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StockInvestor℠

Investing in the wide-moat stocks of today and tomorrow

Understanding the Affordable Care Act

Few pieces of legislation have aroused political passions in recent years quite like the Affordable Care Act. While the health-care reform law was passed in 2010, its most important provisions take effect in 2014, which means the ACA is once more top-of-mind in Washington and on Wall Street. I don't much care for partisan bickering—our primary interest in the law is to understand how it could affect our portfolios. Wherever you stand on health-care policy, it's worth taking the time to consider the investment implications of the ACA.

Health-Care Costs and Insurance Coverage

The United States' health-care system is unique in the developed world, involving a patchwork of government and private benefit plans. According to the Census Bureau, as of 2012, employer-based plans were the most common form of health insurance, providing coverage to about 54.9% of the population, or 171 million individuals. Medicare—a federal program for people over age 65 or with disabilities—covers about 15.7% of the population. Medicaid—which is jointly administered by state and federal governments and is for families with low incomes—covers 16.4% of the population. Lastly, 9.8% of the population purchases private insurance directly, 4.4% receives military benefits, and 15.4% goes without insurance altogether. Note that the percentages don't sum to 100% because of double counting (for example, certain low-income seniors are eligible for both Medicare and Medicaid).

In addition to leaving a large segment of the population uninsured, the U.S. health-care system is infamous for its high costs. No matter how you slice the data, the U.S. spends far more on health care than any other developed country, as shown in Exhibit 01. In 2011, we spent 2.5 times as much per person on health care as the OECD average, or $2,800 more than the next-highest country, Norway. Spending amounted to 17.7% of U.S. gross domestic product, 90% more than the OECD average and 5.7 percentage points more than the next-highest country, the Netherlands. Remarkably, even per capita government health-care expenditures in the U.S. (that is, excluding all private spending) are the second-highest in the world, behind only Norway.

There are many theories as to why the U.S. spends so much on health care, and I won't get into any of them here. Regardless of the underlying causes, there is very little evidence that the country is getting good value for its money in terms of better overall health. For example, life expectancy at birth in the U.S. was 78.7 years as of 2011—2.7 years short of the OECD average and placing us 27th among developed nations.

Provisions of the ACA

The Affordable Care Act is a very complex piece of legislation, but it basically has two goals: to extend insurance coverage to the nation's uninsured and to slow the growth in health-care spending. In general, the law does more to address the first issue than the second. The impact of the law on health-care companies will largely depend on the balance between two conflicting forces:

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Matthew Coffina, CFA
Editor

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My rationale for selling VMC and purchasing PM

Analysis of Q3 earnings results

Morningstar's Q4 Market Outlook

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https://www.surveymonkey.com/s/msi2013

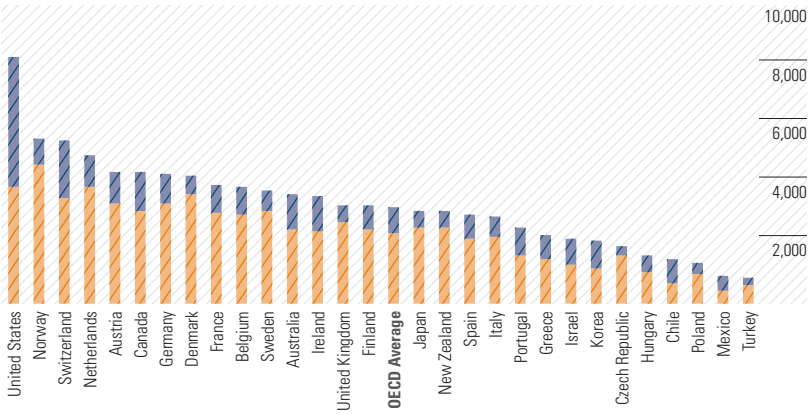
Express Scripts ESRX	
Star Rating	★★★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Exemplary
Uncertainty	Medium
Price/Fair Value	0.70
Current Price ($)	62.52
Fair Value ($)	89.00
Sector	Healthcare
Market Cap ($bil)	50.4
P/E	26.9
Dividend Yield (%)	—

1. The benefit from increased volumes as more people carry health insurance.
2. Pricing pressure due to government reimbursement cuts and shifts in the relative bargaining power of health-care payers and providers.

According to the Congressional Budget Office, the ACA is expected to increase the number of people with health insurance by 25 million by 2016, leaving 31 million people uninsured in that year. The newly insured are expected to gain coverage through two sources: Medicaid (12 million people) and insurance exchanges (22 million people). These gains will be partly offset by about 10 million people who will drop out of existing employer-sponsored or individual insurance plans. The Medicaid expansion will occur on a state-by-state basis, and many states have opted not to participate, even though the federal government will shoulder the majority of the cost. Policies sold through the new insurance exchanges will be eligible for federal subsidies based on income.

From 2014 to 2023, the Medicaid expansion is expected to cost the federal government about $640 billion cumulatively, while the exchange subsidies are expected to cost $1.2 trillion. According to CBO, there will be $550 billion in offsets from penalties paid by people who remain uninsured, employers that don't offer coverage, and similar sources. The rest of the cost will be funded by more than $700 billion in other health-care spending cuts (primarily to Medicare) and more than $500 billion in new revenue: a variety of taxes on pharmaceutical firms, health insurers, and medical device manufacturers, as well as increased taxes on higher-income individuals.

Exhibit 01 Per Capita Spending on Health Care ($ PPP)



Source: OECD Health Data. Data as of 2011 or latest available.

Providers Versus Payers

U.S. health-care spending growth has consistently outpaced overall economic growth for 50 years, as shown in Exhibit 02. On average, health-care spending has grown 270 basis points per year faster than nominal GDP. Health-care payers (e.g., employers, governments, and health insurers) are engaged in a continual battle with health-care providers (e.g., hospitals, physicians, pharmaceutical firms, and others) over reimbursement terms. While there have been rare occasions when payers gained the upper hand and managed to slow spending growth—most notably during the mid-1990s when aggressive cost control by health maintenance organizations (HMOs) enjoyed brief popularity—most of the time providers seem to have the stronger negotiating position.

The ACA could shift the relative bargaining power of payers and providers, although it's not yet clear in which direction. For example, the law encourages the creation of Accountable Care Organizations, or ACOs, which are basically an updated version of HMOs. ACOs are given financial incentives to slow health-care spending and improve quality. However, ACOs may also enable consolidation among hospitals and physicians, which could increase provider bargaining power in the long run. This could improve the competitive position of large hospital systems at the expense of insurers, hospital suppliers, and independent physician practices.

Exchanges—online marketplaces where consumers can shop for health benefit plans—are another wild card. The rollout of the federal health insurance exchanges has been plagued by software problems, and I think it is unlikely that we will see a wholesale shift away from traditional employer-sponsored plans in the near future. However, private health exchanges have gained some traction, and in the long run employers will probably be anxious to consider any alternatives that could limit their exposure to rising health-care costs—similar to the transition that has occurred in retirement benefits toward defined-contribution plans.

Johnson & Johnson JNJ	
Star Rating	★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Low
Price/Fair Value	1.03
Current Price ($)	92.61
Fair Value ($)	90.00
Sector	Healthcare
Market Cap ($bil)	261.0
P/E	21.1
Dividend Yield (%)	2.9

Novartis NVS	
Star Rating	★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Low
Price/Fair Value	0.99
Current Price ($)	77.55
Fair Value ($)	78.00
Sector	Healthcare
Market Cap ($bil)	188.8
P/E	20.2
Dividend Yield (%)	3.3

Novo-Nordisk NVO	
Star Rating	★★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Exemplary
Uncertainty	Medium
Price/Fair Value	0.80
Current Price ($)	166.67
Fair Value ($)	209.00
Sector	Healthcare
Market Cap ($bil)	91.7
P/E	20.4
Dividend Yield (%)	2.0

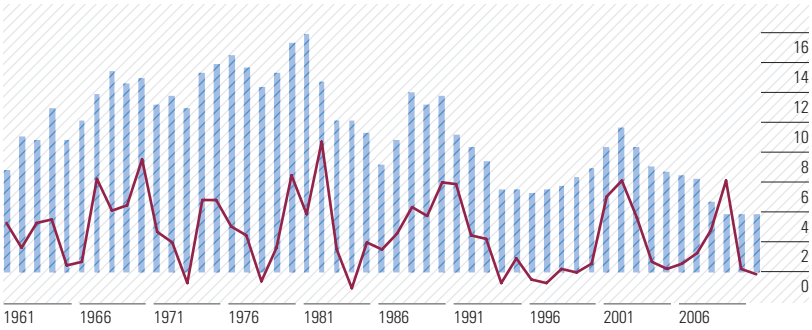
Once again, it remains to be seen how exchanges will affect payer and provider bargaining power. Exchanges lower barriers to entry for health plans, which could lead to fragmentation in the insurance industry and greater bargaining power for providers. Alternatively, scale and brand recognition may become more important than ever in the exchanges, resulting in market share gains for leading insurers like **UnitedHealth** UNH and **WellPoint** WLP, which would be bad for most other health-care firms.

Impact on Health-Care Companies

Rapid health-care spending growth may not be good for the country, but it has been a boon to investors, providing a strong tailwind to earnings growth—especially since economic moats are prevalent in the health-care sector. So the first question to ask ourselves is: Will the ACA meaningfully slow health-care spending growth?

Only time will tell how the law will work in practice. However, my inclination is that the ACA won't slow health-care spending materially, and it may even accelerate growth a bit. Assuming the CBO is right about the 25 million people expected to gain insurance coverage, this would represent a 9% increase in the insured population. While this group is probably healthier than average and was already paying for some health care out of pocket, it seems likely that they will increase their consumption of care when someone else is footing the bill. More importantly, the ACA also includes a variety of minimum coverage mandates on insurance plans, which means even people who were already insured may end up with significantly more generous coverage.

Exhibit 02 U.S. Health-Care Spending Growth (%)



Sources: Centers for Medicare and Medicaid Services, Bureau of Economic Analysis, Morningstar.

Much of the benefit of increased patient volumes will be offset by reimbursement pressure. Medicare cuts, industry-specific taxes, a mix shift toward Medicaid (which reimburses at lower levels than other programs), hospital and physician consolidation, and increased reimbursement pressure from private insurers (both because of greater competition and regulatory oversight of premiums) could all weigh on revenue and margins for health-care companies. For the group as a whole, higher volumes and compressed pricing seem likely to offset each other—leaving much of the health-care sector about where it started.

That said, companies that are more exposed to volumes and less exposed to reimbursement pressure—such as distributors, pharmacy benefit managers, and generic drugmakers—may come out slightly ahead from the ACA. In contrast, device manufacturers are relatively poorly positioned, as their focus on older patients already covered by Medicare means there should be minimal incremental volume to offset reimbursement cuts and new taxes. The law looks to be neutral for pharmaceutical and biotech firms, although the negative aspects are largely already baked into run-rate earnings, while the positives lie in the future. Headwinds and tailwinds also seem to be in balance for health insurers and hospitals, though there is much greater uncertainty surrounding the outlook for these industries.

Our Kind of Health-Care Company

Regardless of how the ACA unfolds, there are two things that I look for when investing in health care: innovation and cost saving. Companies that offer innovative, cost-effective treatments or find ways to lower health-care costs without sacrificing quality will continue to thrive, in my view. Health-care companies that try to skate by with me-too products and minor tweaks between product cycles will struggle. I think our largest health-care holdings—**Express Scripts** ESRX, **Novo Nordisk** NVO, **Johnson & Johnson** JNJ, and **Novartis** NVS—are well positioned for this new environment. MI

Tortoise Portfolio

Goal of the Tortoise

The Tortoise Portfolio aims to outperform the S&P 500 Index over time. Companies in this portfolio tend to be mature, relatively slow-growing, and have moderate to low risk. New purchases must have an economic moat, preferably wide. I attempt to tilt the portfolio toward companies with at least stable competitive advantages (stable moat trends).

	Morningstar Ratings & Fundamentals									Portfolio Data							
Stock Name and Ticker	Star Rating	Moat	Moat Trend	Steward-ship	Fair Val Uncert.	Current Price	Fair Value	P/FV	Div. Yield	First Purchase	Shares Owned	Cost/ Share [1]	Capital Gain/ Loss (%)	Total Return (%) [3]	Total Cost [1]	Current Value	% of Port
Berkshire Hathaway BRK.B	★★★★	Wide	↘	Exemp.	Med.	115.09	143	0.80	0.0	06-18-01	260	60.52	90.2	90.2	15,736	29,923	10.8
Lowe's LOW	★★	Wide	→	Exemp.	Med.	49.78	44	1.13	1.5	11-15-07	500	25.07	98.6	108.2	12,534	24,890	9.0
ITC Holdings ITC	★★★	Wide	→	Exemp.	Low	100.59	98	1.03	1.7	06-19-13	195	89.12	12.9	13.4	17,378	19,615	7.1
Exxon Mobil XOM	★★★★	Wide	↘	Exemp.	Low	89.62	97	0.92	2.8	07-11-08	178	76.68	16.9	27.5	13,648	15,952	5.8
Novartis NVS	★★★	Wide	→	Stand.	Low	77.55	78	0.99	3.3	02-09-07	185	56.80	36.5	55.8	10,509	14,347	5.2
Coca-Cola KO	★★★★	Wide	→	Exemp.	Low	39.57	45	0.88	2.8	08-16-13	350	39.05	1.3	2.0	13,667	13,850	5.0
Automatic Data Processing ADP	★★	Wide	→	Stand.	Med.	75.03	65	1.15	2.3	06-14-02	175	27.84	169.5	211.7	4,873	13,129	4.7
Johnson & Johnson JNJ	★★★	Wide	→	Stand.	Low	92.61	90	1.03	2.9	12-06-05	130	59.51	55.6	81.6	7,736	12,039	4.3
Wells Fargo WFC	★★★	Narrow	→	Exemp.	Med.	42.69	46	0.93	2.8	03-08-13	275	36.52	16.9	18.5	10,042	11,740	4.2
Enterprise Products Partners EPD [2]	★★★	Wide	↗	Exemp.	Med.	63.28	63	1.00	4.4	08-12-13	180	60.80	4.1	4.1	10,944	11,390	4.1
Exelon EXC	★★★★★	Wide	→	Stand.	Med.	28.54	42	0.68	4.3	10-06-09	370	46.55	-38.7	-23.8	17,225	10,560	3.8
American Express AXP	★★★	Wide	→	Stand.	Med.	81.80	77	1.06	1.1	07-18-01	125	29.46	177.7	201.5	3,683	10,225	3.7
General Dynamics GD	★★★	Wide	→	Stand.	Med.	86.63	92	0.94	2.6	03-12-03	110	33.12	161.6	199.2	3,643	9,529	3.4
Kinder Morgan Management KMR	★★★★	Wide	→	Stand.	Med.	75.32	98	0.77	7.2	03-08-06	110	32.61	131.0	158.4	3,587	8,285	3.0
CH Robinson Worldwide CHRW	★★★★	Wide	→	Exemp.	Med.	59.74	69	0.87	2.3	02-21-13	130	57.95	3.1	4.9	7,533	7,766	2.8
First American Financial FAF	★★★	Narrow	↗	Stand.	High	25.86	30	0.86	1.9	03-17-04	300	12.21	111.8	138.0	3,663	7,758	2.8
JPMorgan Chase JPM	★★★	Narrow	→	Stand.	High	51.54	52	0.99	2.9	07-23-02	150	30.49	69.0	103.1	4,574	7,731	2.8
Wal-Mart Stores WMT	★★★	Wide	↘	Stand.	Low	76.75	74	1.04	2.5	07-19-02	100	47.43	61.8	83.4	4,743	7,675	2.8
Abbott Laboratories ABT	★★★★	Narrow	→	Stand.	Low	36.55	40	0.91	2.4	02-04-11	200	22.75	60.7	69.8	4,550	7,310	2.6
TransCanada TRP	★★★★	Narrow	↗	Stand.	Low	45.11	52	0.87	3.9	01-23-04	150	21.21	112.7	166.2	3,182	6,767	2.4
PepsiCo PEP	★★★	Wide	→	Stand.	Low	84.09	88	0.96	2.7	07-19-02	75	35.92	134.1	180.1	2,694	6,307	2.3
Cisco Systems CSCO	★★★★	Wide	→	Stand.	Med.	22.56	26	0.87	3.0	07-31-12	250	16.13	39.9	44.8	4,032	5,640	2.0
Cash Holdings																15,044	5.4
Tortoise Portfolio Total																277,472	

Legend:

- ⊕ Shares added
- ⊖ Shares sold
- ✶ New addition
- UR Under Review
- ↗ Positive
- → Stable
- ↘ Negative

Footnotes:

Morningstar ratings and fundamentals as of Oct. 31, 2013.
Portfolio inception date: June 18, 2001.

