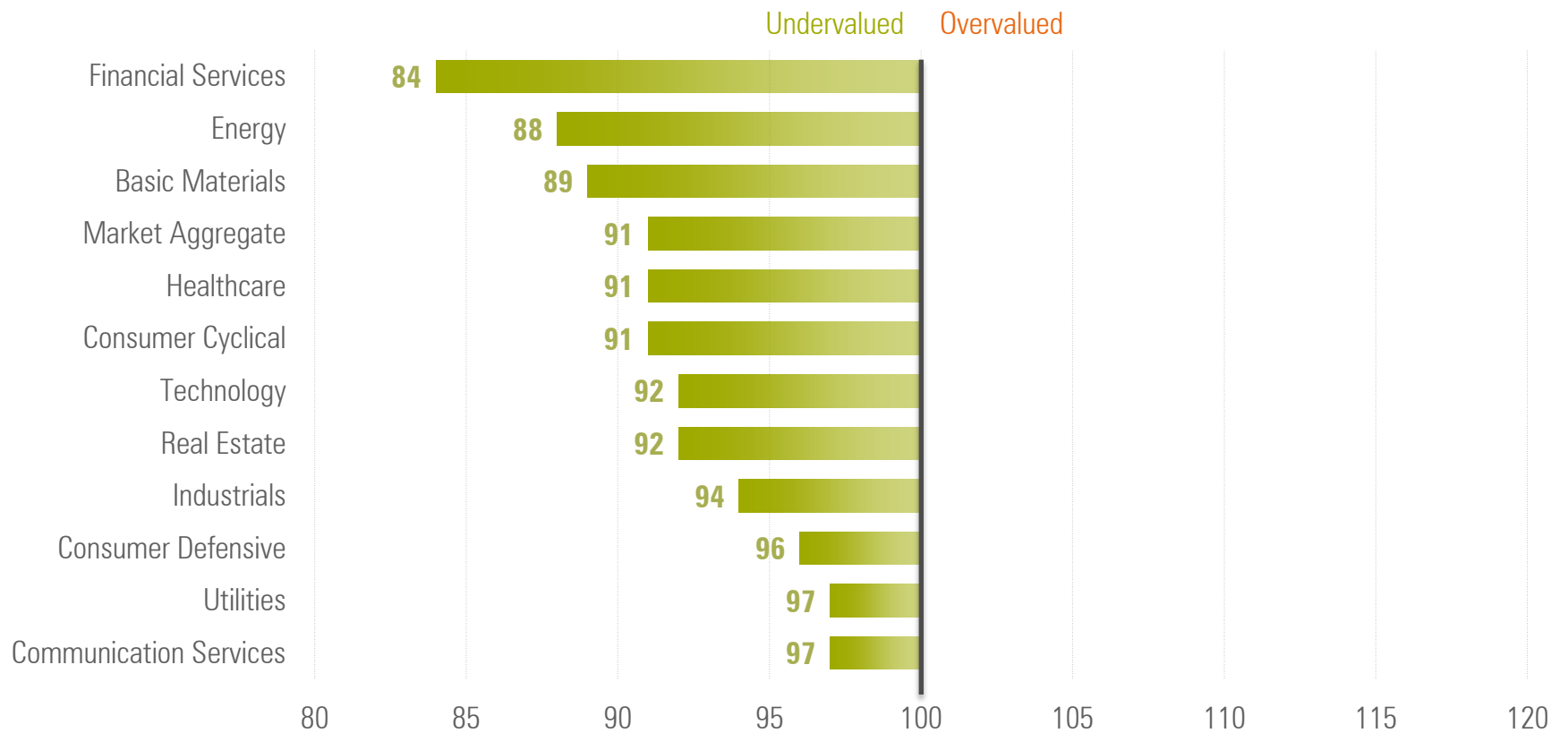
As of January 2016, Energy, Financial Services, and Industrials are among our most undervalued sectors.



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Aggregate Price to Fair Value By Industry

Sector Valuations as of 30 Sept 2015: Financial Services, Energy, and Basic Materials were among our most undervalued sectors.

