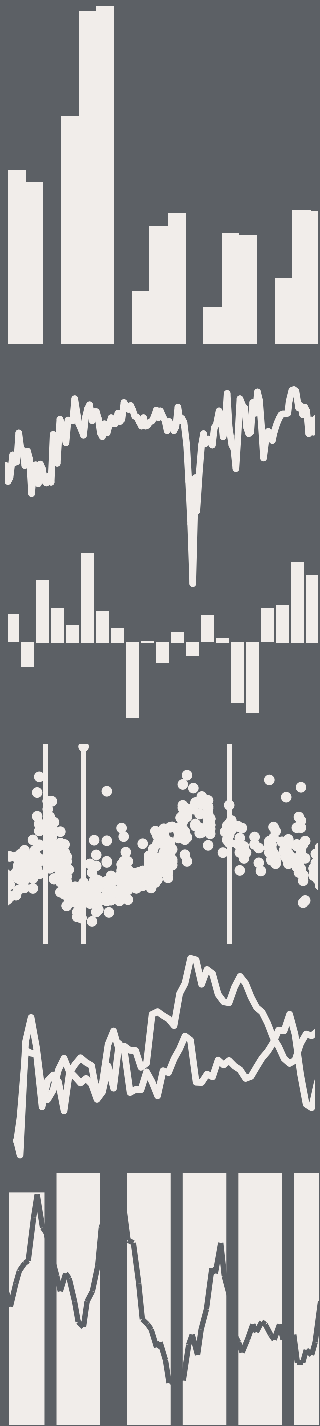

Morningstar® Markets Observer

4th Quarter 2014

Data as of September 30, 2014

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Market Overview

Market Dashboard

The third quarter was not a stellar one for stocks, with six out of the nine Morningstar Style Box categories posting negative returns. Emerging markets are the cheapest equity asset class, trading at around 13 times current earnings. For all the talk about rising interest rates, the 10-year Treasury is down over the last year. Commodities' dismal returns over most time periods are worrisome, to say the least.

		Return (%)				
Equities	**12 Mo. Yield**	**YTD**	**3 Mo**	**1 Yr**	**3 Yrs**	**5 Yrs**
S&P 500	1.8	8.3	1.1	19.7	23.0	15.7
Russell 2000	1.4	–4.4	–7.4	3.9	21.3	14.3
MSCI EAFE	3.4	–1.4	–5.9	4.3	13.6	6.6
MSCI Emerging Markets	2.8	2.4	–3.5	4.3	7.2	4.4
Fixed Income	**Curr. Yield**					
U.S. Aggregate	2.4	4.1	0.2	4.0	2.4	4.1
U.S. Corporates	3.4	5.7	–0.2	6.7	5.8	7.2
High Yield	6.5	3.6	–1.9	7.2	10.9	10.4
Municipals	2.2	7.6	1.5	7.9	4.6	4.7
Emerging Markets	5.4	8.0	–0.6	9.7	7.9	8.0
Broad Commodities						
Bloomberg Commodity		–5.6	–11.8	–6.6	–5.3	–1.4
Morningstar Commodity		–7.0	–13.2	–7.2	–1.8	3.5

Fundamental Measures			
P/E	**P/B**	**P/S**	**P/C**
18.4	2.6	1.8	11.2
19.8	2.0	1.2	10.4
15.9	1.6	1.0	8.8
12.8	1.5	1.2	7.0

Interest Rates	**Current**	**1 Yr Ago**
2 Yr Treasury	0.6	0.3
5 Yr Treasury	1.8	1.4
10 Yr Treasury	2.5	2.6
20 Yr Treasury	3.2	3.7
Prime Rate	3.3	3.3
Commodities		
Brent Crude Oil	95.5	108.6
Gold	1,216.5	1,326.5

3–Month Return

	Value	Blend	Growth
Large	0.2	1.7	2.2
Mid	–3.2	–1.1	–1.3
Small	–6.4	–6.0	–6.1

1–Year Return

	Value	Blend	Growth
Large	18.3	18.6	22.7
Mid	17.1	18.6	11.8
Small	11.1	9.5	2.6

5–Year Return

	Value	Blend	Growth
Large	13.5	16.3	16.6
Mid	17.1	18.5	16.7
Small	16.2	15.3	15.9

Return (%)