[1] Cost basis includes commissions.
[2] Master limited partnership units have different tax characteristics than common stocks and may not be suitable for tax-deferred accounts such as IRAs. Please consult your tax advisor before buying.
[3] Total returns include dividends.

Invest in the Tortoise Approach—The Hassle-Free Way.
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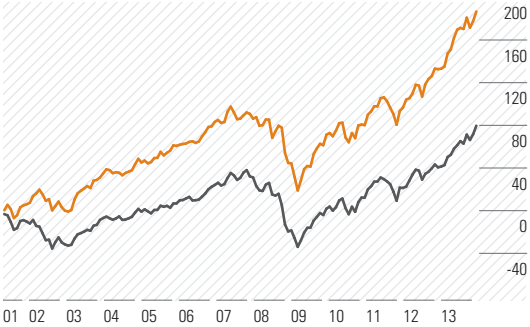
Tortoise Performance and Allocation

Total Return Comparison (%)

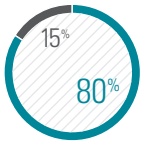
	Oct.	12 Month	10 Year	Since Inception
Tortoise Portfolio	3.2	22.9	8.2	9.1
S&P 500 Index	4.6	27.2	7.5	5.1



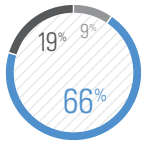
Total returns include reinvested dividends. Periods longer than one year are annualized. Portfolio distribution percentages don't sum to 100% because of cash.

Portfolio Distributions (%)

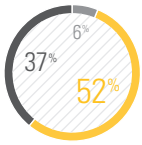
Moat



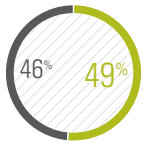
Moat Trend



Uncertainty



Stewardship



Style Breakdown (%)

Value	Blend	Growth		
26	32	26	Lrg	51–100
0	3	10	Med	26–50
3	0	0	Sm	11–25
				0–10

Top Five Sectors (%)

Financial Services	25.7
Energy	16.2
Healthcare	12.8
Industrials	11.6
Utilities	11.5

Portfolio Roundup

by Matthew Coffina, CFA

From inception on June 18, 2001, through Oct. 31, 2013, the Tortoise has delivered a total return, including dividends, of 192.5%, compared with 84.5% for the S&P 500 and 88.8% for the average large-cap blend mutual fund. The Tortoise has outperformed only 15.1% of large-cap blend funds over the past 12 months, but it is still beating 98.4% of them since inception.

After a strong start to the year, the Tortoise has now lagged its benchmark for four consecutive months. However, given the conservative nature of its holdings, it's hard to be disappointed with a 21.6% total return so far in 2013. In absolute terms, the Tortoise is on track for its second-best year since inception, behind only 2003. Furthermore, underperformance relative to the S&P 500 is to be expected in a strong bull market. In years when the S&P has delivered at least a 15% total return, the Tortoise has lagged by 362 basis points on average, in line with the year-to-date shortfall of 365 basis points.

Our best performers in October included **Abbott** ABT (up 10.1%), **American Express** AXP (up 8.3%), **ITC Holdings** ITC (up 7.2%), **Johnson & Johnson** JNJ (up 6.8%), and **First American Financial** FAF (up 6.2%). This group benefited from a combination of strong earnings reports and a reprieve from concerns over higher interest rates when the Fed once again opted not to taper its quantitative easing program. Our worst performers were **Cisco Systems** CSCO and **Exelon** EXC, each of which was down 3.7%.

I have been extremely pleased with the improvement in the Tortoise's estimated intrinsic value this year. Aggregating our analysts' fair value estimates for our holdings, we believe the Tortoise's intrinsic value is now close to $296,000, up 18% since the beginning of the year. During October, we raised our fair value estimate for American Express to $77 per share from $66, reflecting more optimistic assumptions for long-run credit quality. We also added $2 to **General Dynamics**' GD fair value estimate and trimmed $1 from our valuation of **JPMorgan Chase** JPM because of mounting legal costs. The Tortoise's price/fair value ratio stood at 0.94 at the end of October, and the average star rating was 3.28. Both measures indicate that the portfolio is only slightly undervalued—an unavoidable situation considering the relative dearth of opportunities in the market. M

Contact Matthew Coffina at matthew.coffina@morningstar.com. Matthew Coffina owns all of the Tortoise stocks in his personal accounts.

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Hare Portfolio

Goal of the Hare

The Hare Portfolio aims to outperform the S&P 500 Index over time. Companies in this portfolio tend to be faster-growing, with both higher risk and higher return potential than those in the Tortoise. New purchases must have an economic moat, preferably wide. I attempt to tilt the portfolio toward companies with growing competitive advantages (positive moat trends).

	Morningstar Ratings & Fundamentals									Portfolio Data							
Stock Name and Ticker	Star Rating	Moat	Moat Trend	Steward-ship	Fair Val Uncert.	Current Price	Fair Value	P/FV	Div. Yield	First Purchase	Shares Owned	Cost/ Share[1]	Capital Gain/ Loss (%)	Total Return (%)[3]	Total Cost[1]	Current Value	% of Port
Baidu BIDU	★★	Narrow	↗	Stand.	High	160.80	140	1.15	0.0	01-28-13	170	106.28	51.3	51.3	18,068	27,336	8.9
Energy Transfer Equity ETE [2]	★★★	Wide	→	Stand.	Med.	67.59	65	1.04	4.0	10-13-10	325	37.94	78.1	95.4	12,331	21,967	7.1
Novo Nordisk NVO	★★★★	Wide	→	Exemp.	Med.	166.67	209	0.80	2.0	05-15-13	120	169.85	-1.9	-1.9	20,382	20,000	6.5
National Oilwell Varco NOV	★★★	Wide	↗	Exemp.	Med.	81.18	85	0.96	1.3	10-18-11	240	67.78	19.8	21.2	16,267	19,483	6.3
Paychex PAYX	★★	Wide	→	Stand.	Med.	42.27	38	1.11	3.3	06-24-02	450	29.66	42.5	66.2	13,348	19,019	6.2
Express Scripts ESRX	★★★★★	Wide	→	Exemp.	Med.	62.52	89	0.70	0.0	04-03-12	295	56.32	11.0	11.0	16,614	18,443	6.0
✶ Philip Morris International PM	★★★	Wide	→	Exemp.	Med.	89.12	95	0.94	4.2	10-16-13	200	85.73	4.0	4.0	17,146	17,824	5.8
Google GOOG	★★	Wide	→	Stand.	High	1,030.58	875	1.18	0.0	07-14-11	17	530.59	94.2	94.2	9,020	17,520	5.7
eBay EBAY	★★★★	Wide	↗	Exemp.	Med.	52.71	63	0.84	0.0	04-20-06	330	33.08	59.3	59.3	10,918	17,394	5.6
Compass Minerals International CMP	★★★	Wide	→	Exemp.	Med.	74.47	84	0.89	2.9	08-18-05	215	29.02	156.6	198.8	6,240	16,011	5.2
MasterCard MA	★★	Wide	→	Stand.	High	717.10	620	1.16	0.3	05-30-06	20	44.00	1529.8	1543.9	880	14,342	4.7
Charles Schwab SCHW	★★★	Narrow	↗	Stand.	High	22.65	23	0.98	1.1	02-28-13	630	16.36	38.5	39.2	10,304	14,270	4.6
CME Group CME	★★★	Wide	→	Stand.	High	74.21	71	1.05	2.4	01-13-12	150	47.03	57.8	68.7	7,054	11,132	3.6
Autodesk ADSK	★★★	Wide	→	Stand.	Med.	39.90	38	1.05	0.0	11-18-08	250	19.43	105.4	105.4	4,858	9,975	3.2
Potash Corp of Saskatchewan POT	★★★★	Wide	→	Exemp.	High	31.10	38	0.82	4.5	05-30-12	320	41.18	-24.5	-22.4	13,176	9,952	3.2
CarMax KMX	★★★	Narrow	↗	Stand.	High	46.99	45	1.04	0.0	01-20-04	200	14.71	219.4	219.4	2,942	9,398	3.1
Oracle ORCL	★★★★	Wide	→	Stand.	Med.	33.50	38	0.88	1.4	01-13-12	250	26.99	24.1	26.4	6,747	8,375	2.7
Discover Financial Services DFS	★★★	Narrow	↗	Exemp.	High	51.88	46	1.13	1.5	08-08-07	150	21.39	142.6	150.5	3,208	7,782	2.5
Facebook FB	★★	Wide	→	Stand.	High	50.21	36	1.39	0.0	07-31-12	150	20.31	147.2	147.2	3,047	7,531	2.4
Cloud Peak Energy CLD	★★★★★	Narrow	↗	Stand.	High	15.61	28	0.56	0.0	03-15-11	400	19.97	-21.9	-21.9	7,990	6,244	2.0
⊖ Vulcan Materials VMC	★★★	Wide	→	Poor	High	53.55	57	0.94	0.1	10-03-07	0	87.53	-40.6	-34.1	10,504	0	0.0
Cash Holdings																14,568	4.7
Hare Portfolio Total																308,565	

Legend:

- ⊕ Shares added
- ⊖ Shares sold
- ✶ New addition
- UR Under Review
- ↗ Positive
- → Stable
- ↘ Negative

Footnotes:

Morningstar ratings and fundamentals as of Oct. 31, 2013.
Portfolio inception date: June 18, 2001.

[1] Cost basis includes commissions.
[2] Master limited partnership units have different tax characteristics than common stocks and may not be suitable for tax-deferred accounts such as IRAs. Please consult your tax advisor before buying.
[3] Total returns include dividends.

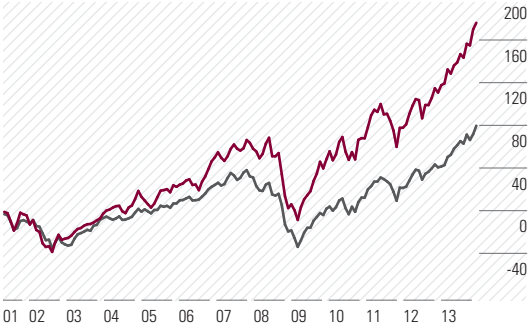
Invest in the Hare Approach—The Hassle-Free Way.
Did you know that Morningstar Investment Services now offers a customizable portfolio patterned after *StockInvestor*'s Hare portfolio?
To learn more, call **1-866-765-0663**.

Morningstar Investment Services, Inc. is a registered investment advisor and wholly owned subsidiary of Morningstar, Inc.

Hare Performance and Allocation

Total Return Comparison (%)

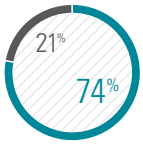
	Oct.	12 Month	10 Year	Since Inception
Hare Portfolio	2.2	30.5	11.7	8.7
S&P 500 Index	4.6	27.2	7.5	5.1



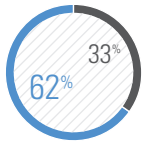
Total returns include reinvested dividends. Periods longer than one year are annualized. Portfolio distribution percentages don't sum to 100% because of cash.

Portfolio Distributions (%)

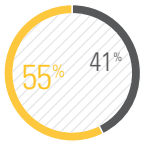
Moat



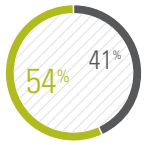
Moat Trend



Uncertainty



Stewardship



Style Breakdown (%)

	Value	Blend	Growth	
Lrg	9	21	47	
Med	0	0	7	
Sm	2	5	0	

51–100
26–50
11–25
0–10

Top Five Sectors (%)

Technology	24.1
Financial Services	16.2
Energy	14.1
Healthcare	13.1
Basic Materials	11.0

Portfolio Roundup

by Matthew Coffina, CFA

From inception on June 18, 2001, through Oct. 31, 2013, the Hare has delivered a total return, including dividends, of 181.8%, compared with 84.5% for the S&P 500 and 82.3% for the average large-cap growth mutual fund. The Hare has outperformed 66.2% of large-cap growth funds over the past 12 months and is beating 99.6% of them since inception.

The Hare suffered its worst month of relative performance in two years in October, trailing the S&P 500 by 2.4 percentage points. The portfolio is still ahead of the index in 2013, but barely. The Hare's estimated intrinsic value (calculated by aggregating our analysts' fair value estimates) is up 12.2% year to date—not as much as the Tortoise, but a good result in absolute terms. The Hare's intrinsic value hasn't improved nearly as much as its market value this year, and with a price/fair value ratio of 0.96 and an average star rating of 3.06, the portfolio looks only slightly undervalued.

As usual, there was greater volatility in the performance of our Hare holdings. **Google** GOOG was our top performer, up 17.7% following a strong third-quarter earnings report. Google's continued rapid revenue growth is very impressive for a company its size—a testament both to the strength of its business model and to management's foresight and strategic execution. I believe Google has one of the widest moats in technology. Other leaders in the Hare this month included **Charles Schwab** SCHW (up 7.1%), **MasterCard** MA (up 6.6%), and **Cloud Peak Energy** CLD (up 6.4%, though the stock is still down 19% in 2013). Laggards included **eBay** EBAY (down 5.5%), **CarMax** KMX (down 3.1%), and **Autodesk** ADSK (down 3.1%).

There were five fair value estimate increases and no decreases since last issue. We raised our appraisal of Google (up $105 per share to $875), **Baidu** BIDU (up $15 to $140), **Discover Financial Services** DFS (up $2 to $46), **Facebook** FB (up $2 to $36), and Cloud Peak (up $1 to $28) due to a combination of strong earnings and routine updates for recent cash flows. I made one set of trades in the month, selling **Vulcan Materials** VMC and using the cash we raised by trimming Facebook last month to initiate a new position in **Philip Morris International** PM. For more on my rationale for these trades, visit msi.morningstar.com. M

Contact Matthew Coffina at matthew.coffina@morningstar.com. Matthew Coffina owns all of the Hare stocks in his personal accounts. He sold his VMC position, added to his ESRX position, and initiated a new position in PM in the last month.

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Matt's Favorites for New Money

Recommended Ways to Use the Tortoise and Hare in Your Portfolio

1. Buy every stock, regardless of current valuation. Over time I will rebalance to the greatest opportunities. This is the best way to replicate the performance of the portfolios.
2. Focus only on the most undervalued current holdings. The stocks on this page are a good place to start, and you can expand this list by looking at all the 4- and 5-stars in the portfolios.

1. Philip Morris International PM ★★★

Fair Value Est. $95.00 | Current Price $89.12

Between the addictive nature of its products and its premium brands, Philip Morris International has a tremendous amount of pricing power, which is the primary driver of growth. Growing demand for cigarettes in emerging markets largely offsets volume declines in developed markets. While increasing taxation and regulation are persistent challenges, they also raise barriers to entry and contribute to pricing power by making all cigarettes more expensive. I expect Philip Morris to deliver earnings-per-share growth in the neighborhood of 10% annually on top of a 4.2% yield. In light of the reasonable price/earnings multiple, this should enable double-digit total returns. For subscribers who prefer not to invest in tobacco for ethical reasons—a point of view I completely understand and respect—I suggest Unilever PLC UL or American Tower AMT as potential substitutes.