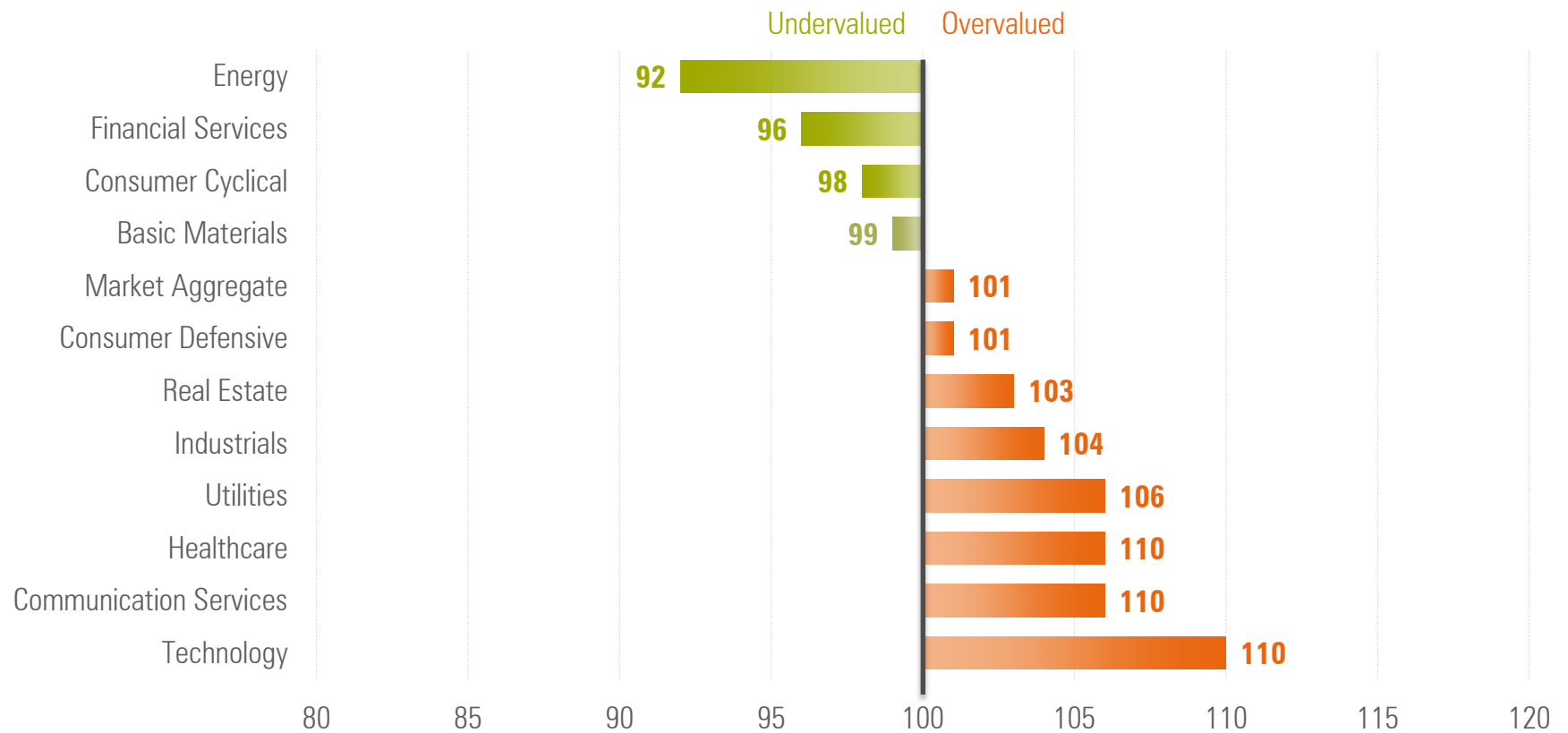


Data as of September 30, 2015

Morningstar Equity Research

Aggregate Price to Fair Value By Industry

Sector Valuations from 30 Sept 2014: S&P declined more than 300 basis points after this period.

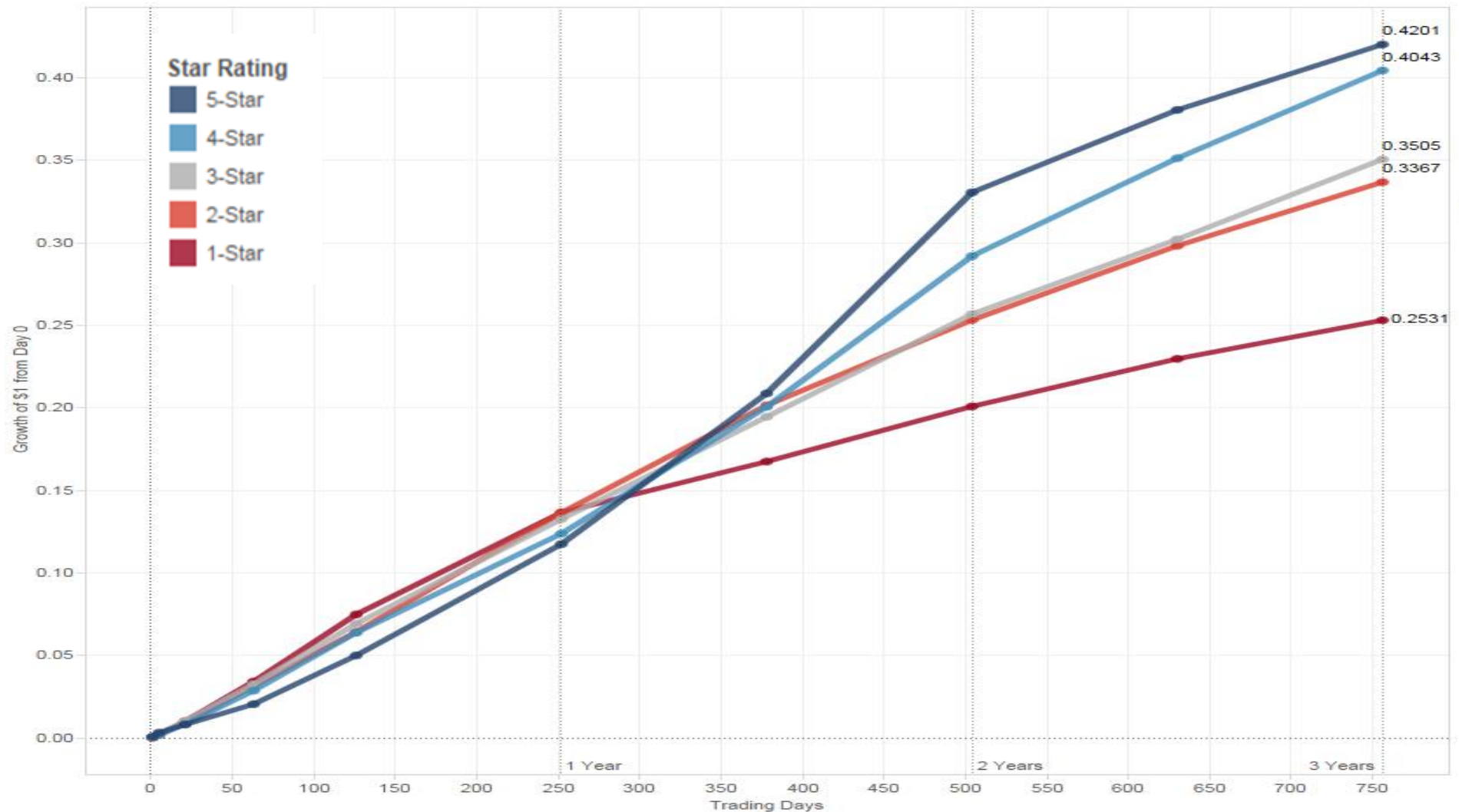


Data as of September 30, 2014

Morningstar Equity Research

The Effectiveness of Morningstar Ratings for All Stocks

From 2002-2015, 5-star rated stocks outperformed stocks of all other star ratings.