2. Express Scripts ESRX ★★★★★

Fair Value Est. $89.00 | Current Price $62.52

Express Scripts is one of the few health-care companies that benefits from controlling—rather than encouraging—health-care spending growth. As employers, governments, and managed-care organizations adapt to the Affordable Care Act and seek ways to make drug benefits more cost effective, Express Scripts is likely to remain a partner of choice. The company continues to flex its bargaining muscle and achieve operating cost synergies in the wake of the Medco merger. Express Scripts is on the opposite side of the reimbursement pressure facing pharmaceutical firms—it recently excluded nearly 50 drugs from its national formulary. Express Scripts also generates plentiful free cash flow, and a depressed share price should enable it to accelerate share repurchases.

3. Coca-Cola KO ★★★★

Fair Value Est. $45.00 | Current Price $39.57

Coca-Cola is home to some of the world's most well-known and well-liked beverage brands as well as an unmatched global distribution system. Furthermore, management is exceptional; the company described its strategic vision for 2020 back in 2009 and has been steadily executing against the goals it set for itself ever since. While some of Coke's products are past the point of saturation—especially carbonated soft drinks in North America—the company still has plenty of room to grow in emerging markets and through its diversified portfolio, which includes sodas, waters, juices, teas, sports drinks, and endless variations on these themes.

4. Novo Nordisk NVO ★★★★

Fair Value Est. $209.00 | Current Price $166.67

Novo Nordisk has faced a number of challenges this year, including regulatory delays for ultra-long-acting insulins Tresiba and Ryzodeg, advances in competitors' diabetes drug pipelines, and the announcement that Express Scripts has decided to exclude a few of Novo's drugs from its national formulary. However, I still think the company has one of the widest moats in health care, with numerous advantages including manufacturing scale, intellectual property, marketing expertise, and brand loyalty. Diabetes is an attractive niche for drugmakers, with rising incidence driven by aging populations, unhealthy diets, and increasingly sedentary lifestyles. The company may see a slowdown in growth in the next couple of years as it works through a soft spot in its product cycle, but Novo remains well positioned over the long run.

5. eBay EBAY ★★★★

Fair Value Est. $63.00 | Current Price $52.71

Investors are enamored of Amazon's AMZN rapid growth, and are willing to look the other way on a complete absence of profits. I find eBay easier to own, as the company combines growth with a very profitable business model. John Donahoe has led an impressive turnaround since becoming CEO, and he has a uniquely compelling strategic vision for eBay: to make it into a leading impartial facilitator of online commerce, without competing with its retail partners. The network effect is only strengthening as eBay attracts more users to its core marketplaces and PayPal products, resulting in a positive moat trend. The stock has lagged this year, but the fundamentals look stronger than ever.

6. Exelon EXC ★★★★★

Fair Value Est. $42.00 | Current Price $28.54

Exelon is basically a bet on natural gas and electricity prices. While I normally try to avoid speculating on commodity prices, the risk/reward profile looks to be in our favor in this case. The shale gas boom in North America has driven natural gas prices far below what we consider a normalized level, but curtailed drilling and growing demand should eventually cause gas prices to rise. Electricity prices could receive another boost if environmental regulation leads to the closure of older coal-fired plants. Exelon would be a prime beneficiary of higher electricity prices, given its unparalleled fleet of low-marginal-cost, low-emissions nuclear plants.

Data as of Oct. 31, 2013.

Wide-Moat Watchlist

More Wide-Moat Watchlist Information!
If you wish to learn more about the Wide-Moat Watchlist, please visit **msi.morningstar.com**. There you can find the latest data, sort the list alphabetically or by any of the datapoints, and download the analyst report for each of the companies on the watchlist.

Basic Materials

I sold Vulcan Materials this month to help fund my purchase of Philip Morris International. Our timing with Vulcan couldn't have been much worse, having first purchased the stock in October 2007—right before the worst of the housing crash and financial crisis. We overpaid for our shares and as a result were stuck with a 34.1% loss (including dividends) over a six-year holding period. While Vulcan has a relatively high degree of pricing power, the company has no control over the demand for aggregates, leaving it more exposed to economic cycles than most of our holdings. Demand is set to rebound with a recovery in construction activity, and Vulcan is on track to post a profit in 2014. However, that follows five consecutive years of pretax losses. Our $57 fair value estimate relies on a major recovery in aggregates demand and a return to near-peak operating margins. Trading at 13 times our estimate of 2017 earnings, I didn't think Vulcan's upside potential was enough to justify its risk. Elsewhere, fertilizer markets ground to a halt in the third quarter. Farmers are delaying purchases—especially of potash—as they wait for the Uralkali/Belaruskali dispute to lower prices. I expect to hold PotashCorp and Compass Minerals as this dynamic situation evolves.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Potash Corporation of Saskatchewan POT	★★★★	Stable	Exemplary	High	0.82	31.1	38	13.8	4.5	H
Compass Minerals International CMP	★★★★	Stable	Exemplary	Medium	0.89	74.47	84	24.2	2.9	H
Martin Marietta Materials MLM	★★★	Stable	Standard	High	0.93	98.09	106	46.3	1.6	H
Vulcan Materials VMC	★★★	Stable	Poor	High	0.94	53.55	57	—	0.1	H
Praxair PX	★★★	Stable	Standard	Medium	0.96	124.71	130 ↑	21.2	1.9	T
Monsanto MON	★★★	Stable	Standard	Medium	0.99	104.88	106 ↑	22.9	1.6	H

Consumer Cyclical

Weight Watchers' stock took another tumble last month after the company suspended its dividend and once again highlighted problems recruiting new members. While the stock is trading at the deepest discount to our fair value estimate of any wide moat, it's hard to read much into that when our valuation involves so much uncertainty. I'm not convinced that Weight Watchers can overcome high member turnover and the competitive threat from free smartphone apps, and I expect to watch this drama unfold from the sidelines. EBay's stock was down after management issued a cautious outlook for fourth-quarter holiday sales. This seems like a short-term macro concern rather than anything fundamentally wrong with eBay's competitive position, and I intend to hold. EBay combines rapid growth with a highly profitable business model, making it easier to own than peer Amazon. We also upgraded the moat ratings on a handful of media and luxury goods companies—for more, see the spotlights on pages 26 and 28.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Weight Watchers International WTW	★★★★	Stable	Standard	Very High	0.64	32.11	50	7.6	2.2	H
eBay EBAY	★★★★	Positive	Exemplary	Medium	0.84	52.71	63	25.1	0.0	H
McDonald's MCD	★★★★	Stable	Exemplary	Low	0.92	96.52	105	17.4	3.4	T
Harley-Davidson HOG	★★★	Stable	Standard	High	1.00	64.04	64	20.7	1.3	H
✶ Twenty-First Century Fox FOXA	★★★	Stable	Standard	Medium	1.00	34.08	34 ↑	—	0.7	H
John Wiley & Sons JW.A	★★★	Negative	Exemplary	Medium	1.01	50.29	50	20.9	2.0	H
Grupo Televisa, S.A.B. TV	★★★	Stable	Standard	Medium	1.01	30.44	30 ↑	—	0.4	H
Home Depot HD	★★★	Stable	Exemplary	Medium	1.04	77.89	75	23.1	2.0	T
Starbucks SBUX	★★★	Stable	Exemplary	Medium	1.04	81.05	78	38.8	1.0	H
Amazon.com AMZN	★★★	Stable	Exemplary	High	1.04	364.03	350 ↑	—	0.0	H
✶ Time Warner TWX	★★★	Stable	Standard	Medium	1.04	68.74	66 ↑	18.6	1.7	H
Walt Disney DIS	★★★	Stable	Standard	Medium	1.06	68.59	65	20.8	1.1	T
Lowe's LOW	★★	Stable	Exemplary	Medium	1.13	49.78	44	25.3	1.5	T

✶ = New Addition ❗ = Lowered Economic Moat Rating T = Tortoise Holding T = Potential Tortoise Holding H = Hare Holding H = Potential Hare Holding

Continued From Page 9

Consumer Cyclical (cont'd)

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
✶ Discovery Communications DISCK	★★	Stable	Standard	Medium	1.13	82.71	73 ↑	30.0	0.0	H
✶ Tiffany & Co. TIF	★★	Stable	Standard	Medium	1.20	79.17	66 ↑	23.4	1.7	H
Nike NKE	★★	Stable	Exemplary	Medium	1.26	75.76	60 ↑	26.0	1.1	H

Financial Services

Western Union predicted a significant increase in regulatory compliance costs next year, which will once again prevent growth in operating income. This prompted us to lower our fair value estimate by $3 per share on less-optimistic long-run margin assumptions. This latest development only serves to reinforce my reason for selling Western Union. There are plenty of companies out there with a demonstrated ability to compound their intrinsic values over time and a high probability of continuing to do so in the future—why should we devote our limited capital to situations where this isn't the case? The ultimate value compounder—Berkshire Hathaway—looks like the most attractive wide-moat financial services company for new money right now.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Western Union WU	★★★★	Negative	Standard	High	0.77	17.02	22 ↓	10.8	2.9	H
Berkshire Hathaway BRK.B	★★★★	Negative	Exemplary	Medium	0.80	115.09	143	14.8	0.0	T
Bank of New York Mellon BK	★★★	Stable	Standard	High	0.88	31.8	36	18.1	1.9	T
Franklin Resources BEN	★★★	Stable	Standard	Medium	0.93	53.86	58	15.8	0.7	H
Westpac Banking WBK	★★★	Stable	Standard	Medium	0.96	32.65	34	16.6	5.0	H
Northern Trust NTRS	★★★	Stable	Exemplary	High	0.97	56.42	58	18.6	2.2	T
BlackRock BLK	★★★	Positive	Exemplary	Medium	1.00	300.81	300 ↑	19.6	2.2	T
T. Rowe Price Group TROW	★★★	Stable	Exemplary	Medium	1.03	77.41	75	20.7	2.0	H
CME Group CME	★★★	Stable	Standard	High	1.05	74.21	71	26.5	2.4	H
American Express AXP	★★★	Stable	Standard	Medium	1.06	81.8	77 ↑	19.2	1.1	T
Eaton Vance EV	★★	Stable	Standard	Medium	1.10	41.81	38	21.6	2.1	H
State Street STT	★★★	Stable	Poor	High	1.13	70.07	62 ↑	15.0	1.5	H
MasterCard MA	★★	Stable	Standard	High	1.16	717.1	620	29.6	0.3	H
Visa V	★★	Stable	Standard	High	1.29	196.67	153	30.8	0.8	H
IntercontinentalExchange ICE	★★	Stable	Standard	High	1.32	192.73	146	25.7	0.0	H
SEI Investments SEIC	★★	Stable	Standard	Medium	1.33	33.19	25	20.8	1.2	H

Real Estate

If you prefer not to invest in tobacco for ethical reasons—a position I completely understand and respect—the runner-up for the Hare when I purchased Philip Morris International was narrow-moat American Tower. Telecom companies around the world are engaged in a feverish effort to build out their networks to meet the growing demand for mobile data as consumers adopt smartphones. The more data traffic on a network, the more towers you need. American Tower is well positioned to grow both by building and acquiring new towers and by adding tenants to existing towers.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
CoStar Group CSGP	★	Positive	Exemplary	High	1.97	176.99	90 ↑	—	0.0	H

Data as of Oct. 31, 2013. Fair value based on Morningstar analyst estimates. ↑ = Rating Upgrade ↓ = Rating Downgrade UR = Under Review

Communication Services

No current opportunities.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Comcast CMCSA	★★	Negative	Standard	Medium	1.22	47.6	39	18.2	1.6	T
Time Warner Cable TWC	★	Negative	Standard	Medium	1.43	120.15	84	16.4	2.2	T

Energy

We own a handful of energy companies, mostly in the midstream sector. I prefer pipeline companies for their steady cash flows and lack of commodity price exposure. The valuation on Kinder Morgan Management continues to look attractive. The growth headwinds are very real, including a massive general partner burden and long-term commodity price and production risks in the enhanced oil recovery segment. However, with an implied yield above 7% (keeping in mind that we receive our distributions in additional shares rather than cash), we don't need much growth to achieve an attractive total return. The general partner structure is an encumbrance to KMR but a boon to Kinder Morgan Inc. (KMI). The latter's more favorable growth outlook makes up for its lower yield. Spectra Energy and Enbridge are also possible destinations for new money.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Kinder Morgan Management KMR	★★★★	Stable	Standard	Medium	0.77	75.32	98	39.1	7.2	T
Enbridge ENB	★★★★★	Positive	Standard	Low	0.80	43.39	54	44.2	2.8	H
Kinder Morgan Energy Partners KMP	★★★★	Stable	Standard	Medium	0.82	80.7	98	10.4	6.7	T
Kinder Morgan KMI	★★★★	Stable	Standard	Medium	0.86	35.31	41	34.0	4.6	T
El Paso Pipeline Partners EPB	★★★★	Stable	Standard	Medium	0.88	40.56	46	14.0	6.4	T
Spectra Energy SE	★★★★	Stable	Exemplary	Low	0.91	35.57	39	22.7	3.4	T
Exxon Mobil XOM	★★★★	Negative	Exemplary	Low	0.92	89.62	97	10.9	2.8	T
ONEOK Partners OKS	★★★	Positive	Standard	Medium	0.93	53.77	58	14.7	5.4	H
Williams Partners WPZ	★★★	Positive	Standard	Medium	0.93	51.42	55	17.2	6.8	T
Spectra Energy Partners SEP	★★★	Stable	Standard	Low	0.95	43.72	46	22.4	4.7	T
National Oilwell Varco NOV	★★★	Positive	Exemplary	Medium	0.96	81.18	85	15.1	1.3	H
Schlumberger NV SLB	★★★	Stable	Standard	Medium	0.99	93.72	95 ↑	18.7	1.3	H
Buckeye Partners BPL	★★★	Stable	Standard	Medium	0.99	67.27	68 ↑	23.6	6.3	T
Holly Energy HEP	★★★	Stable	Standard	Low	1.00	31.84	32	37.7	6.2	T
Boardwalk Pipeline Partners BWP	★★★	Stable	Standard	Low	1.00	29.95	30 ↑	21.7	7.1	T
Sunoco Logistics Partners SXL	★★★	Stable	Standard	Medium	1.00	70.18	70 ↑	15.6	3.6	T
Enterprise Products Partners EPD	★★★	Positive	Exemplary	Medium	1.00	63.28	63	22.8	4.4	T
Energy Transfer Equity ETE	★★★	Stable	Standard	Medium	1.04	67.59	65	19.3	4.0	H
Core Laboratories N.V. CLB	★★	Stable	Exemplary	Low	1.04	187.22	180 ↑	37.2	0.6	H
Plains All American Pipeline PAA	★★★	Stable	Exemplary	Medium	1.07	51.22	48	12.9	4.7	T
Williams WMB	★★★	Positive	Standard	Medium	1.08	35.71	33	28.3	4.1	H
Magellan Midstream Partners MMP	★★	Stable	Exemplary	Low	1.11	60.04	54	28.9	3.7	T
Cheniere Energy Partners CQP	★★	Stable	Standard	Medium	1.19	30.93	26	—	5.5	H
Cheniere Energy LNG	★	Stable	Standard	Medium	1.42	39.8	28	—	0.0	H

Continued From Page 11

Industrials

Values are hard to come by across the market right now, and that's especially true in the industrials sector. I'm most intrigued by transportation companies. C.H. Robinson has faced persistent margin pressure this year because of slack demand and tight supply, which is a theme across the truck brokerage industry. This is a cyclical business, and it remains unclear whether margin pressure will reverse in a more favorable environment, or if the industry has become permanently more competitive. I'm content to hold our small position but would demand a larger margin of safety before adding more. I'm considering adding a railroad to the Tortoise, but here, too, a larger discount to fair value would be welcome. Union Pacific would be my first choice among the rails—see Page 16 for more.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
CH Robinson Worldwide CHRW	★★★★	Stable	Exemplary	Medium	0.87	59.74	69	16.3	2.3	T
CSX CSX	★★★★	Stable	Standard	Medium	0.87	26.06	30	14.0	2.3	T
Caterpillar CAT	★★★	Negative	Standard	High	0.89	83.36	94	13.1	2.9	H
Ritchie Bros. Auctioneers RBA	★★★★	Stable	Standard	Medium	0.90	19.8	22	28.5	2.6	H
Union Pacific UNP	★★★	Stable	Standard	Medium	0.90	151.4	168 ↑	16.7	2.1	T
General Dynamics GD	★★★	Stable	Standard	Medium	0.94	86.63	92 ↑	—	2.6	T
Expeditors International EXPD	★★★	Stable	Exemplary	Medium	0.96	45.29	47	27.4	1.3	T
General Electric GE	★★★	Stable	Standard	Medium	0.97	26.14	27	18.2	2.9	T
Fastenal FAST	★★★	Stable	Standard	Medium	1.00	49.83	50	33.1	2.0	H
Norfolk Southern NSC	★★★	Stable	Standard	Medium	1.00	86.02	86 ↑	15.1	2.4	T
Canadian National Railway CNI	★★★	Stable	Standard	Medium	1.03	109.93	107 ↑	19.0	1.5	T
Grupo Aero del Pacifico PAC	★★★	Stable	Standard	High	1.04	51.99	50	19.0	—	H
United Technologies UTX	★★★	Stable	Standard	Medium	1.04	106.25	102	17.5	2.2	T
Landstar System LSTR	★★★	Stable	Standard	Medium	1.04	55.25	53	20.7	0.0	H
Canadian Pacific Railway Ltd CP	★★★	Stable	Standard	Medium	1.04	143.07	137 ↑	32.7	1.0	T
3M MMM	★★★	Stable	Exemplary	Low	1.05	125.85	120 ↑	19.4	2.0	T
United Parcel Service Inc UPS	★★★	Stable	Standard	Medium	1.07	98.24	92 ↑	—	2.5	T
Graco GGG	★★★	Stable	Standard	Medium	1.09	77.26	71 ↑	23.2	1.3	H
IHS IHS	★★	Stable	Standard	Medium	1.09	109.05	100	53.2	0.0	H
★ FactSet Research Systems FDS	★★★	Stable	Standard	Medium	1.10	108.94	99 ↑	24.4	1.3	H
ADT ADT	★★	Stable	Standard	Medium	1.11	43.37	39	23.7	1.2	H
Grupo Aero del Sureste ASR	★★★	Stable	Standard	High	1.11	119.01	107 ↑	19.9	—	H
Paychex PAYX	★★	Stable	Standard	Medium	1.11	42.27	38	26.7	3.3	H
Grupo Aero del Centro Norte OMAB	★★★	Stable	Standard	High	1.13	27.19	24 ↑	21.4	—	H
Automatic Data Processing ADP	★★	Stable	Standard	Medium	1.15	75.03	65	26.8	2.3	T
Stericycle SRCL	★★	Positive	Standard	Medium	1.16	116.2	100	35.1	0.0	T
Rockwell Automation ROK	★★	Positive	Exemplary	Medium	1.16	110.41	95	21.2	1.9	H
Lockheed Martin LMT	★★	Stable	Standard	Medium	1.20	133.34	111 ↑	14.4	4.0	T
Fiserv FISV	★★	Stable	Exemplary	Medium	1.20	104.73	87 ↑	23.7	0.0	H
Kansas City Southern KSU	★★	Stable	Standard	Medium	1.22	121.52	100 ↑	40.5	0.7	H
Equifax EFX	★★	Stable	Standard	Medium	1.24	64.67	52	25.8	1.4	H
Dun & Bradstreet DNB	★★	Stable	Standard	Medium	1.30	108.79	84	16.0	1.5	H
Jack Henry & Associates, JKHY	★	Stable	Standard	Medium	1.52	54.61	36	26.8	1.5	H

Data as of Oct. 31, 2013. Fair value based on Morningstar analyst estimates. ↑ = Rating Upgrade ↓ = Rating Downgrade UR = Under Review

Technology

In the ever-changing technology industry, it's especially important to demand a large margin of safety and be sure that a company's competitive advantage will really be sustainable over the long run. While I remain comfortable holding Cisco and Oracle, I don't see many opportunities for new money. Facebook remains a possible source of funds. I believe Google has one of the widest moats in technology, but the stock price seems to fully reflect this. I will probably pass on IBM without a deeper discount to fair value in light of the negative moat trend.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
International Business Machines IBM	★★★★	Negative	Exemplary	Medium	0.86	179.21	208	12.4	2.1	T
Cisco Systems CSCO	★★★★	Stable	Standard	Medium	0.87	22.56	26	12.2	3.0	T
Oracle ORCL	★★★★	Stable	Standard	Medium	0.88	33.5	38	14.5	1.4	H
Qualcomm QCOM	★★★	Stable	Standard	Medium	0.93	69.49	75	18.6	2.0	H
Microsoft MSFT	★★★	Negative	Standard	Medium	0.93	35.41	38 ↑	13.2	3.2	T
Intel INTC	★★★	Negative	Standard	Medium	0.98	24.47	25	13.2	3.7	H
Maxim Integrated Products MXIM	★★★	Stable	Standard	Medium	0.99	29.7	30	20.6	3.5	H
Applied Materials AMAT	★★★	Stable	Standard	Medium	0.99	17.86	18	—	2.2	H
Autodesk ADSK	★★★	Stable	Standard	Medium	1.05	39.9	38	41.5	0.0	H
Dassault Systemes DASTY	★★★	Stable	Standard	Medium	1.06	121.8	115 ↑	33.8	0.9	H
Linear Technology LLTC	★★	Stable	Exemplary	Medium	1.11	41.16	37	24.0	2.5	H
Analog Devices ADI	★★	Stable	Exemplary	Medium	1.12	49.3	44	23.6	2.8	H
Cerner CERN	★★	Positive	Standard	Medium	1.12	56.03	50	43.9	0.0	H
Google GOOG	★★	Stable	Standard	High	1.18	1,030.58	875 ↑	28.7	0.0	H
Intuit INTU	★★	Stable	Standard	Medium	1.19	71.41	60	25.3	1.1	H
KLA-Tencor KLAC	★★	Stable	Exemplary	Medium	1.19	65.6	55	21.4	2.7	H
VMware VMW	★★	Negative	Standard	Medium	1.21	81.28	67	45.0	0.0	H
Facebook FB	★★	Stable	Standard	High	1.39	50.21	36 ↑	—	0.0	H
Adobe Systems ADBE	★	Stable	Standard	Medium	1.43	54.22	38	62.1	0.0	H
LinkedIn LNKD	★	Stable	Standard	High	1.49	223.67	150 ↑	—	0.0	H

Consumer Defensive

With the market's almost uninterrupted climb this year, greed appears to be winning out over fear on Wall Street. That makes this a great time to direct funds to the less-risky consumer defensive sector, in my view. These stocks generally haven't kept up with the market's advance, and in several cases investors don't seem to be attaching enough of a premium to their intrinsic quality and stability. I'm considering adding to our Coca-Cola position, and either Unilever PLC or Procter & Gamble could also find a home in the Tortoise. I recently purchased Philip Morris International for the Hare. While cigarette consumption is declining in developed markets, Philip Morris has significant exposure to emerging markets and tremendous pricing power, which give it a similar growth profile to other consumer staples names—but with a much more attractive yield and price/earnings multiple.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Sysco SYY	★★★★	Stable	Standard	Medium	0.85	32.34	38	19.3	3.5	T
Coca-Cola KO	★★★★	Stable	Exemplary	Low	0.88	39.57	45	20.3	2.8	T
Unilever UL	★★★	Stable	Standard	Medium	0.90	40.59	45	18.0	3.6	T
Procter & Gamble PG	★★★★	Negative	Standard	Low	0.93	80.75	87	20.4	3.0	T
Philip Morris International PM	★★★	Stable	Exemplary	Medium	0.94	89.12	95	16.9	4.2	H
Nestle NSRGY	★★★	Stable	Standard	Low	0.95	72.41	76 ↑	18.5	3.1	T
PepsiCo PEP	★★★	Stable	Standard	Low	0.96	84.09	88	19.6	2.7	T
McCormick & Co. MKC	★★★	Stable	Standard	Low	0.96	69.15	72	24.1	2.0	T
Ambev ABV	★★★	Stable	Exemplary	High	0.98	37.2	38	22.5	3.3	T

✶ = New Addition ❗ = Lowered Economic Moat Rating T = Tortoise Holding T = Potential Tortoise Holding H = Hare Holding H = Potential Hare Holding

Continued From Page 13

Consumer Defensive (cont'd)

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Campbell Soup CPB	★★★	Negative	Standard	Medium	0.99	42.57	43	19.6	2.9	T
CVS Caremark CVS	★★★	Stable	Standard	Medium	1.00	62.26	62	18.5	1.5	T
Diageo DEO	★★★	Stable	Exemplary	Medium	1.02	127.59	125	20.2	2.4	T
British American Tobacco BTI	★★★	Stable	Exemplary	Medium	1.03	110.49	107	15.6	3.9	T
Wal-Mart Stores WMT	★★★	Negative	Standard	Low	1.04	76.75	74	14.3	2.5	T
Imperial Tobacco Group ITYBY	★★★	Stable	Standard	High	1.04	74.99	72	46.3	4.7	H
SABMiller SBMRY	★★★	Stable	Standard	Medium	1.09	52.25	48	23.9	1.8	T
Anheuser-Busch Inbev BUD	★★★	Stable	Exemplary	Medium	1.09	103.73	95	—	2.2	T
Colgate-Palmolive CL	★★	Stable	Exemplary	Low	1.10	64.73	59 ↑	25.0	2.1	T
Brown-Forman BF.B	★★	Stable	Exemplary	Medium	1.12	72.98	65	26.7	1.4	T
Lorillard LO	★★★	Stable	Standard	High	1.13	51.01	45 ↑	15.9	4.3	H
Beam BEAM	★★	Stable	Exemplary	Medium	1.14	67.3	59	26.7	1.3	T
Mondelez International MDLZ	★★	Stable	Standard	Medium	1.16	33.65	29	31.3	1.7	T
Altria Group MO	★★	Stable	Standard	Medium	1.16	37.23	32 ↑	14.5	5.2	T
Hershey HSY	★★	Negative	Standard	Medium	1.20	99.24	83 ↑	31.1	2.0	T

Healthcare

Novo Nordisk sold off after management predicted high-single-digit revenue and operating income growth in 2014. While this level of growth would be the envy of most other large pharmaceutical firms, investors have higher expectations for Novo, reflected in a P/E multiple meaningfully above the industry average. Novo is hitting a soft spot in its product cycle because of regulatory delays to ultra-long-acting insulins in the U.S., but I think growth can reaccelerate in a few years as the pipeline continues to progress. Even high-single-digit growth would be enough to support the current valuation, in my view. Express Scripts is my top health-care pick. The firm is flexing its bargaining muscle and leveraging operating costs in the wake of the Medco merger, while also repurchasing shares hand over fist. Express Scripts is one of the few companies that makes money from controlling health-care spending growth, positioning it as a key player in the post-Affordable Care Act world.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Express Scripts ESRX	★★★★★	Stable	Exemplary	Medium	0.70	62.52	89	26.9	0.0	H
Novo Nordisk NVO	★★★★	Stable	Exemplary	Medium	0.80	166.67	209	20.4	2.0	H
Sanofi SNY	★★★★	Stable	Exemplary	Medium	0.82	53.48	65	31.7	2.4	T
Baxter International BAX	★★★★	Stable	Standard	Low	0.82	65.87	80	16.7	3.0	T
Merck MRK	★★★★	Negative	Standard	Medium	0.87	45.09	52	26.2	3.8	T
Allergan AGN	★★★	Negative	Exemplary	Medium	0.91	90.61	100	22.9	0.2	H
Intuitive Surgical ISRG	★★★	Positive	Exemplary	High	0.93	371.5	400	22.2	0.0	H
GlaxoSmithKline GSK	★★★	Stable	Standard	Medium	0.94	52.63	56	20.1	4.6	T
Covidien COV	★★★	Stable	Standard	Medium	0.94	64.11	68	16.1	2.0	T
AstraZeneca AZN	★★★	Negative	Standard	Medium	0.94	52.86	56	13.4	5.3	T
Medtronic MDT	★★★	Stable	Standard	Medium	0.96	57.4	60	16.5	2.0	T
Eli Lilly LLY	★★★	Negative	Standard	Medium	0.96	49.82	52	11.4	3.9	T
Waters WAT	★★★	Stable	Exemplary	Medium	0.96	100.92	105	18.2	0.0	H
Amgen AMGN	★★★	Negative	Standard	Medium	0.98	116.14	119	18.4	1.6	H
Novartis NVS	★★★	Stable	Standard	Low	0.99	77.55	78	20.2	3.3	T
Roche Holding RHHBY	★★★	Stable	Standard	Low	1.00	69.34	69 ↑	18.7	2.3	T
Pfizer PFE	★★★	Stable	Standard	Medium	1.02	30.69	30	20.1	3.1	T

Data as of Oct. 31, 2013. Fair value based on Morningstar analyst estimates. ↑ = Rating Upgrade ↓ = Rating Downgrade UR = Under Review

Healthcare (cont'd)

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Johnson & Johnson JNJ	★★★	Stable	Standard	Low	1.03	92.61	90	21.1	2.9	T
Stryker SYK	★★★	Negative	Standard	Medium	1.06	73.86	70	31.7	1.4	T
St Jude Medical STJ	★★★	Stable	Standard	Medium	1.08	57.39	53 ↑	27.5	1.7	H
Patterson PDCO	★★★	Stable	Standard	Medium	1.09	42.51	39	21.0	1.5	T
Zimmer Holdings ZMH	★★★	Negative	Standard	Medium	1.09	87.47	80	21.6	0.9	T
Biogen Idec BIIB	★★	Stable	Standard	Medium	1.10	244.19	222 ↑	34.4	0.0	H
Henry Schein HSIC	★★	Stable	Standard	Medium	1.14	112.43	99	24.4	0.0	T
Bristol-Myers Squibb BMY	★★	Negative	Standard	Medium	1.28	52.52	41 ↑	31.4	2.7	T
Zoetis ZTS	★★	Stable	Standard	Medium	1.32	31.66	24	37.7	0.8	T

Utilities

Natural gas prices have remained under pressure, hurting Exelon's margins from generating electricity. I think the risk/reward profile is still in our favor, but higher natural gas prices are the key to our investment thesis—and I generally hesitate to make bets on commodity prices. ITC Holdings has been performing exactly as I expected—reinvesting capital at favorable regulated rates of return and growing earnings far faster than its utility peers. Barring some unforeseen development—such as a change of heart at the Federal Energy Regulatory Commission, which has been encouraging investments in transmission with attractive allowed returns—I expect ITC to deliver us a midteens annual total return with modest risk.

Company	Star Rating	Moat Trend	Stewardship	Uncertainty	P/FV	Current Price	Fair Value	P/E (TTM)	Yield	Portfolio
Exelon EXC	★★★★★	Stable	Standard	Medium	0.68	28.54	42	20.8	4.3	T
ITC Holdings ITC	★★★	Stable	Exemplary	Low	1.03	100.59	98	26.5	1.7	T

Note from the Editor

Establishing a wide economic moat is extremely difficult: Only 170 stocks in Morningstar's coverage universe with U.S. listings have achieved this distinction. These companies make up the Wide-Moat Watchlist, and in general this list doesn't change much over time.