Appendix

Morningstar institutional equity research services is a **global and independent** research provider. Our long-term outlook and **emphasis on economic moats**, or sustainable competitive advantages, differentiate our research and have proven to drive **long-term outperformance**.

Morningstar Equity Research
Global Analyst Team

Our accomplished team of award-winning analysts apply one consistent methodology across our global coverage universe.

100

Equity Analysts

1,450

Companies Covered Globally

1

Methodology

Morningstar Equity Research




Comprehensive Equity Coverage

Our coverage spans the globe and all major market sectors.

Regional Coverage

Asia	136
Australia/New Zealand	223
Europe	257
Latin America	32
Middle East/Africa	46
North America	763
Total Global Coverage	1,457












Market Cap Coverage

 Large-cap Stocks	731
 Mid-cap Stocks	409
 Small-cap Stocks	317

The market caps were broken down by the following breakpoints:

Large cap: 10+ Billion USD
 Mid-cap: 2-10 Billion USD
 Small-cap: 0-2 Billion USD

Sector Coverage

 Cyclical	
 Basic Materials	133
 Consumer Cyclical	213
 Financial Services	207
 Real Estate	58
 Sensitive	
 Communication Services	60
 Energy	123
 Industrials	191
 Technology	158
 Defensive	
 Consumer Defensive	98
 Health Care	133
 Utilities	83

*Institutional coverage numbers

Data as of September 30, 2015

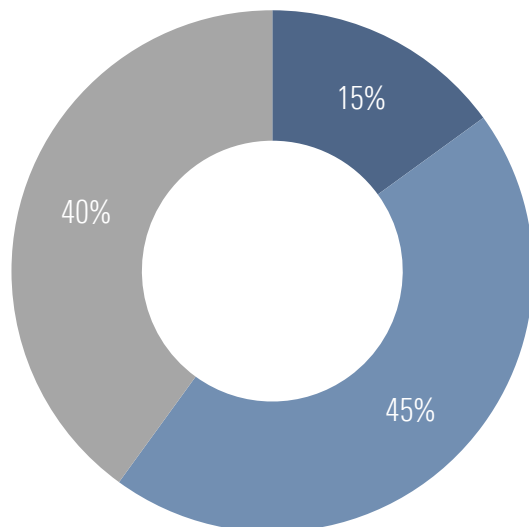
Morningstar Equity Research Moat Rating Distribution

Our analyst coverage universe skews toward companies with economic moats, though in the overall economy, most firms do not have an economic moat.

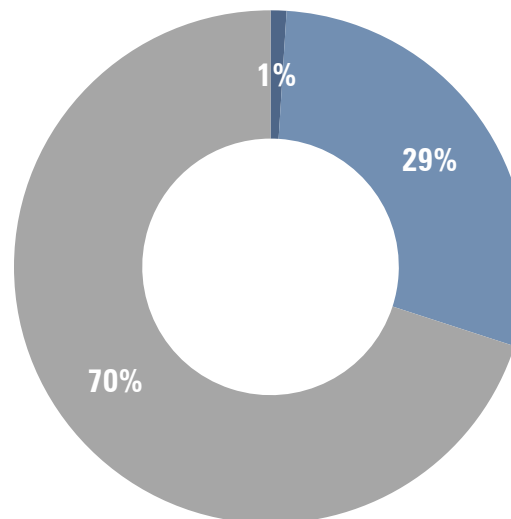
Morningstar Coverage Universe Moat Rating Distribution