That said, 2013 has witnessed a meaningful increase in the number of companies we consider to have wide moats, and I expect the list to continue to expand in the coming months. Partly this reflects corporate actions and growth in Morningstar's coverage universe. For example, Zoetis joined the watchlist following its spin-off from Pfizer, and we only recently initiated coverage on ITC Holdings. However, I believe the bigger driver of moat upgrades has been the formalization of our definition of a wide moat. In particular, we have now explicitly stated that wide-moat companies must be expected to earn excess normalized returns (that is, returns on invested capital above the cost of capital) with near certainty 10 years from now, and more likely than not 20 years from now. Furthermore, excess returns must be attributable to one of our five sources of a moat: the network effect, intangible assets, a cost advantage, switching costs, or efficient scale. Crafting this formal definition has helped us to identify a number of wide-moat companies that we previously overlooked.

To accommodate the ongoing growth in the Wide-Moat Watchlist—while preserving space for comments—this month it became necessary to add a page to this section. We've accomplished this by cutting the "Stock to Sell" article, which I always found to be of questionable usefulness anyway. When we sell stocks from our own portfolios, it doesn't necessarily mean that we are predicting the stocks to fall—rather, we usually just need the funds for other opportunities with more favorable risk/reward profiles. And since we don't advocate short selling, highlighting stocks to sell that we didn't previously own seems beside the point.

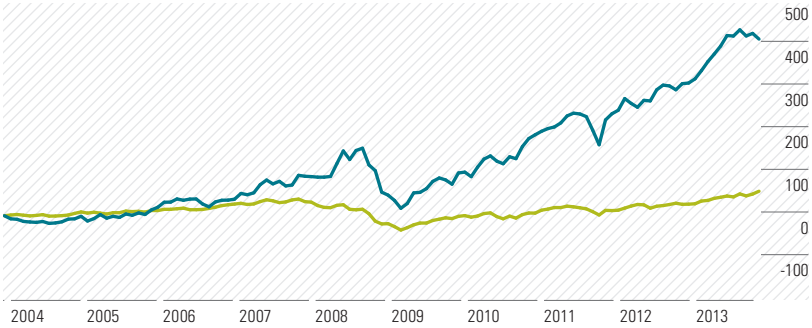
Note that this change also required us to move the "Wide-Moat and Market Statistics" page to the end of the newsletter (the old Page 15 can now be found on Page 31).

Union Pacific UNP | ★★★

Wide-Moat Stock Focus | Keith Schoonmaker, CFA

Moat	Moat Trend	Uncertainty	Stewardship	Stock Style
Wide	Stable	Medium	Standard	Lg. Growth
Price/Fair Value	**Current Price ($)**	**Fair Value ($)**	**P/E**	**Yield (%)**
0.90	151.40	168.00	16.7	2.1
Market Cap ($bil)	**Credit Rating**	**P/B**	**P/S**	**P/FCF**
69.7	A-	3.4	3.3	22.7

Total Returns (%)



Fundamental Table

Fiscal Year Ended	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16
Sales ($ mil)	16,965	19,557	20,926	21,909	23,503	24,666	25,889
Sales Growth (%)	20.0	15.3	7.0	4.7	7.3	4.9	5.0
Operating Income ($ mil)	4,981	5,724	6,745	7,449	8,226	8,633	9,320
Operating Margin (%)	29.4	29.3	32.2	34.0	35.0	35.0	36.0
Free Cash Flow ($ mil)	1,623	2,697	2,423	3,368	4,248	4,488	4,904
Adjusted EPS ($)	5.53	6.72	8.27	9.45	10.98	11.91	13.34
Adjusted ROIC (%)	8.7	10.8	11.7	13.0	13.6	13.6	14.0

Source: Morningstar estimates.

Profile

Omaha, Neb.-based Union Pacific is the largest public railroad in North America. Operating on 32,000 miles of track in the western two thirds of the U.S., Union Pacific's 43,000 employees generated $20.9 billion of revenue in 2012 by hauling coal, industrial products, intermodal containers, agricultural goods, chemicals, and automotive goods. Union Pacific owns about one fourth of Mexican railroad Ferromex and derives around 10% of its revenue hauling freight to and from Mexico.

Management & Stewardship

Overall, we consider Union Pacific's stewardship to be solid and have no material criticism of its governance. In 2011, James Young completed his sixth year as chief executive. In early 2012, Young began a medical leave of absence from the CEO role for pancreatic cancer treatment; he remains board chairman. John Koraleski now serves as president and CEO. Koraleski joined Union Pacific in 1971 and has served in a variety of leadership roles throughout the firm. Union Pacific's operating margin improvement under Young's leadership has been highly impressive—advancing more than 10 percentage points.

Matt's Position

Among railroads, **CSX** CSX, which was highlighted in the September newsletter, is trading at the greatest discount to fair value. However, I prefer Union Pacific over the long run, given its more diversified freight volumes and its exposure to Powder River Basin coal, which should see more stable demand than Appalachian coal.

Morningstar's Take

Union Pacific is a massive railroad, and it's getting bigger and more profitable. Success followed a couple of decades after partial deregulation in 1980, as the railroad eliminated unprofitable routes and gained efficiency during industry consolidation. Rails have improved performance by rightsizing assets, reducing crew size, and deploying technology. Union Pacific is surprisingly nimble for a huge asset-based enterprise: When 2009 carloads slid 16%, Union Pacific cut costs faster than sales declined, then set record operating margins in 2010 and 2012. Even double-digit coal carload declines in first-quarter 2013 couldn't keep the company from achieving record margins.

Union Pacific's $21 billion of 2012 revenue was heaviest in coal, intermodal, and agriculture. Powder River Basin coal is a giant $3.9 billion franchise for the rail. Because PRB coal is cheaper to mine than Appalachian coal, we think demand for it is unlikely to diminish as severely as for the latter in an environment of cheap natural gas. Union Pacific historically was less exposed to intermodal shipping than its western peer BNSF, but the company's intermodal offering now constitutes 20% of its top line.

More than other railroads, Union Pacific has upside potential remaining in repricing old contracts, some of which lack effective fuel surcharges or fail to fully capitalize on the pricing power rails have enjoyed since around 2004. Union Pacific has steadily decreased the fraction of its revenue spent on salaries and benefits and reached new high-margin levels during many recent quarters.

We are impressed by progress made so far and project more record-setting margins in coming years, as well

as additional share buybacks. Union Pacific produced a prodigious $2.4 billion of free cash in 2012 (a strong 11.6% of sales), even after capital expenditures and dividends consumed $3.7 billion and $1.1 billion, respectively, of the $6.2 billion cash from operations. The firm increased dividends per share 150% from the start of 2010 to the end of 2012, making shares attractive to yield-seeking investors.

Valuation

We increased our fair value estimate for Union Pacific to $168 from $166 per share based on the time value of money since our previous update. We project Union Pacific to attain a 64% operating ratio (operating costs as a percentage of revenue) by 2016. Our confidence in the margin outlook was increased when the firm achieved a 69% operating ratio in the first quarter of 2013 despite a nearly 20% decline in coal tonnage from the prior-year period. We think the rail has shown it can continue to improve profitability even facing steep coal demand headwinds. Management has set and achieved a series of operating ratio targets during the past decade, and we doubt this team is setting a goal the rail is unlikely to reach. Internal goals may well be better than the stated 65%.

We project salary and benefits as a percentage of revenue to cost 20% in the long run. We believe the firm will make more efficient use of manpower in future freight hauling—a trend displayed since the rail renaissance began around 2004 and confirmed during the recession and recovery. We also credit attrition (estimated at 8%–10% of employees in 2012 and likely similar going forward) for labor efficiency improvement because Union Pacific can replace retiring employees at lower wages and at less than a 1:1 ratio, given new practices and work rules.

We model about 1% volume growth in 2013 and believe revenue per car will improve around 5%–6% from prior-year levels, but commodity-price-based fuel surcharges bring uncertainty to this estimate. We expect the greatest pricing gains in the portion of the intermodal and coal books that have not been repriced since the modern railroading era began around 2004. About $300 million of "legacy contracts" were repriced during 2012, and the firm will lap these increases during 2013 (around 90% of contracts were renewed—the remainder probably switched to BNSF). Over the long run, we think Union Pacific can raise prices 4% per year. The valuation is constrained by the need for heavy reinvestment in Union Pacific's rail network. We project that 16% of sales will be deployed annually on capital investment.

Scenario Analysis

We model three scenarios in our discounted cash-flow valuation model. In each scenario, we assume Union Pacific can cover shocks to diesel pricing via effective fuel surcharges. Naturally, these surcharges dilute operating ratio to some extent—a small price to pay on paper for recovery of this volatile commodity cost. Fuel surged from just 7.4% of revenue in 1999 to 22% of revenue in 2008—from $832 million to $4 billion.

Our bear case assumes flat to 1% volume contraction annually during the next five years (with coal down 5% and intermodal up 1% annually), as well as only 3% annual price increases after 2014. Volume pressure could result from a weaker U.S. economy, while pricing could be constrained by more aggressive regulation. In this case, we project that Union Pacific will achieve only a 67% operating ratio. These assumptions knock about 17% off our fair value estimate.

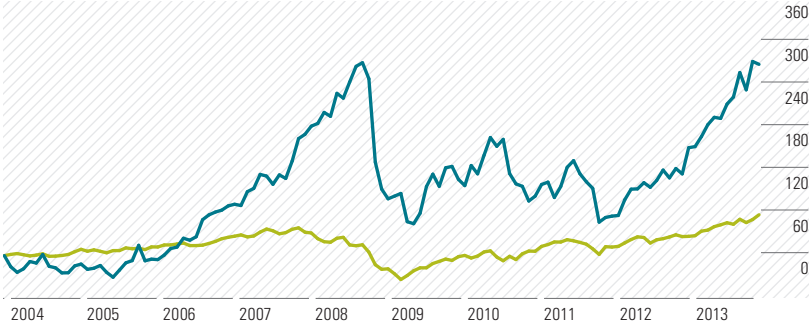
Our bull case assumes 5% annual price increases combined with 2% annual volume growth (coal and intermodal growing 1% and 3% per year, respectively). In this scenario, Union Pacific would return to its historical peak (2006) total carloads in 2016. We model the company's operating ratio to continue improving from 67.8% in 2012 down to 63% by 2016. Such a low operating ratio would be unprecedented for Union Pacific, but the firm breached the 70% operating ratio threshold during several quarters of 2010–13, and crossed below 66% in mid-2013. This operating ratio has been routinely bettered by **Canadian National** CNI for years, which has hit even sub-60% levels in some quarters despite having only about half of Union Pacific's revenue over which to spread fixed costs. These optimistic assumptions would add about 10% to our fair value estimate. M

ICON ICLR | ★★★★

Expanding-Moat Stock Focus | David Krempa

Moat	Moat Trend	Uncertainty	Stewardship	Stock Style
Narrow	Positive	Medium	Standard	Mid Growth
Price/Fair Value	**Current Price ($)**	**Fair Value ($)**	**P/E**	**Yield (%)**
0.81	40.49	50.00	27.5	—
Market Cap ($bil)	**Credit Rating**	**P/B**	**P/S**	**P/FCF**
2.5	—	3.1	1.9	—

Total Returns (%) ■ ICON ■ S&P 500 Index



Fundamental Table

Fiscal Year Ended	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16
Sales ($ mil)	900	946	1,115	1,324	1,509	1,691	1,893
Sales Growth (%)	1.4	5.1	17.9	18.8	14.0	12.0	12.0
Operating Income ($ mil)	92	39	74	122	151	183	222
Operating Margin (%)	10.2	4.2	6.6	9.2	10.0	10.8	11.8
Free Cash Flow ($ mil)	56	-15	82	112	112	161	168
Adjusted EPS ($)	1.44	0.52	1.00	1.66	2.05	2.48	3.02
Adjusted ROIC (%)	18.0	6.3	11.0	18.3	19.7	21.7	23.3

Source: Morningstar estimates.

Profile

ICON is a global clinical research organization that provides drug development and clinical testing services to pharmaceutical, biotechnology, and medical device companies. While the vast majority of its revenue comes from clinical research, ICON also offers ancillary services such as laboratory and imaging capabilities.

Management & Stewardship

We award ICON a standard stewardship rating. Ciarán Murray has been CEO since 2011 and was previously CFO. Operationally, we believe he has done a quality job since taking control. ICON has made great strides in increasing efficiency and drastically reducing operating costs. However, we believe management has an overly conservative capital allocation strategy. The firm's balance sheet carries no debt and a hefty cash pile. ICON initiated a small share repurchase program in 2011, but it was used largely to offset dilution from options. Given the firm's depressed stock price over the past few years, shareholders would have been better served with a more aggressive buyback program.

Matt's Position

With the patent clock always ticking, pharmaceutical companies want to get their clinical trials completed as quickly, efficiently, and safely as possible. As a result, clinical trial work is increasingly being outsourced to CROs like ICON. I am considering adding one of these expanding-moat research providers to the Hare, most likely either ICON or **Quintiles** Q (which was highlighted in July).

Morningstar's Take

ICON's almost exclusive focus on late-stage drug development makes it the best-positioned clinical research organization, or CRO, to benefit from the industry's favorable long-term growth prospects and strong competitive advantages. ICON is one of the few CROs with the global infrastructure necessary to compete for big pharmaceutical firms' strategic partnerships, and it has almost no exposure to the highly competitive early-stage industry that has weighed on the earnings of many of its peers. With the recently signed strategic partnership with **Pfizer** PFE, we expect ICON to see the strongest earnings growth in the group over the next five years.

We believe Big Pharma's increased outsourcing and willingness to sign long-term partnerships are a validation of CROs' value proposition. CROs can add value to the drug development process for pharmaceutical firms large and small, primarily by improving on the cost, speed, or success of clinical trials. Specifically in the late-stage business, we believe top-tier CROs possess narrow economic moats because of their global scale, depth of data, and expertise. By contrast, we see the early-stage market as a highly competitive no-moat industry that provides a commoditized service with minimal opportunity for differentiation.

While we expect only low-single-digit growth in global biopharmaceutical research and development spending, increased outsourcing penetration should create favorable growth tailwinds for the entire CRO industry. We expect R&D outsourcing penetration to increase from 33% in 2012 to 43% by 2017. In addition, the ongoing shift to strategic partnerships—which has Big Pharma firms reducing the number of

CROs they use from dozens down to just one or two—should consolidate industry revenue among the six largest players, including ICON.

Economic Moat

We award ICON a narrow economic moat because of scale and expertise advantages. We believe the late-stage CRO business is highly conducive to moats for large players given the small number of global competitors, minimal invested capital needs, and the numerous ways CROs can add value to the development process and command premium prices.

The biggest factor driving clinical research organizations' moats is their global infrastructure, which creates a cost advantage over smaller competitors. Phase III trials usually require thousands of patients and frequently take place across many geographic locations. Trial sponsors need CROs with broad government and physician/investigator expertise and relationships. We believe the competition for these global contracts is limited to just the six largest CROs.

A secondary moat source for CROs is the intangible assets of their expertise, data, and reputation. CROs are able to retain experts on numerous different niche fields all across the globe. CROs' data and experience in thousands of trials helps clients position their trials for the highest probability of success. While CROs are not allowed to record proprietary data on their clients' specific drug interactions and results, they are able to retain data on enrollment in specific regions and investigator sites, which they use to advise future clients on site selection. CROs' data can also be used to predict more accurate time lines, which can lead trial sponsors to savings in other areas such as manufacturing.

Pharmaceutical and biotech firms will also award contracts based on a CRO's brand and reputation, giving an additional advantage to established players. Clinical trials are put under intense scrutiny by regulators, and even the slightest error or abnormality in a clinical trial can cause regulators to reject a drug or require a new trial. Trial sponsors want to see existing infrastructure and a long and successful track record from a CRO before putting the future of a potentially billion-dollar asset in its hands. Although the physical barriers to entry are low, a new CRO would have a very challenging time convincing pharmaceutical firms to trust it with their clinical trials.

Moat Trend

We award ICON and the other top-tier late-stage CROs with positive moat trends because of the industry's ongoing shift toward strategic partnerships. Historically, outsourcing had taken place on a project-by-project basis, which opened up the bidding process to hundreds of CROs. For instance, if a sponsor was outsourcing a specific trial in China, local CROs could bid on the project, even if they did not have the capability to handle the sponsor's other trials outside of China. Now, Big Pharma firms are looking to partner with just one or two CROs to handle their entire pipelines, limiting contracts to only global players. For example, Pfizer has reduced the number of CRO partners it uses from 17 to 2 (**Parexel** PRXL and ICON). In addition to limiting the pool of competitors, strategic partnerships are leading to longer contracts and are bringing CROs deeper into their clients' drug development process, creating stickier customers and higher switching costs.

Valuation and Scenario Analysis

Our fair value estimate is $50 per share, which implies 24 times our 2014 earnings forecast. We believe this multiple is justified given our expectation of an annual 13% top-line and 29% earnings per share growth rate over the next five years. The firm was forced to drastically increase staff levels ahead of the Pfizer partnership, which weighed on near-term margins. However, as the partnership matures and revenue flows in, ICON will see rapid margin expansion. We think operating margins can reach 13% by 2017, up from just 6.6% in 2012.

In our bear-case scenario—which would likely be driven by a slowdown in global R&D spending and lower-than-expected outsourcing—ICON could be worth $33 per share. If ICON were to see faster-than-expected revenue growth of 18% per year—perhaps driven by another large strategic partnership win—our fair value estimate could increase to $70 per share. M

Coach COH | ★★★★

Exemplary Stewardship Stock Focus | Paul Swinand

Moat	Moat Trend	Uncertainty	Stewardship	Stock Style
Narrow	Stable	High	Exemplary	Mid Core
Price/Fair Value	**Current Price ($)**	**Fair Value ($)**	**P/E**	**Yield (%)**
0.83	50.68	61.00	14.0	2.7
Market Cap ($bil)	**Credit Rating**	**P/B**	**P/S**	**P/FCF**
14.2	—	5.9	2.9	12.4

Total Returns (%) ■ Coach ■ S&P 500 Index

Fundamental Table

Fiscal Year Ended	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16
Sales ($ mil)	4,159	4,763	5,075	5,167	5,541	5,973	6,490
Sales Growth (%)	15.3	14.5	6.6	1.8	7.2	7.8	8.7
Operating Income ($ mil)	1,305	1,505	1,578	1,468	1,624	1,828	2,032
Operating Margin (%)	31.4	31.6	31.1	28.4	29.3	30.6	31.3
Free Cash Flow ($ mil)	753	1,037	1,173	946	1,117	1,319	1,449
Adjusted EPS ($)	2.92	3.53	3.73	3.49	4.05	4.80	5.63
Adjusted ROIC (%)	44.8	43.5	40.1	25.1	26.7	28.1	28.2

Source: Morningstar estimates.

Profile

Coach makes, distributes, and sells handbags and accessories and is expanding to broader product categories. Its products offer the quality of higher luxury brands but at more attractive prices. Although about 60% of sales come from its more than 450 North American retail stores, Coach also sells its products through department stores, international shops, the Internet, and its catalog.

Management & Stewardship

Lew Frankfort has served as chairman and CEO since 1995 and helped lead the firm through its initial public offering in 2000. At the end of calendar 2013, he will retire and be replaced by Victor Luis, who was head of international operations and is serving as president and chief commercial officer during the 2013 transition period. Luis has experience at Baccarat and LVMH earlier in his career. We believe his international experience will be important to the future of the firm. We rate Coach's stewardship of shareholder capital as exemplary given its long record of above-average returns and recent actions to return cash to shareholders.

Matt's Position

The best luxury brands like Cartier, **Tiffany** TIF, and Hermes can endure for over 100 years. Coach isn't quite in that class yet, and the company has a bit too much fashion risk for my taste. However, the valuation looks more reasonable than most of the other luxury companies we cover.

Morningstar's Take

Coach has developed a narrow economic moat through a brand that enables strong pricing, sourcing, and distribution advantages and capital efficiency. We believe these competitive advantages are sustainable over our explicit forecast period, resulting in excess economic profits.

Attention to capital efficiency and consumers' strong brand loyalty have been key drivers of Coach's economic returns. We judge brand to be more important in bags and leather accessories than other soft-goods categories. Despite Coach's long-run plans to increase penetration in footwear and ready-to-wear, we believe accessories will remain the core of the business. The men's business—just over 10% of sales—also offers some upside.

Coach's international business is still underdeveloped and represents an opportunity if growth continues on its current trajectory. Many investors assume that Coach's fortunes are too closely linked to those of the American consumer, but with long-run success in Japan as a guide, we think there is plenty of room for Coach to take share from European luxury goods makers in other markets. In Japan, Coach has posted flat to low-single-digit growth rates for the past 10 years, while other competitors generally have experienced declines.

The company only just entered Europe last year through department store partnerships. Although some investors question whether Coach will be able to compete with European bag makers, we believe there is room for new brands offering unique styles, makes, and prices. In China, Coach lags other luxury brands with respect to sales but has greater growth potential. The company grew its China business to more than $100 million in 2010 and projects that in fiscal 2014 it

will attain $530 million in sales. Coach should also see higher operating margins in China as it expands because of lower operating costs and higher gross margins. Similar estimates can be made for Europe, where Coach has just a small number of boutiques and dedicated shops in department stores. We estimate that the company could attain $500 million in sales in Europe over our forecast period.

Economic Moat

While Coach might not have complete pricing power due to the value positioning of its midtier luxury offerings, the company's ability to design, distribute, and source enable it to produce premium operating margins. Coach's gross margins and gross margin return on investment are among the best in our luxury coverage universe. In our opinion, Coach has a defensible economic moat. Brand history and the extensive directly operated and wholesale distribution network also contribute to the moat. Returns on capital have averaged over 40% for the last five years, despite the recession. Operating margins have averaged above 30%, better than the rate of many more prestigious luxury goods makers.

Valuation

Our fair value estimate is now $61 per share, down from $63 as a lower operating margin expected in fiscal 2014, slower-than-expected sales, and modestly higher capital expenditures weigh on our cash flow model. Our fair value estimate implies a multiple of 17 times forward earnings and approximately a 5% free cash flow yield, in line with the five-year historical range of 4%–6%.

For fiscal 2014, we project overall growth of less than 2%, with negative same-store sales growth in North America. Gross margins are now below 71%, and although cost pressures have diminished, we are modeling roughly 200 basis points of gross margin decline in fiscal 2014. Some additional selling, general, and administrative spending should produce operating margins just above 28%, down from over 31% in fiscal 2013.

Over our 10-year explicit forecast period, we model operating margins between 28% and 33%, with some cyclicality, and an average just under 31%. Top-line growth averages in the midsingle digits in our model.

Scenario Analysis

Under our upside scenario, we've assumed more optimistic growth, mainly because of China, but also good traction in Europe. In this scenario, top-line growth would average 9% over 10 years. Operating margins could rise above 32% within four years and remain high for the entire forecast period. In this case, our fair value estimate would be $83.

In our bear case, sales continue to be slow for multiple years. We model 1% average revenue growth for the first five years, accelerating to 4% annual growth for the last five years of our forecast period. In this case, operating margins average 29%–30%, and our fair value estimate would be $40.

Risk

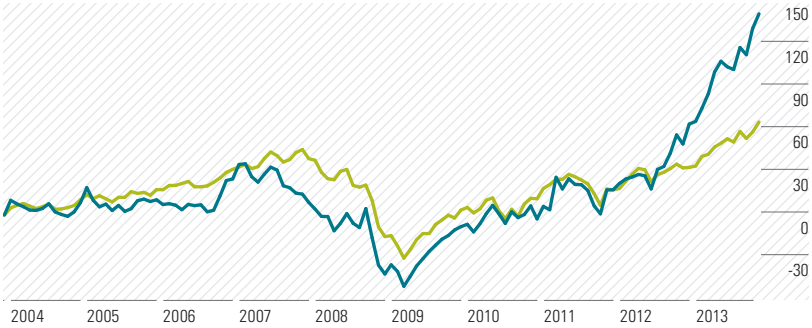
Remaining fashionable and overextending the brand are constant risks at Coach. Coach has embarked on an ambitious plan to expand its product lines and become a full lifestyle brand, not unlike many older and more prestigious European luxury brands. Footwear does leverage some advantages in leather sourcing, but in our opinion is a different category than bags and accessories. Men's accessories have lower risk, in our opinion, but we cannot be sure that the extension will not dilute the women's business. If Coach extends the brand too far, the company could damage its core business. While Coach has established a niche in the fashion world, and customers are very brand-loyal in the handbag and accessories category, Coach runs the risk that changes in tastes and preferences will eventually lead to consumers turning elsewhere. Coach also has been successful thus far extending the brand into new geographies, and a portion of our fair value estimate is based on that expansion continuing. Today, sales growth prospects appear strong, but there is a risk that new entrants or other market forces could derail international projects. M

Time Warner TWX ★★★

Wide-Moat Stock Focus | Michael Corty, CFA

Moat	Moat Trend	Uncertainty	Stewardship	Stock Style
Wide	Stable	Medium	Standard	Lg. Growth
Price/Fair Value	**Current Price ($)**	**Fair Value ($)**	**P/E**	**Yield (%)**
1.04	68.74	66.00	18.6	1.7
Market Cap ($bil)	**Credit Rating**	**P/B**	**P/S**	**P/FCF**
63.2	BBB+	2.1	2.3	17.5

Total Returns (%)



Fundamental Table

Fiscal Year Ended	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16
Sales ($ mil)	26,888	28,974	28,729	29,738	31,147	32,636	34,212
Sales Growth (%)	5.9	7.8	-0.8	3.5	4.7	4.8	4.8
Operating Income ($ mil)	5,739	5,955	6,214	6,854	7,250	7,706	8,189
Operating Margin (%)	21.3	20.6	21.6	23.0	23.3	23.6	23.9
Free Cash Flow ($ mil)	2,683	2,676	2,833	3,739	4,261	4,546	4,859
Dividends per Share ($)	2.51	2.83	3.28	3.73	4.17	4.78	5.44
Adjusted ROIC (%)	15.2	15.6	15.4	16.4	17.7	19.0	20.0

Source: Morningstar estimates.

Profile

Time Warner owns several television networks, including HBO, CNN, TNT, and the CW. The filmed entertainment segment creates and distributes movies and television programming. Warner Bros. and New Line Cinema combine to form the largest filmmaker in the world. The publishing unit includes titles such as People, Time, and Sports Illustrated. Time Warner generates about 30% of sales from outside the United States.

Management & Stewardship

We look favorably upon the current management team. Jeff Bewkes became CEO in January 2008 and became chairman a year later. Bewkes has a long history with the company. We think having a CEO with a background in running the key content businesses is a positive for shareholders, and Bewkes has protected the firm's valuable content while looking to monetize it in new ways. Bewkes was more willing than his predecessor to break up Time Warner's conglomerate structure, as evidenced by the company's spin-off of Time Warner Cable and AOL. We think recent capital-allocation decisions—more buybacks and fewer major acquisitions—are superior to those of most of Time Warner's peer media companies.

Matt's Position

There aren't many bargains in media right now. However, with the recent upgrade to our moat rating, I'll be keeping a closer eye on Time Warner. The company's HBO segment led the way to the current revolution in high-quality serial television.

Morningstar's Take

Time Warner's portfolio of cable networks, which includes HBO, generates about 70% of overall cash flow. We assign the company a wide economic moat, as its entrenched cable networks and successful content studio benefit from barriers to entry. Establishing a new cable network, developing worthy content, and gaining distribution agreements require huge upfront investments. Networks like TBS, TNT, and CNN are among the most widely distributed and watched cable networks; they generate a steady stream of advertising dollars as well as affiliate fees through long-term agreements with distributors.

Time Warner's premium HBO offering benefits from its award-winning original programming and is the nation's most widely distributed premium pay-TV service. While the network has not generated domestic paid subscriber growth during the past five years, HBO has benefited from fee increases and international subscriber growth. Also, the HBO Go streaming service has been a huge hit in attracting and retaining subscribers over the past few years.

The film and television entertainment studio, Warner Bros., generates about 20% of overall cash flow. While it is not specifically disclosed, we estimate that about half of segment cash flow comes from TV programming. We like the TV business better than movies, as the high demand for quality television content from the broadcast and cable networks ensures a steady stream of cash flow.

While most TV programs do not become hits, those that do can be monetized in several additional windows after their original airing, including international deals, syndication rights, and online streaming rights for **Amazon** AMZN and **Netflix** NFLX. We believe investors overlook Time Warner's deep library

of content and the fact that its studio continues to generate new TV and movie hits annually.

Economic Moat

We have upgraded our moat rating to wide from narrow. Our overriding premise in media continues to be that quality video content will get paid for. We've always viewed Time Warner as a great company, but uncertainty about the duration of its intangible asset competitive advantage beyond 10 years prevented us from placing it into the wide-moat bucket until now. As a vertically integrated content company that owns domestic and international channels and also owns much of the content on those channels, Time Warner should be able to withstand any potential disruption to its business model over the next 20 years. While there is plenty of debate regarding the long-term viability of the current pay-TV ecosystem, we believe that content and channel owners like Time Warner are well equipped to adapt to changes.

Intangible assets are the most common source of moats for entertainment firms like Time Warner. Video content is the core asset, and in most countries this intellectual property is protected by copyright laws, which allow owners to license the content at their discretion. With advances in technology, content is distributed in multiple ways and content owners can choose to license programming to a variety of distributors around the world.

We think replicating the company's large studio and generating a consistent flow of hit programs is much harder than many people assume, even with the emergence of new distribution methods outside traditional pay TV. Deep-pocketed companies like **Apple** AAPL and **Google** GOOG are often cited as significant threats to content-generating firms, but building from scratch would be much more challenging than it may seem. These technology-oriented firms seem more willing to license content and channels from the likes of Time Warner than compete directly in creating television programming.

Valuation and Scenario Analysis

We've increased our fair value estimate to $66 per share from $60, with the change largely driven by moving our moat rating to wide from narrow. Our fair value estimate implies a price/earnings ratio of 16 times our 2014 earnings per share estimate. We project overall average annual revenue growth of 4.5% through 2017. We expect average annual revenue growth of 5.6% for the cable networks, 4.3% for the film and TV studio, and flat sales in magazine publishing. Our cable network forecast assumes 7% average annual affiliate fee growth and 3% advertising growth over the next five years, fueled in part by international expansion. We expect overall operating margins to improve from 21.6% in 2012 to 24% in 2017. Time Warner's focus on cost containment, especially for nonprogramming expenses, should help offset continued investment in content.

Although our $66 fair value estimate reflects what we believe is the most likely outcome for Time Warner, we have contemplated downside and upside cases to frame our base assumptions. Our base case assumes the current pay-TV ecosystem remains solid, with an economic backdrop of slow growth and no significant downturns during the next five years.

In our downside case, the cable network business would be affected by a decline in pay-TV subscribers without a material offset in revenue from third-party distributors of video content. In this scenario, HBO would suffer from gradual subscriber losses in the U.S. due to competition and periods of economic weakness that force premium subscribers to cut back. This would lead to 2% average annual growth and 2017 operating margins of 21%. Our downside-case fair value estimate is $47 per share.

In our upside case, we assume traditional pay-TV pricing power continues without a decline in U.S. household penetration (currently 90%) and no material macroeconomic disruptions during our explicit forecast period. This scenario assumes 6.5% average annual revenue growth, including 8% growth for the cable networks thanks to strong advertising and affiliate fee increases. The strong growth would lift operating margins in 2017 to more than 26% and lead to a fair value estimate of $81 per share.

Late-Stage Trials Business Drives Narrow Moats for CROs

Industry Spotlight | David Krempa

Equity Analyst, Health Care

Top-tier clinical research organizations, or CROs, possess strong competitive advantages that should allow them to capture a disproportionate share of the rapidly growing market for outsourced research and development. Specifically in the late-stage clinical trials business, we believe CROs' global scale, depth of data, and expertise warrant narrow economic moats. Despite our expectation of low-single-digit annual growth in global biopharmaceutical R&D spending during the next five years, increased outsourcing penetration and market share gains by top players should drive double-digit revenue growth for our late-stage CRO coverage universe, as shown in Exhibit 01. Margin expansion from operating leverage and better asset utilization will create an even more pronounced impact on the bottom line, where we expect earnings per share to grow at a 21% compound annual rate over the next five years.