■ Wide Moat ■ Narrow Moat ■ No Moat

Analyst Coverage



Quantitative Research Coverage

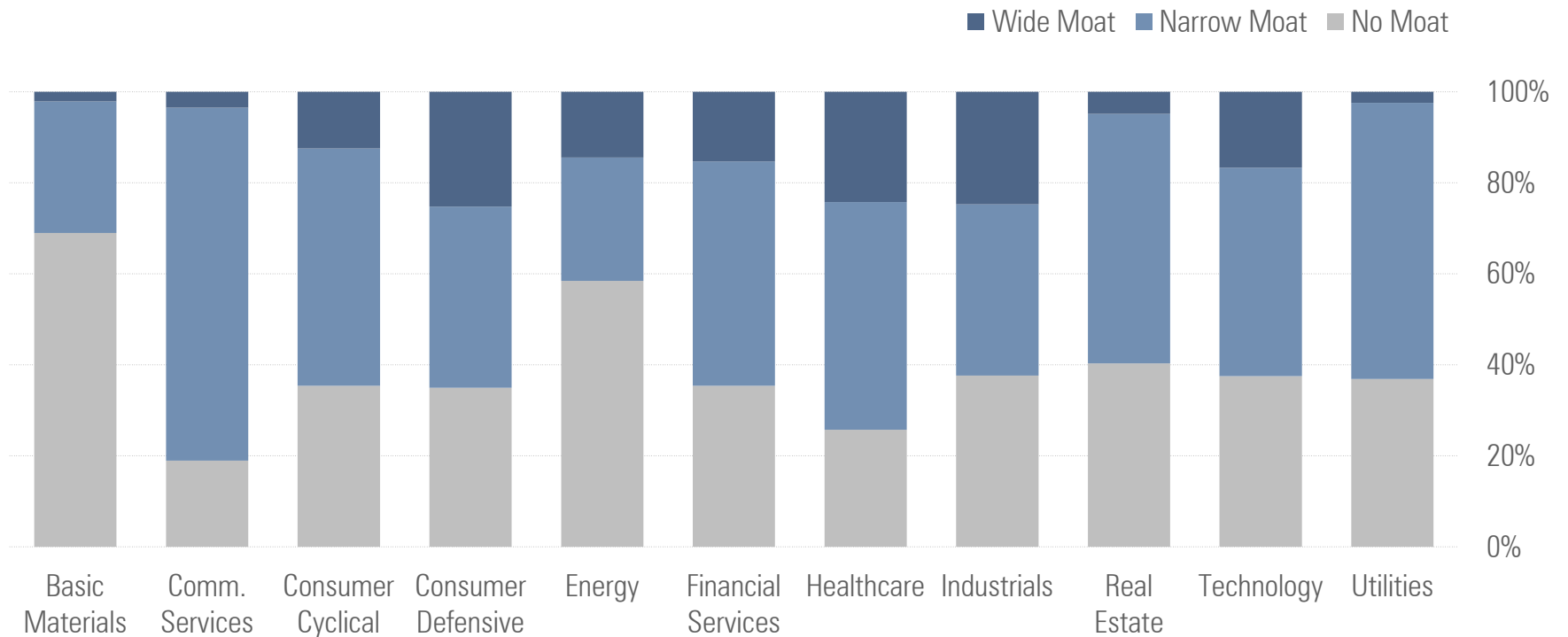


Data as of March 31, 2016

Morningstar Equity Research

Moat Rating Distribution

Moats are not equally distributed across sectors. Highly commoditized or competitive industries will have fewer companies with moats.

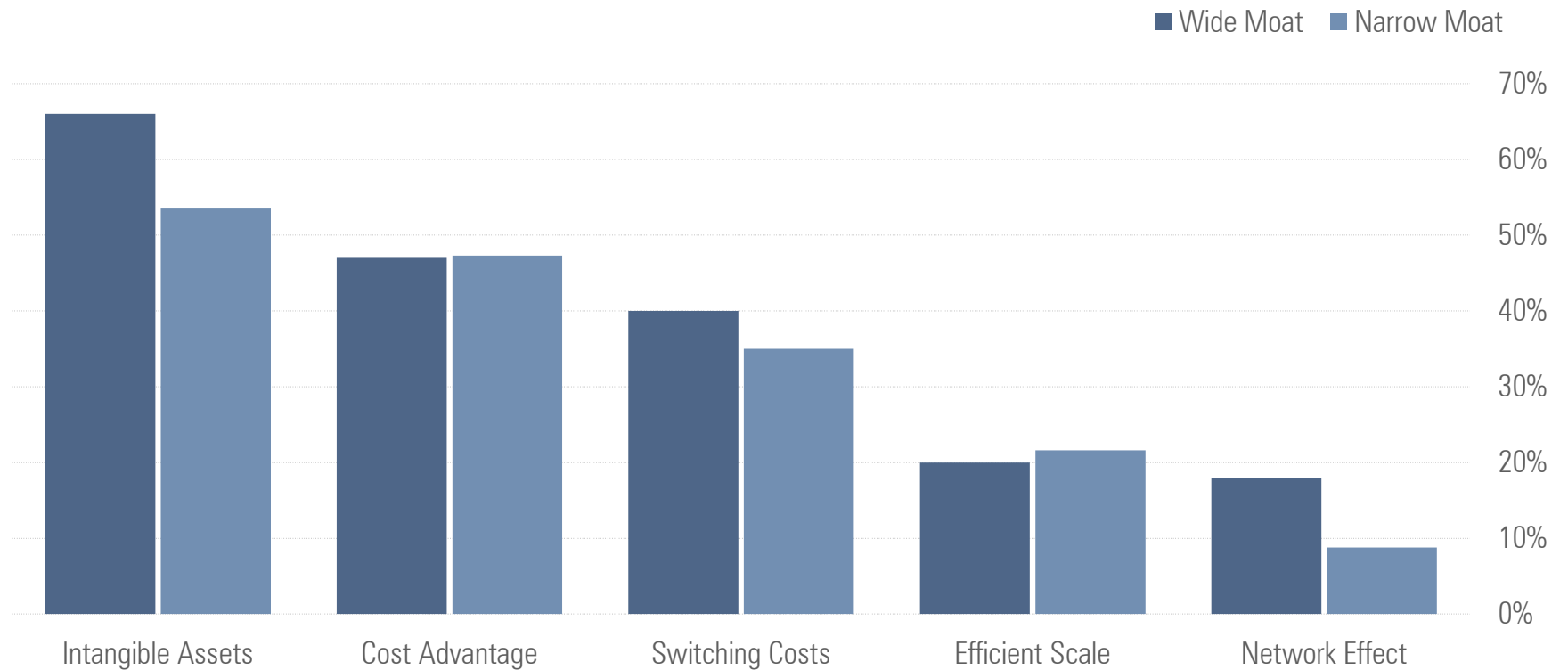


Data as of March 31, 2016

Morningstar Equity Research

Moat Rating Distribution

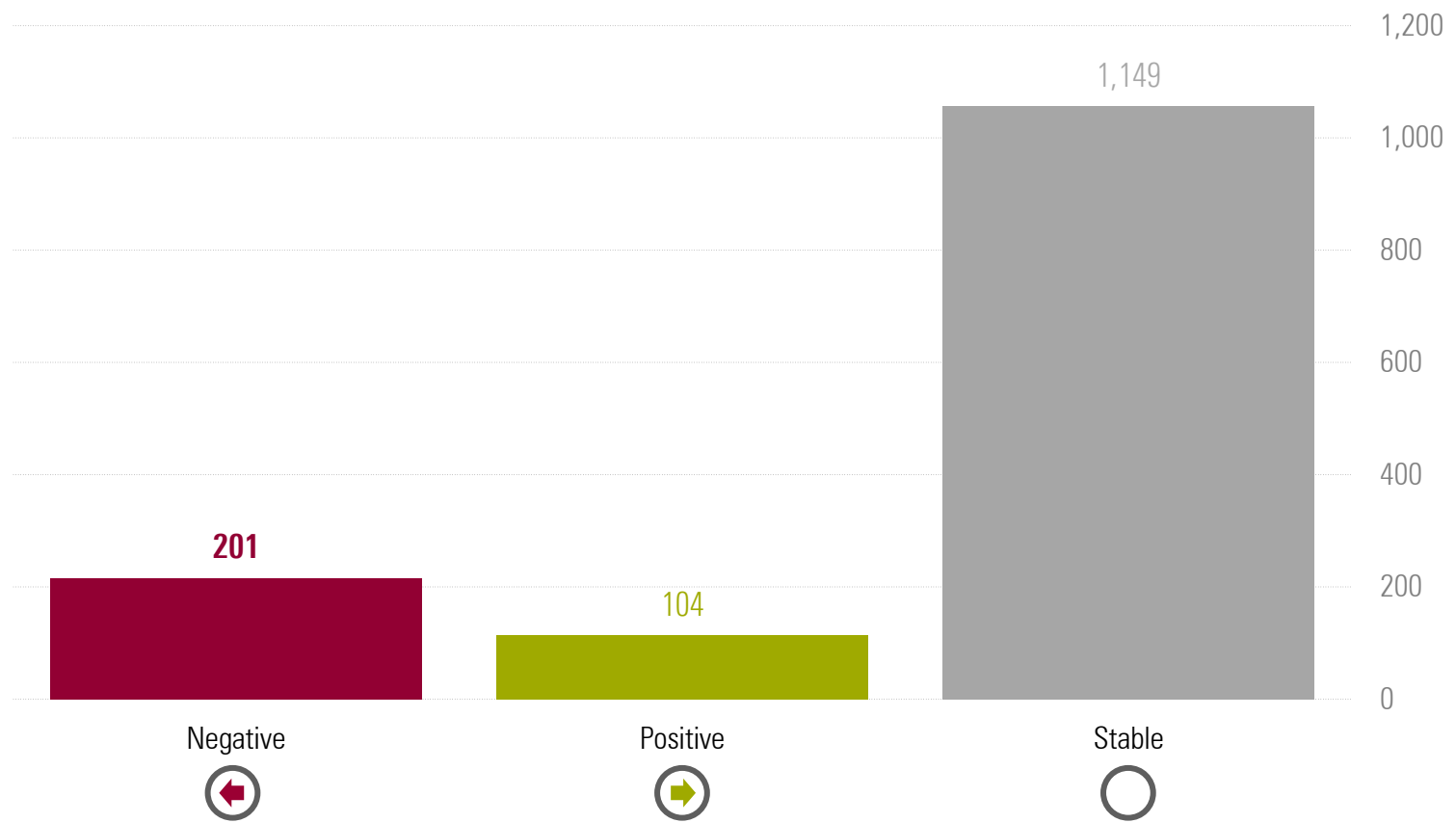
The sources of competitive advantage are widely distributed across our moat companies.



Data as of March 31, 2016

Morningstar Equity Research
Morningstar[®] Economic Moat[™] Trend Distribution

The number of companies with negative, positive, and stable moat trend ratings.

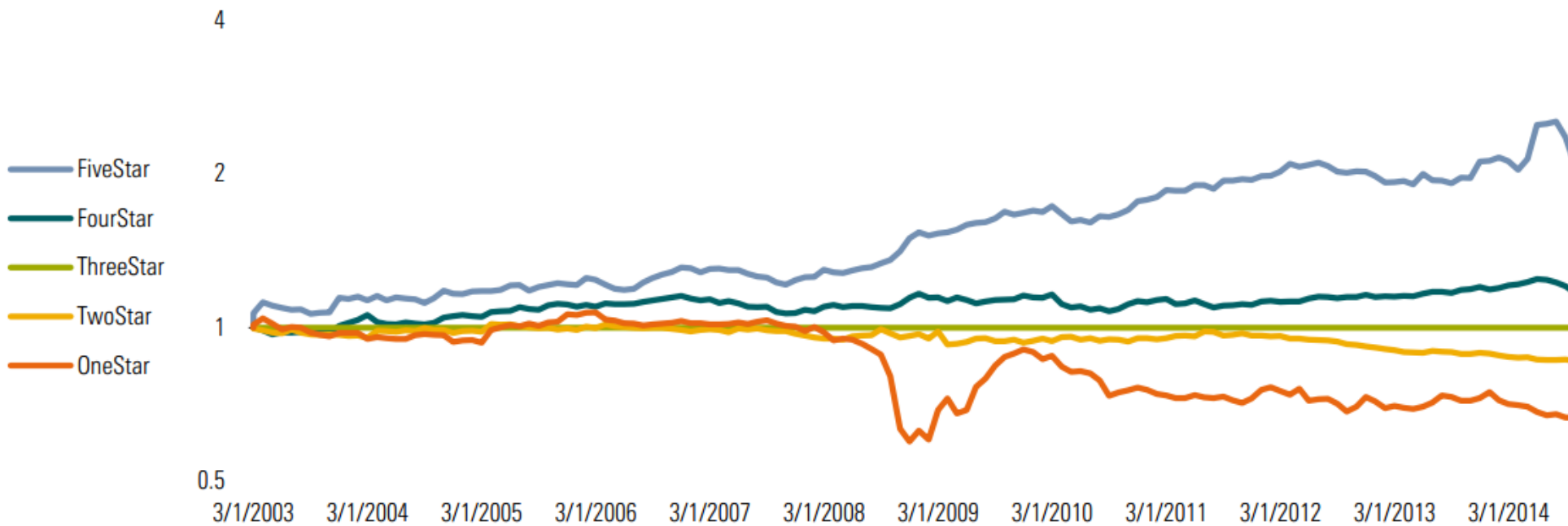


Data as of March 31, 2016.