Exhibit 01 Late-Stage CRO Market Projections

$ Millions	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	5-YR CAGR
Global Development Spending	80,000	78,450	78,261	79,663	82,201	84,682	
Growth Rate (%)		-1.9	-0.2	1.8	3.2	3.0	1.1
Outsourcing Penetration (%)	32.5	35.0	37.0	39.0	41.0	43.0	
CRO Industry Revenue	26,000	27,458	28,957	31,068	33,702	36,413	
Growth Rate (%)		5.6	5.5	7.3	8.5	8.0	7.0
Big 4 CRO Market Share (%)	25.2	27.5	29.1	29.9	30.4	30.8	
Big 4 CRO Revenue	6,551	7,562	8,431	9,301	10,257	11,198	
Growth Rate (%)		15.4	11.5	10.3	10.3	9.2	11.3

Sources: Company reports, Morningstar estimates.

Exhibit 02 Revenue Sources for Leading CROs

	Estimated 2012 Revenue Sources (%)			
Company	Early Stage	Late Stage	Other	Other Businesses
Late-Stage CROs				
Quintiles Q	5	69	26	Contract Sales
Covance CVD	40	60	0	
ICON ICLR	5	95	0	
Parexel PRXL	10	65	25	IT, Communication
Early Stage CROs				
Charles River CRL	38	0	62	Research Models
WuXi WX	77	0	23	Manufacturing

Sources: Company reports, Morningstar estimates.

Large pharmaceutical firms have demonstrated an increased willingness to outsource clinical trials and sign long-term partnership agreements with CROs. We believe CROs add value to the drug development process by improving costs, speed, and success rates.

CROs Can Reduce Development Costs

With small, capital-constrained biopharmaceutical firms, cost savings from outsourcing can be enormous. However, even at larger firms with existing infrastructure, CROs can often reduce costs. Clinical trial demand at pharmaceutical firms tends to be lumpy. Pharma firms looking to conduct trials on their own either have to quickly hire employees when there is demand for a trial, or maintain permanent employees who would be idle during downtime. Trying to hire on demand results in weaker talent and delays.

CROs Can Speed Development

Covance CVD estimates that more than 50% of clinical trials do not meet their timeline or size targets for patient enrollment. CROs speed drug development through faster patient enrollment. CROs also aid trial sponsors through strategic planning, regulatory guidance, and data aggregation and analysis. CROs have accumulated patient databases as well as relationships with regulators and investigators around the world. This allows CROs to identify the specific locations and investigators that are most likely to deliver the necessary number of patients as quickly as possible. Since the patent clock is already ticking while a drug is in development, getting a product to market even a few months earlier can translate into huge financial gains for a trial sponsor.

CROs Have Experienced and Specialized Talent

By outsourcing to CROs, pharmaceutical firms are typically able to benefit from more specialized and

Quintiles Transnational Q	
Star Rating	★★★★
Size of Moat	Narrow
Moat Trend	Positive
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	0.84
Current Price ($)	41.99
Fair Value ($)	50.00
Sector	Healthcare
Market Cap ($bil)	5.6
P/E	29.0
Dividend Yield (%)	—

Covance CVD	
Star Rating	★★★
Size of Moat	Narrow
Moat Trend	Positive
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.05
Current Price ($)	89.26
Fair Value ($)	85.00
Sector	Healthcare
Market Cap ($bil)	5.0
P/E	31.0
Dividend Yield (%)	—

Parexel International PRXL	
Star Rating	★★★
Size of Moat	Narrow
Moat Trend	Positive
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	0.91
Current Price ($)	45.71
Fair Value ($)	50.00
Sector	Healthcare
Market Cap ($bil)	2.6
P/E	28.3
Dividend Yield (%)	—

Charles River CRL	
Star Rating	★★★
Size of Moat	Narrow
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	0.95
Current Price ($)	49.21
Fair Value ($)	52.00
Sector	Healthcare
Market Cap ($bil)	2.4
P/E	24.2
Dividend Yield (%)	—

experienced talent that can help with strategic decisions and trial design. Many pharmaceutical firms may not have enough demand to keep a full-time team dedicated to specific niches, such as regulatory affairs in Poland, or a rare form of cancer. CROs will have experts in those fields.

Late-Stage Trials Are Especially Attractive

We believe competitive advantages are strongest in the late-stage business, where the need for global scale limits competition to only the largest clinical research organizations. By contrast, the early-stage business has fewer barriers to entry and significantly more competition. The asset-heavy nature of early-stage trials also weighs on returns. CROs' exposure to late-stage clinical trials can be seen in Exhibit 02.

In the late-stage (Phase II and Phase III) business, there are few global competitors, minimal invested capital needs, and numerous ways for CROs to add value to the drug development process and command premium prices. CROs are essentially consultants to the trial sponsor (the pharma or biotech firm). CROs help clients with all aspects of the trial, including planning the size and structure of trials and comparator drugs to use, submitting the trial for regulatory review, choosing geographic regions and investigators, enrolling patients, collecting and analyzing data, and completing applications for regulatory approval.

Economic moats for CROs are based on their global infrastructure—including relationships with local physicians and regulators—and their intangible assets from expertise, data, and reputation. CROs are able to maintain experts on numerous different niche areas all across the globe. CROs' data and experience in thousands of trials help clients position their trials for the highest probability of success. Reputation is also critical. Regulators put clinical trials under intense scrutiny, and even the slightest error can cause a drug to be rejected.

Expected quality and speed, not price, are the primary decision drivers when clinical trial sponsors award contracts. Sponsors are willing to pay a premium to increase the probability that their trials will get completed on time and that data will be recorded accurately with all protocols followed. Less financially secure biotech or pharmaceutical companies may be tempted to use smaller CROs that try to undercut on price or overpromise enrollment sizes and timelines in an attempt to win business. However, these CROs have a much higher likelihood of failing to enroll the number of patients promised, which can result in significant delays and often requires another CRO to come in and rescue the trial. The risk/reward trade-off of choosing a smaller CRO to save a little money is rarely appealing, in our view.

In drug development, speed is paramount. Patent law puts pharmaceutical firms in a constant race against the clock. In the United States (and most developed countries), drug patents begin when the new molecule is discovered, so a significant amount of the patent life is eaten up during clinical trials. Getting a new drug to market faster gives the sponsor a longer time period to monetize the product. Timelines vary by size and complexity of trials, but it typically takes three to 12 months to pick investigator sites and get a trial approved by local regulators and another three to 12 months to enroll patients. We believe a top-tier CRO could easily shave a few months off of this process compared with a less sophisticated competitor. For a blockbuster product, an extra three months of patent protection could mean tens or even hundreds of millions of dollars worth of present value.

Partnerships Drive Positive Moat Trends

Pharmaceutical firms see numerous benefits to working closely with just one or two CROs. Despite less competition for bids, pharma firms are able to negotiate slightly lower prices by committing to the strategic partnerships. Partnerships also enable pharma firms to cut internal staff needed to manage many different CRO relationships.

The shift to strategic partnerships has subjected CROs to lower prices and higher customer concentration. Even so, we believe the transition is a net positive for top-tier players and is strengthening their competitive positions. Slightly lower prices are offset by stickier customers, increased volume, and more predictable workflow, which will allow CROs to better manage facility and staff utilization.

Upgrading Fox, Time Warner, and Discovery to Wide Moat

Industry Spotlight | Michael Corty, CFA

Senior Equity Analyst, Media

Twenty-First Century Fox FOXA	
Star Rating	★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.00
Current Price ($)	34.08
Fair Value ($)	34.00
Sector	Consumer Cyclical
Market Cap ($bil)	78.7
P/E	—
Dividend Yield (%)	0.7

Discovery Comm DISCK	
Star Rating	★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.13
Current Price ($)	82.71
Fair Value ($)	73.00
Sector	Consumer Cyclical
Market Cap ($bil)	20.1
P/E	30.0
Dividend Yield (%)	—

We believe **Twenty-First Century Fox** FOXA, **Time Warner** TWX, and **Discovery Communications** DISCK have achieved wide economic moats. We've always viewed these as great companies, but uncertainty about the duration of their intangible-asset competitive advantage beyond 10 years prevented us from placing them into the wide-moat bucket until now.

However, we have become convinced that these three vertically integrated content companies—which own domestic and international channels and much of the content on their channels—should be able to withstand potential disruptions to their business models. While there is plenty of debate regarding the long-term viability of the current pay-television ecosystem, we believe the content/channel owners are well equipped to adapt to a changing marketplace.

Content Owners Maintain Bargaining Power

Some pundits believe that the emerging changes in how consumers view content—on laptops, tablets, smartphones, and so on—will severely harm the pay-TV industry. We disagree. These additional ways to consume programming actually make quality content more valuable, as the number of firms generating content has essentially stayed the same. We estimate that the eight firms in Exhibit 01 control roughly 90% of pay-TV affiliate fees and advertising dollars in the United States.

Meanwhile, there are new distributors emerging that are looking to tap into the rich profit pool of delivering television service. **Verizon**'s VZ and **AT&T**'s T video offerings have clearly benefited the content firms over the past five years, as more competition among the distributors has made it almost impossible to stand up to affiliate fee increases. **Netflix** NFLX and **Amazon** AMZN have emerged as the leading streaming video on demand services, with most of the licensing agreements for dated content in a second window after original airing.

Other firms have been in the headlines recently with rumors about online subscription-based television packages. We are skeptical that these firms will be able to pose a material threat to the existing cable, satellite, and telecom companies. Regardless, more competition among distributors is better for content owners—who control the price of content and are wisely refusing to unbundle their channels. We view emerging distribution options as more of a threat to incumbent distributors such as **Time Warner Cable** TWC and **DirecTV** DTV than it is to the content and channel owners.

Content Ownership Is More Important Than Ever

We expect the large studios to maintain a competitive advantage even with some new entrants. There is plenty of internal competition among the existing media companies for top talent already, whether it is for writers, producers, or actors. We expect the established content studios to remain major players

Exhibit 01 Ownership of Major Domestic Channels

Disney	Twenty-First Century Fox	Comcast/ NBC Universal	Time Warner	CBS	Viacom	Discovery	Scripps
ABC	Fox (Broadcast)	NBC	TNT	CBS	Nickelodeon	Discovery Channel	Food Network
ESPN	Fox News	USA	TBS	Showtime	MTV	TLC	HGTV
Disney Channel	FX	CNBC	CNN	CBS Sports Network	VH1	Animal Planet	
A&E (50%)	Regional Sports Networks	E!	HBO		Comedy Central		
Lifetime (50%)		Comcast Sports Networks					
History (50%)							

Sources: Company reports, Morningstar.

Walt Disney DIS	
Star Rating	★★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.06
Current Price ($)	68.59
Fair Value ($)	65.00
Sector	Consumer Cyclical
Market Cap ($bil)	122.5
P/E	20.8
Dividend Yield (%)	1.1

Comcast CMCSA	
Star Rating	★★
Size of Moat	Wide
Moat Trend	Negative
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.22
Current Price ($)	47.60
Fair Value ($)	39.00
Sector	Comm. Services
Market Cap ($bil)	124.5
P/E	18.2
Dividend Yield (%)	1.6

AMC Networks AMCX	
Star Rating	★★
Size of Moat	Narrow
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.25
Current Price ($)	70.09
Fair Value ($)	55.00
Sector	Consumer Cyclical
Market Cap ($bil)	5.0
P/E	19.9
Dividend Yield (%)	—

Scripps Networks SNI	
Star Rating	★★
Size of Moat	Narrow
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.21
Current Price ($)	80.50
Fair Value ($)	66.00
Sector	Consumer Cyclical
Market Cap ($bil)	11.7
P/E	17.5
Dividend Yield (%)	0.8

for procuring original content, given the high level of investment required to launch one new show, let alone a series of programs.

When we think about the streaming video on demand providers like Netflix and Amazon, they are essentially bundling content, albeit on a smaller scale than a pay-television service. The fact that the most innovative distributors are bundling content is one sign that "breaking the cable bundle" via a la carte offerings is more unlikely than it sounds. In our view, bundling is here to stay. Even if all content eventually migrates to the Internet, we don't see why the popular channels of today can't simply become Internet channels.

With fragmentation among distributors coupled with more delayed viewing options available to consumers, we expect quality, unique programming to gain value. In theory, it should be easier for the average consumer to watch more of the "better" content, which puts the mediocre or easily replicable content at risk of losing value. The firms most likely to emerge as winners will be those with the strongest and most differentiated programming: Time Warner and Fox clearly fit this category, in our view.

Our Rationale for Recent Wide-Moat Upgrades

We believe the competitive advantages of television video content companies will be durable, even though we recognize that with advances in technology there is a chance that their business models could change materially (for better or worse). Intangible assets are the most common source of moats for entertainment firms. Video content is the core asset of these firms, and in most countries this intellectual property is protected by copyright laws which allow owners to license content at their discretion.

Most firms that own content also own channels that are part of a pay-TV channel bundle. These channels are valuable assets. Building a widely distributed channel from scratch is very difficult, because distributors universally believe they already offer enough channels. Ownership of widely distributed broadcast channels (available free over the air) generally depends on licenses from the government.

Given the strong demand for television content—especially in the U.S.—there is plenty of room for multiple wide-moat firms to coexist. Competition for hit programming and audience ratings among existing firms in the industry can be intense, but the lack of significant new entrants to the content creation business—in contrast to multiple new entrants to content distribution—has shifted the balance of power toward the content/channel owners, in our view.

Our level of confidence in a firm's ability to sustain a competitive advantage separates wide moats from narrow moats. Given the potential impact and uncertainty associated with technological changes in media, duration is a significant hurdle in determining moat ratings. Wide-moat firms stand out for their:

1. Vertically integrated business models. These companies own or control long-term exclusive rights to the programming that is featured on their valuable pay-television channels.

2. International channel ownership. If the returns earned in the mature U.S. media market decline because of internal competition or external factors, owning a selection of channels in growing international markets can help maintain long-term positive economic returns.

In contrast, we view firms such as **AMC Networks** AMCX, **CBS** CBS, **Scripps Networks** SNI, and **Viacom** VIAB as only having narrow economic moats. MI

Which Luxury Brands Have Wide Moats?

Industry Spotlight | Paul Swinand

Equity Analyst, Retail

Tiffany TIF	
Star Rating	★★
Size of Moat	Wide
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.20
Current Price ($)	79.17
Fair Value ($)	66.00
Sector	Consumer Cyclical
Market Cap ($bil)	10.1
P/E	23.4
Dividend Yield (%)	1.7

Coach COH	
Star Rating	★★★★
Size of Moat	Narrow
Moat Trend	Stable
Stewardship	Exemplary
Uncertainty	High
Price/Fair Value	0.83
Current Price ($)	50.68
Fair Value ($)	61.00
Sector	Consumer Cyclical
Market Cap ($bil)	14.2
P/E	14.0
Dividend Yield (%)	2.7

Ralph Lauren RL	
Star Rating	★★★
Size of Moat	Narrow
Moat Trend	Stable
Stewardship	Standard
Uncertainty	Medium
Price/Fair Value	1.00
Current Price ($)	165.64
Fair Value ($)	165.00
Sector	Consumer Cyclical
Market Cap ($bil)	15.0
P/E	20.9
Dividend Yield (%)	1.0

We recently upgraded our economic moat ratings on eight luxury goods companies to wide. We now believe that Burberry, Richemont (parent of Cartier), Kering (parent of Gucci), LVMH, Prada, Hermes, **Tiffany** TIF, and Swatch Group have sustainable competitive advantages that should allow excess returns on capital to persist over an extended horizon. (Note that the European companies are not listed on major U.S. stock exchanges, but shares may trade on the over-the-counter market.)

The primary source of economic moats across the luxury category is intangible assets, derived from brand equity and pricing power built up over many years of consumer experiences with those brands. We maintained our narrow moat ratings for **Coach** COH and **Ralph Lauren** RL. While these companies also enjoy strong returns on invested capital, the narrow moats reflect their elevated fashion risk and our somewhat lower level of confidence that high returns will be sustained.

Wide Moats Indicate Enduring Brands

Despite many competitors in the market, the status of major luxury brands in consumers' minds will be very difficult to displace, in our view. Wide-moat luxury companies have cultivated their brand images over the course of decades—in some cases 150 years or more—giving them tremendous pricing power and making it inherently difficult for competitors to gain traction. Premium prices, which at the high end can even enhance a brand's status, result in high margins and returns on capital.

Wide-moat luxury brands have survived for many years, and though they have faced ups and downs over their histories, they have always been able to regain their leadership positions. For example, Tiffany's management mistakenly diluted the brand in the past, but it was restored by returning to the firm's original premium positioning. Hermes and Burberry have also both had tough periods in the 150 years since opening their doors. We believe that the other wide-moat brands would demonstrate similar resilience. For example, if Dom Perignon Champagne (a division of LVMH) were to experience a few bad years for its sparkling wine, we believe the brand could easily be brought back with proper marketing and management. (In practice, LVMH doesn't release vintage wine under the Dom Perignon name if it's not up to standards.) The public views Dom Perignon as among the top Champagne houses, and the brand cannot be destroyed overnight.

Moat Trends Are Stable

Although we rate the moat trends of all the luxury companies as stable, we believe that the ongoing globalization of luxury brands gives some advantages to large incumbents with sufficient capital to expand internationally. If the image of a brand is global, it is likely even harder to change that image in every country, rather than in just a few. In addition, all of these companies have benefited from scale, increasing operating margins as they expanded sales during the last 10 years. Smaller luxury companies might have a harder time locating stores or getting the critical marketing and publicity mass to attack new markets such as China.

Still, a brand that has been at the top of its category for 100 years or more should have a stable position in the marketplace. Despite the improvements in operating statistics we currently see, we believe our wide moat ratings already capture the durability of the brands, and that they will not change their relative competitive position in the market as they grow.

Narrow Moats More Vulnerable to Competition

While Coach and Ralph Lauren both have long histories and strong brands built up over many years of image-making (Coach was founded in the 1950s; Ralph Lauren in the 1960s), we believe that their brands are not as strong as the longer-lived and more prestigious brands that are rated wide moat. Our lower rating is an explicit acknowledgement that we are less certain that the current high returns on capital will persist over time. In both cases, we

also believe that the brands have at times been stretched in search of top-line growth, which can alter consumers' perception of the high-end positioning of the brand.

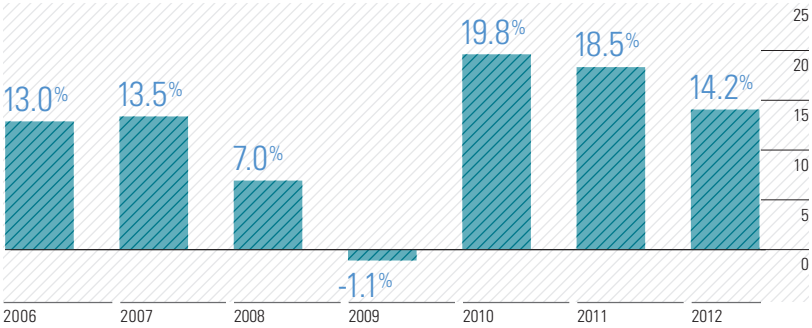
Demand Rebounded Quickly After Recession

On average, the publicly traded luxury firms barely saw a decline in sales in 2009, which was followed by a revenue gain of nearly 20% in 2010, as shown in Exhibit 01. Despite the collapse in real estate and equity values caused by the 2008–09 financial crisis, sales of luxury goods suffered less than many had feared. Luxury goods are by definition extremely discretionary—one doesn't "need" jewelry, handbags, or high-fashion items. However, the financial crisis demonstrated that cash flows of luxury companies are more defensive than you might expect. The luxury companies have also been helped by increasing demand from developing markets such as China.

Flagship Stores Reinforce Brand Equity

Flagship stores contribute to luxury companies' competitive advantage from intangible assets. Flagship stores in key locations both reinforce brand equity and create a barrier to entry. For example, Tiffany's flagship New York City store appears in the opening scene of the film "Breakfast at Tiffany's," giving it a place in the cultural legacy that can't be replicated. This store has historically generated around 10% of Tiffany's sales. In a time when digital shopping is engaging customers in new ways, we still believe grand, historically significant stores in gateway cities are a key component to luxury companies' brand images.

Exhibit 01 Average Revenue Growth, Publicly Traded Luxury Firms



Sources: Company reports, Morningstar.

Leather Goods Enjoy High Brand Loyalty

Because leather goods such as handbags have fit, feel, and performance attributes, consumers often replace bags with the same brand. Consumers also tend to be less price-sensitive because the items can be used more frequently. Leather goods are recognizable status symbols, and consumer knowledge of the retail value of the top brands contributes to the desire to own them. The three companies with dominant leather goods brands, Coach, Prada, and Hermes, all exhibit high gross margins (averaging more than 70%), high operating margins (averaging more than 30%), and high returns on invested capital (as high as 40%). Using available segment information, Kering's Gucci and LVMH's Leather Goods division both generate operating margins in the 30% range, too.

Infrequent Buying Can Support Higher Prices

Watches and high-end jewelry are purchased infrequently and also tend to be highly durable. A diamond engagement ring, for example, is intended to last for a lifetime. A fine Swiss watch can be passed down for generations. Consumers are less price-sensitive when purchasing such items, and the top brands' images and assurance of quality serve as a stamp of authenticity and of value. For example, a Tiffany ring with the original blue box and certificate will typically fetch higher prices at resale compared with unbranded diamonds, which usually can only be sold in the resale market at a discount to wholesale replacement cost.

High Fashion Has Lower Long-Run Brand Loyalty

While fashion apparel brands generally have high markups and strong gross margins, the category exhibits lower brand loyalty and higher frequency of purchase, affording customers the ability to switch brands easily. Consumers purchase apparel based on fashion trends and seasonal needs, and might switch to a different brand in the following season based on changing tastes, colors, and styles. While fashion-apparel-driven brands can have excellent financial metrics during years when their popularity is high, they rarely develop into timeless, multicategory, global luxury brands. M

Expanding-Moat Watchlist

More Expanding-Moat Watchlist Information!
This list contains companies with wide or narrow moat ratings and positive moat trend ratings. It is sorted by price/fair value ratio.

If you wish to read more about any of the companies on the Expanding-Moat Watchlist, please visit **msi.morningstar.com**. We have made available the analyst reports for each of the companies on the watchlist.

Company Name	Star Rating	Moat Trend	Fair Value Uncertainty	Price/Fair Value	Current Price	Fair Value	P/E (TTM)	Yield (%)	Comments
Ultra Petroleum UPL	★★★★★	Narrow	High	0.46	18.36	40	—	0.0	Low-cost natural gas exploration and production, but valuation depends on our bullish outlook for gas prices.
Cloud Peak Energy CLD	★★★★★	Narrow	High	0.56	15.61	28 ↑	7.1	0.0	Cost advantages versus other coal mines, but environmental regulation is a major headwind to growth.
American Tower AMT	★★★★	Narrow	Medium	0.79	79.35	100	60.2	1.4	A top prospect for the Hare; American Tower is benefiting from consumers' insatiable demand for mobile data.
Enbridge ENB	★★★★★	Wide	Low	0.80	43.39	54	44.2	2.8	Enbridge has a first-mover advantage in the Canadian oil sands, with plentiful opportunities for growth.
ICON ICLR	★★★★	Narrow	Medium ↓	0.81	40.49	50 ↑	27.5	0.0	CROs' competitive position is strengthening through strategic partnerships, such as Icon's deal with Pfizer.
Cameco CCJ	★★★★	Narrow	High	0.83	19.00	23	25.6	2.0	A uranium miner that our analysts think is benefiting from an improving cost position.
Biomarin Pharmaceutical BMRN	★★★★	Narrow	Medium	0.83	62.88	76 ↑	—	0.0	Focus on ultrarare diseases limits competition and creates substantial pricing power.
eBay EBAY	★★★★	Wide	Medium	0.84	52.71	63	25.1	0.0	Enhancing network effect as buyers and sellers flock to eBay and PayPal.
Quintiles Transnational Q	★★★★	Narrow	Medium	0.84	41.99	50	29.0	0.0	Leader among CROs. Quintiles had a hand in developing all of the top 50 best-selling biopharmaceuticals.
Crown Castle International CCI	★★★★	Narrow	Medium	0.84	76.02	90	—	0.0	Tower firms have been prime beneficiaries of increased demand for mobile data.
First American Financial FAF	★★★	Narrow	High	0.86	25.86	30	12.4	1.9	Refinancing business at risk through rising interest rates, but this is offset by improving real estate resale.
TransCanada TRP	★★★★	Narrow	Low	0.87	45.11	52	21.4	4.0	TransCanada hopes to capitalize on Canadian oil sands, but regulatory approval of Keystone XL is uncertain.
Apple AAPL	★★★	Narrow	High	0.87	522.70	600	13.0	2.3	Adoption of iPads, iPhones, and iOS creates a virtuous cycle of increasing switching costs.
Nucor NUE	★★★	Narrow	Medium	0.91	51.77	57 ↑	32.6	2.8	Steelmaker with differentiated production process, leading to improved position on industry cost curve.
Parexel International PRXL	★★★	Narrow	Medium ↓	0.91	45.71	50 ↑	28.3	0.0	Another CRO benefiting from market share consolidation through strategic partnerships.
Cameron International CAM	★★★	Narrow	Medium	0.91	54.86	60 ↓	19.4	0.0	Joint venture with Schlumberger could differentiate Cameron's offshore drilling equipment.
ONEOK Partners OKS	★★★	Wide	Medium	0.93	53.77	58	14.7	5.4	ONEOK is well positioned to meet a growing need for natural gas liquids transportation.
Intuitive Surgical ISRG	★★★	Wide	High	0.93	371.50	400	22.2	0.0	Intuitive had a great run, but it seems to have hit a wall in systems sales because of market saturation.
Varian Medical Systems VAR	★★★	Narrow	Medium	0.93	72.58	78	18.2	0.0	Competitor exits should improve Varian's market share in radiation oncology.
Williams Partners WPZ	★★★	Wide	Medium	0.93	51.42	55	17.2	6.8	Pipeline operator ideally situated for booming gas production in the Marcellus Shale.
Deere DE	★★★	Narrow	Medium	0.94	81.84	87	9.4	2.5	Improving quality of the dealer network will cement Deere's position as a leader in farm equipment.

Data as of Oct. 31, 2013. Fair value based on Morningstar analyst estimates. ↑ = Rating Upgrade ↓ = Rating Downgrade

Wide-Moat and Market Statistics

Wide-Moat Firms With ...

Highest Yield (%)		Lowest Trailing Price/Earnings Ratio		Best Price/Fair Value Ratio	
Boardwalk Pipeline Partners BWP	7.1	Weight Watchers International WTW	7.6	Weight Watchers International WTW	0.64
Williams Partners WPZ	6.8	Western Union WU	10.8	Exelon EXC	0.68
Kinder Morgan Energy Partners KMP	6.7	Exxon Mobil XOM	10.9	Express Scripts ESRX	0.70
El Paso Pipeline Partners EPB	6.4	Eli Lilly LLY	11.4	Kinder Morgan Management KMR	0.77
Buckeye Partners BPL	6.3	Cisco Systems CSCO	12.2	Western Union WU	0.77
Holly Energy HEP	6.2	International Business Machines IBM	12.4	Novo Nordisk NVO	0.80
Cheniere Energy Partners CQP	5.5	Caterpillar CAT	13.1	Enbridge ENB	0.80
ONEOK Partners OKS	5.4	Intel INTC	13.2	Berkshire Hathaway BRK.B	0.80
AstraZeneca AZN	5.3	Microsoft MSFT	13.2	Potash Corporation of Saskatchewan POT	0.82
Altria Group MO	5.2	AstraZeneca AZN	13.4	Sanofi SNY	0.82

Market Snapshot	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct
Market Valuation									
S&P 500 P/E (TTM)	15.6	16.2	16.5	16.8	16.3	17.1	16.4	16.9	17.7
S&P 500 Dividend Yield (%, TTM)	2.1	2.0	2.0	2.0	2.1	2.0	2.0	2.0	2.0
Morningstar Median P/FV	1.01	1.01	1.02	1.01	0.99	1.02	0.99	1.02	1.04
Economic Data									
Unemployment Rate (%)	7.7	7.6	7.5	7.6	7.6	7.4	7.3	7.2	—
Change in Nonfarm Payrolls (Thou)	+332	+142	+199	+176	+172	+89	+193	+148	—
12-Month CPI Inflation (%)	2.0	1.5	1.1	1.4	1.8	2.0	1.5	1.2	—
Energy Prices									
Natural Gas ($/MMBTU, HH Spot)	3.48	4.03	4.30	4.02	3.57	3.46	3.57	3.48	3.55
Crude Oil ($/Barrel, WTI)	92.03	97.24	93.22	91.93	96.36	105.10	107.98	102.36	98.74
Yield Curve									
1-Month Treasuries (%)	0.07	0.04	0.03	0.03	0.02	0.03	0.02	0.03	0.03
2-Year Treasuries (%)	0.25	0.25	0.22	0.30	0.36	0.31	0.39	0.33	0.31
10-Year Treasuries (%)	1.89	1.87	1.70	2.16	2.52	2.60	2.78	2.64	2.57

Morningstar Index Returns (%)	1-Year	5-Year
Large-Cap Growth	26.6	17.1
Large-Cap Value	21.4	11.2
Basic Materials	18.8	14.1
Consumer Cyclical	41.1	26.2
Financial Services	36.9	9.0
Real Estate	8.5	14.4
Communication Services	22.0	23.0
Energy	23.5	15.7
Industrials	38.1	17.0
Technology	21.5	17.5
Consumer Defensive	24.0	15.1
Healthcare	36.1	17.8
Utilities	11.4	11.2

Median Price/Fair Value Estimates

Coverage Universe	1.04
Moat Rating	
Wide	1.02
Narrow	1.03
None	1.08
Fair Value Uncertainty	
Low	1.00
Medium	1.05
High	1.04

Sector	
Basic Materials	0.95
Consumer Cyclical	1.08
Financial Services	1.03
Real Estate	1.01
Communication Services	1.00
Energy	0.96
Industrials	1.09
Technology	1.09
Consumer Defensive	1.05
Healthcare	1.05
Utilities	1.04

Sources: Morningstar, S&P, BLS, EIA, Federal Reserve. Data as of Oct. 31, 2013 or latest available.

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Performance: Portfolios vs. S&P 500 (%)

Period	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD 2013	Cumulative [1]	Annualized [1]
Tortoise	26.2	13.1	8.0	13.7	1.6	-22.2	19.4	9.7	7.3	14.9	21.6	192.5	9.1
Hare	26.3	26.9	3.2	22.0	5.2	-32.4	45.6	14.3	1.4	20.8	25.5	181.8	8.7
Combined [2]	26.2	18.8	5.8	17.3	3.3	-26.8	30.5	11.9	4.5	17.7	23.5	187.1	8.9
S&P 500	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	25.3	84.5	5.1
Relative	-2.5	7.9	0.9	1.5	-2.2	10.2	4.1	-3.2	2.4	1.7	-1.8	102.6	3.8

Performance through Oct. 31, 2013. Returns include interest and reinvested dividends, both for our portfolios and the S&P 500 benchmark.
[1]Since inception June 18, 2001. [2] Time-weighted, assuming equal investments at inception.

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