The Effectiveness of Morningstar Ratings for All Stocks

The Morningstar Rating for Stocks shows significant predictive power in our regression analysis.

Exhibit 10 Aggregate Return Premia by Star Rating



Source: Morningstar

Morningstar Equity Research

The Effectiveness of Our Ratings Over Time

Morningstar® Wide Moat Focus IndexSM vs. S&P 500



Index	1-Year	3-Year	5-Year	10-Year	Since Inception (09/30/2002)
Morningstar® Wide Moat Focus IndexSM	4.3	11.7	12.7	10.9	14.3
S&P 500 Index (cap-weighted)	1.9	11.8	11.6	7.0	9.2

Data from September 30, 2002 through March 31, 2016. Indexes are unmanaged and not available for direct investment.

The Effectiveness of Morningstar Ratings for Wide Moat Stocks

Wide Moat stocks sorted by Morningstar Rating for stocks vs. S&P 500

Trailing Annualized Returns (%)

Morningstar Rating™ for Wide Moat stocks	1-Year	3-Year	5-Year	10-Year	Since Inception (06/26/2002)
★★★★★	17.0	17.5	17.7	14.6	18.6
★★★★★	-3.5	10.5	12.0	8.3	10.3
★★★★	-3.5	9.0	11.1	7.6	7.6
★★★	-0.2	7.5	11.2	7.4	8.9
★	-8.5	1.8	9.2	-3.7	-2.8
Morningstar Coverage Universe	-3.3	8.89	7.8	9.0	—
S&P 500 Index (cap-weighted)	1.9	11.8	11.6	7.0	—

Source: Morningstar

Time-weighted returns through: March 31, 2016

Morningstar Equity Research

The Effectiveness of Morningstar Ratings for All Stocks

All stocks sorted by Morningstar Rating for stocks vs. S&P 500

Trailing Annualized Returns (%)

Morningstar Rating™ for stocks	1-Year	3-Year	5-Year	10-Year	Since Inception (08/06/2001)
★★★★★	-11.5	11.9	8.0	13.5	10.9
★★★★★	-4.9	6.7	6.8	8.1	10.8
★★★★	-2.2	10.5	8.7	8.5	8.9
★★★	-5.8	6.2	4.9	4.0	4.9
★	-8.1	7.4	4.6	10.6	8.8
Morningstar Coverage Universe	-3.3	8.89	7.8	9.0	—
S&P 500 Index (cap-weighted)	1.9	11.8	11.6	7.0	—

Source: Morningstar
Time-weighted returns through: March 31, 2016

Morningstar Equity Research

The Effectiveness of Morningstar Indexes and Portfolios

Morningstar Indexes and Portfolios vs. S&P 500

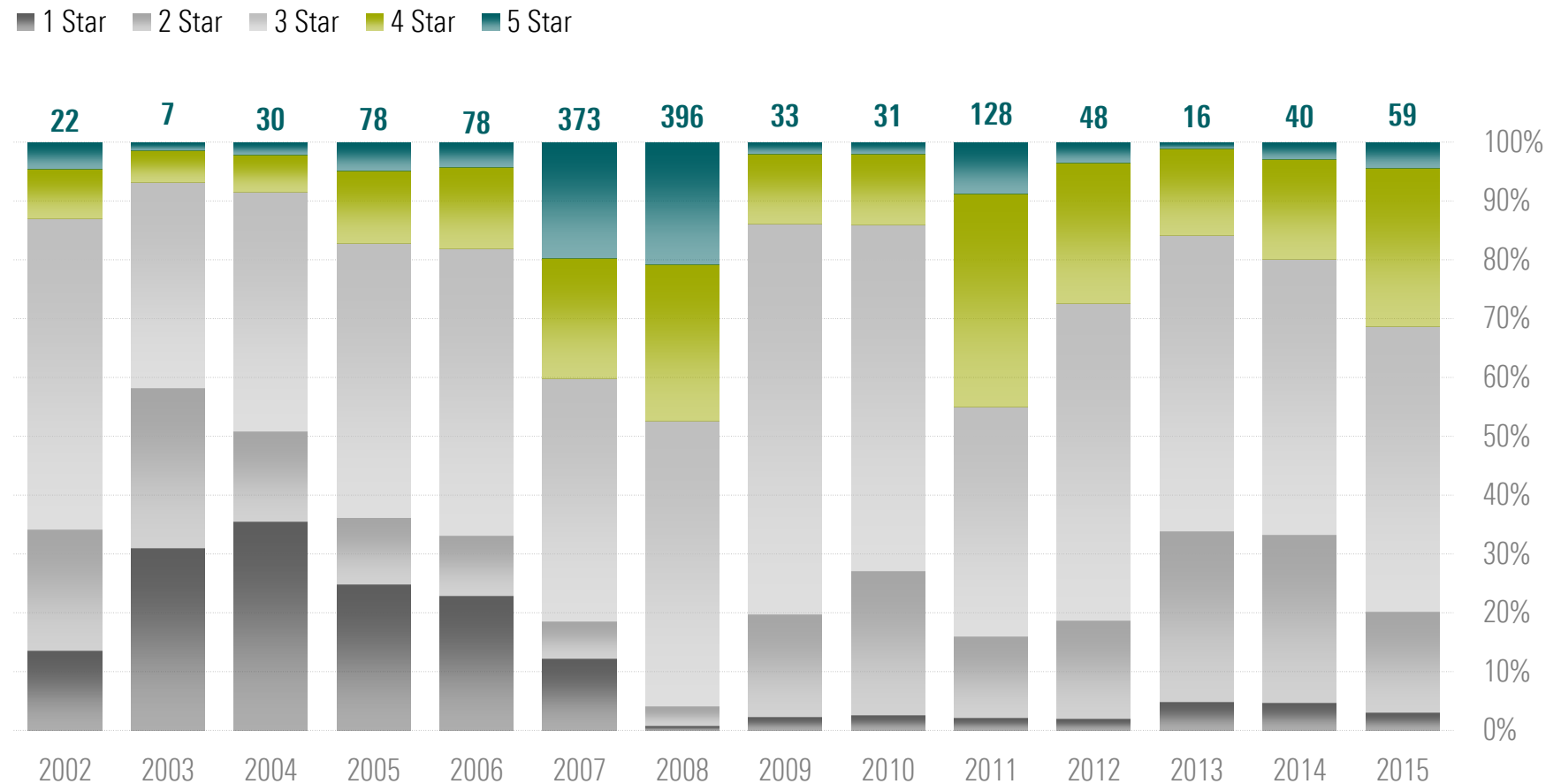
	Trailing Annualized Returns (%)			
	1-Year	3-Year	5-Year	10-Year
Morningstar® Wide Moat Focus IndexSM	4.3	11.7	12.7	10.6
Morningstar Tortoise Portfolio	1.3	11.1	12.9	8.1
Morningstar Hare Portfolio	0.8	15.1	13.3	10.8
Morningstar Dividend Select Portfolio	12.7	11.8	14.4	—
Buy at 5-Star/Sell at 3-Star	-12.9	1.6	3.6	7.5
Morningstar Large-Cap Blend Mutual Fund Cat.	-2.2	9.2	9.0	5.5
S&P 500 Index (cap-weighted)	1.8	11.8	11.6	7.0

Source: Morningstar
Time-weighted returns through: March 31, 2016

Morningstar Equity Research

The Effectiveness of Morningstar Ratings for All Stocks

Be careful with what you are measuring. The number of stocks in each star-rating buck fluctuate from year to year.

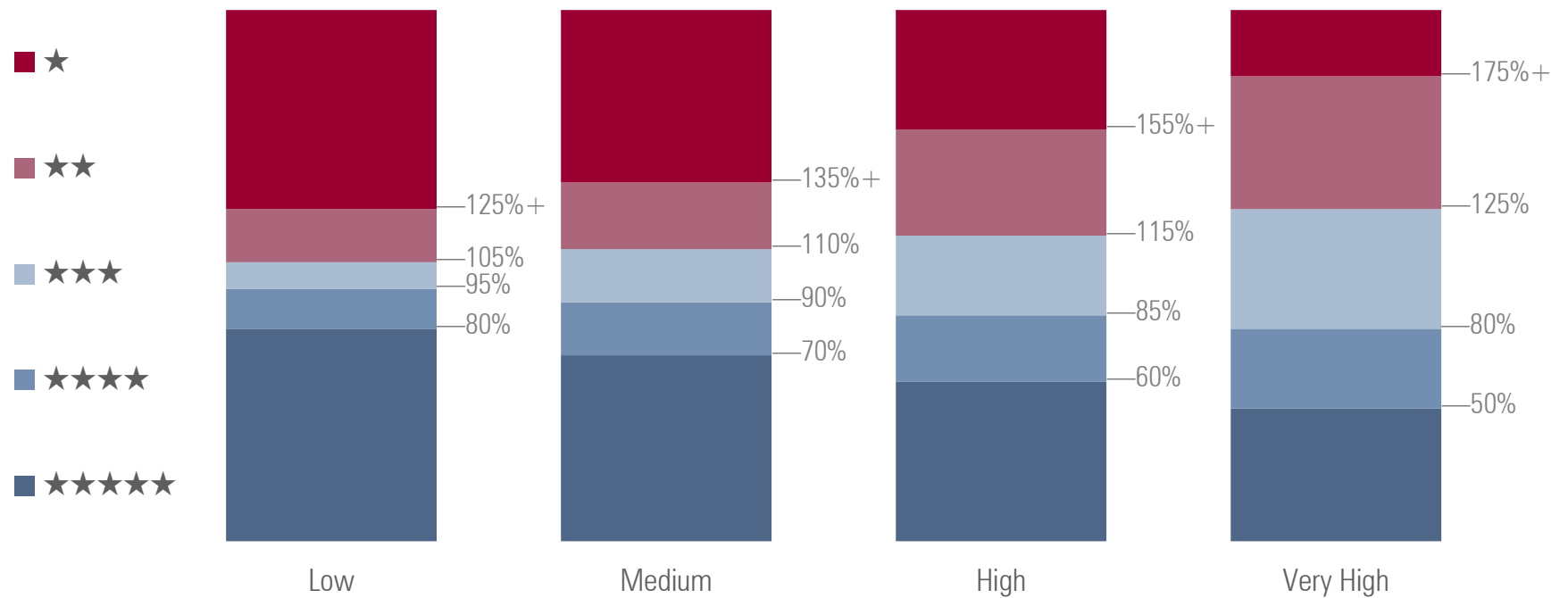


Data as of October 31, 2015

Morningstar Equity Research

Morningstar Rating™

We assign the Morningstar Rating for stocks by comparing the market price to our fair value estimate, adjusted for uncertainty.



Data as of September 30, 2015.

Stewardship Analysis

The purpose of stewardship analysis is to identify managers that are acting in the best interest of shareholders. **A focus on capital allocation decisions** best identifies managers who focus on widening their moats and improving shareholder returns.

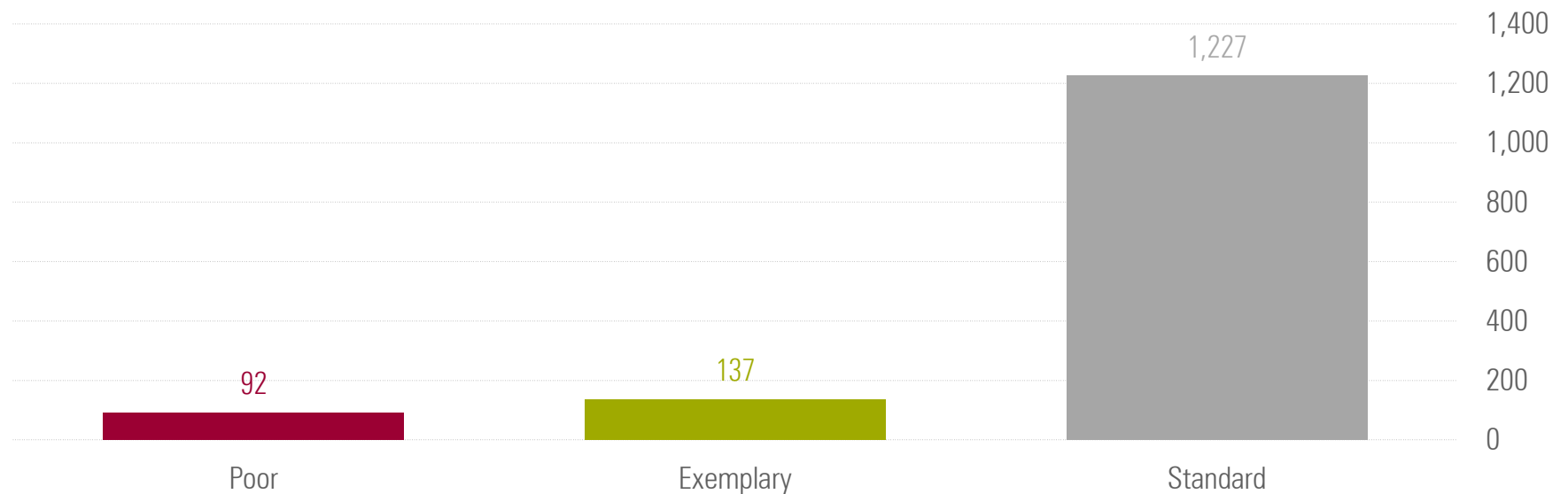
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Key Stewardship Considerations

A focus on capital allocation decisions informs the Stewardship Rating.

Investment Strategy	Investment Valuation	Execution	Dividend and Buy Back	Management Incentives	Financial Leverage	Ownership Structure
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Distribution of Poor, Exemplary, and Standard Stewardship Ratings Across Companies



Data as of March 31 2016

Morningstar Equity Research

Examples of Exemplary and Poor Stewardship

Exemplary Stewardship

Deere

Stock ownership requirements for a broad set of employees, combined with disciplined investment processes and accretive share repurchases.

Nike

Strong brand management, and executive focus on maximizing returns on invested capital.

O'Reilly Automotive

Well-executed acquisitions that has transformed the firm into a highly profitable national player.

Poor Stewardship

AT&T

Poor capital allocation decisions, such as paying a premium price for DirecTV, enacting a questionable strategic move into Mexico, and overpaying for operating assets.

Carlsberg

Shareholders face potentially substantial dilution in the event of a major acquisition, owing to the Carlsberg Foundation's ownership of 75% of voting rights.

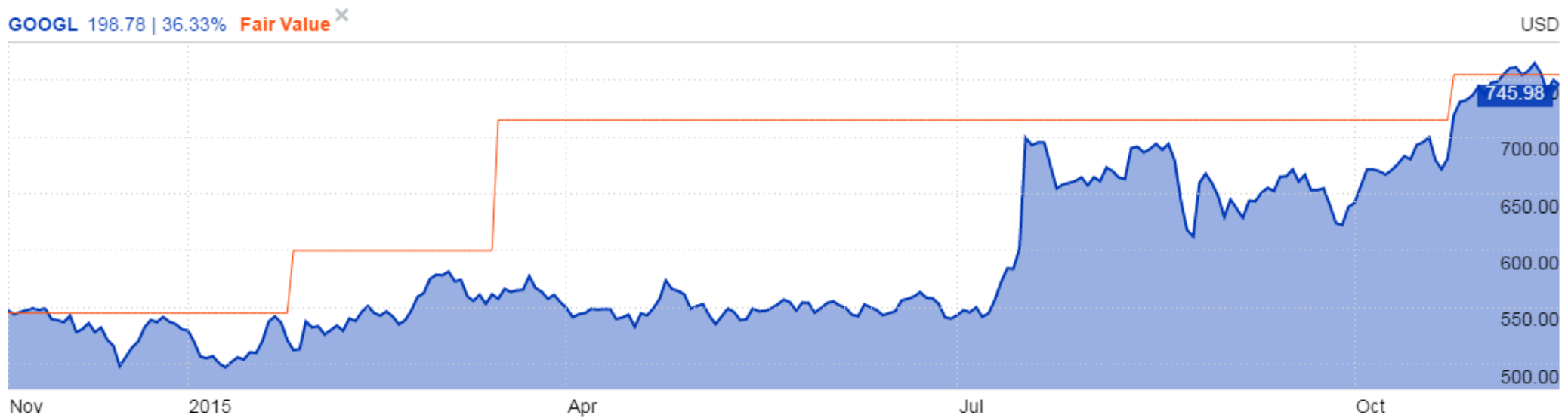
Zions Bancorp

Growth at the expense of risk controls leading up to the 2008/09 financial crisis led to heavy losses.

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Alphabet (GOOGL)

Alphabet – Conviction in growth potential allowed us to look past near term challenges and increase our valuation.



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General Electric (GE)

Focusing on the durability of GE's economic moat allows us to see past near term concerns over exposure to China and energy.