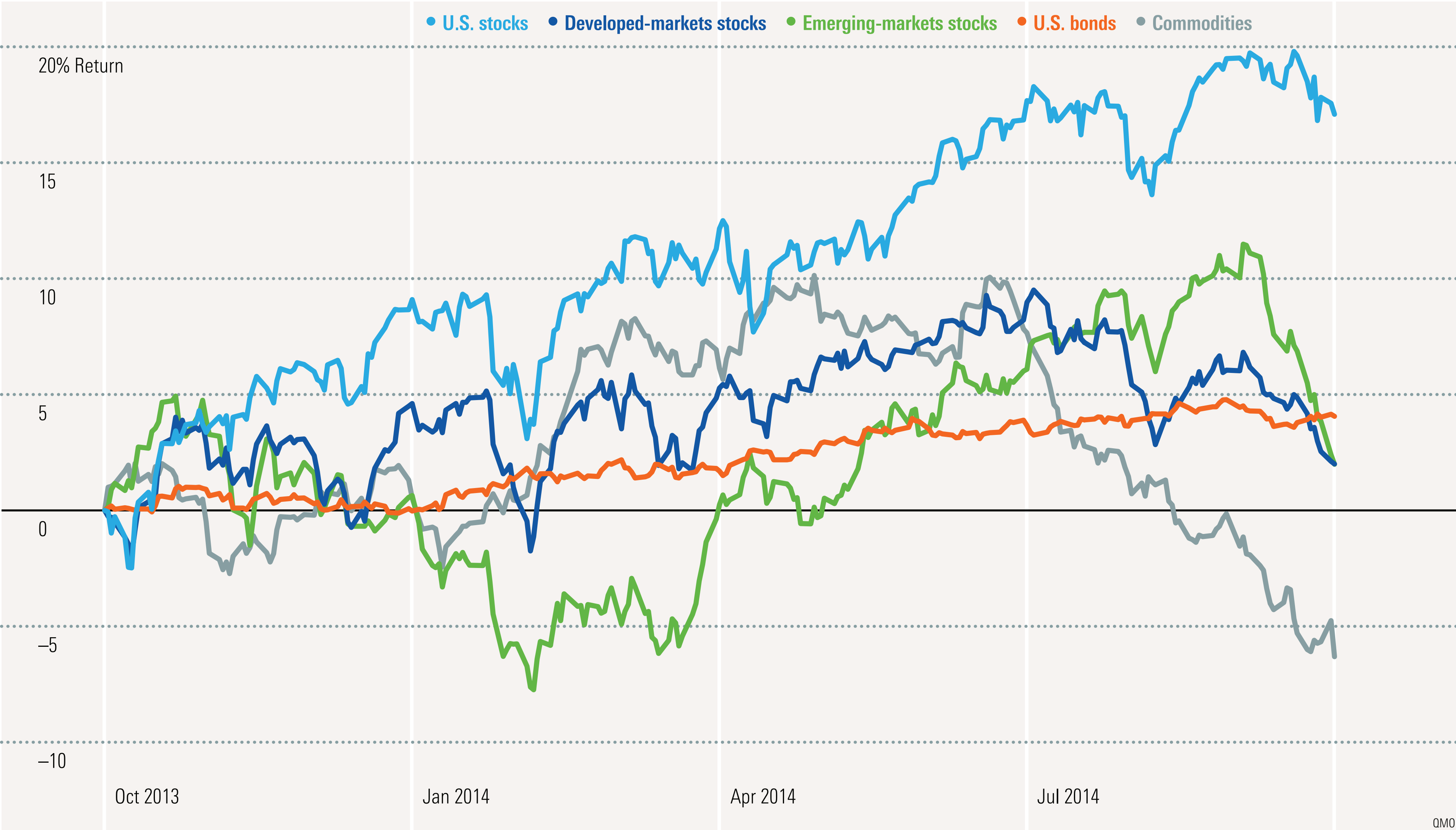
> 20
10 to 20
0 to 10
–10 to 0
–20 to –10
< –20

QM05

Source: Morningstar Direct. U.S. Aggregate—Barclays U.S. Aggregate Bond Total Return, U.S. Corporates—Barclays U.S. Corporate 5-10 Year Total Return, High Yield—Bank of America Merrill Lynch U.S. High Yield Master II Total Return, Municipals—Barclays Municipal Total Return, Emerging Markets—JP Morgan EMBI Global Diversified Total Return, Gold—London Fix Gold PM Price Return.

Trailing 12-Month Performance of Major Asset Classes

Despite increased volatility, U.S. stocks have held up quite well over the past year, substantially outperforming all other asset classes. Emerging-markets stocks were strong in Q1 and Q2, but that trend reversed sharply in Q3, amid global growth concerns. Commodities also registered a drastic decline; oil prices dropped by 12% during the third quarter.



Source: U.S. stocks—Wilshire 5000 Total Market Index. Developed-markets stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. Emerging-markets stocks—Morgan Stanley Capital International Emerging Markets Index. U.S. bonds—Barclays U.S. Aggregate Bond Index. Commodities—Bloomberg Commodity Index.

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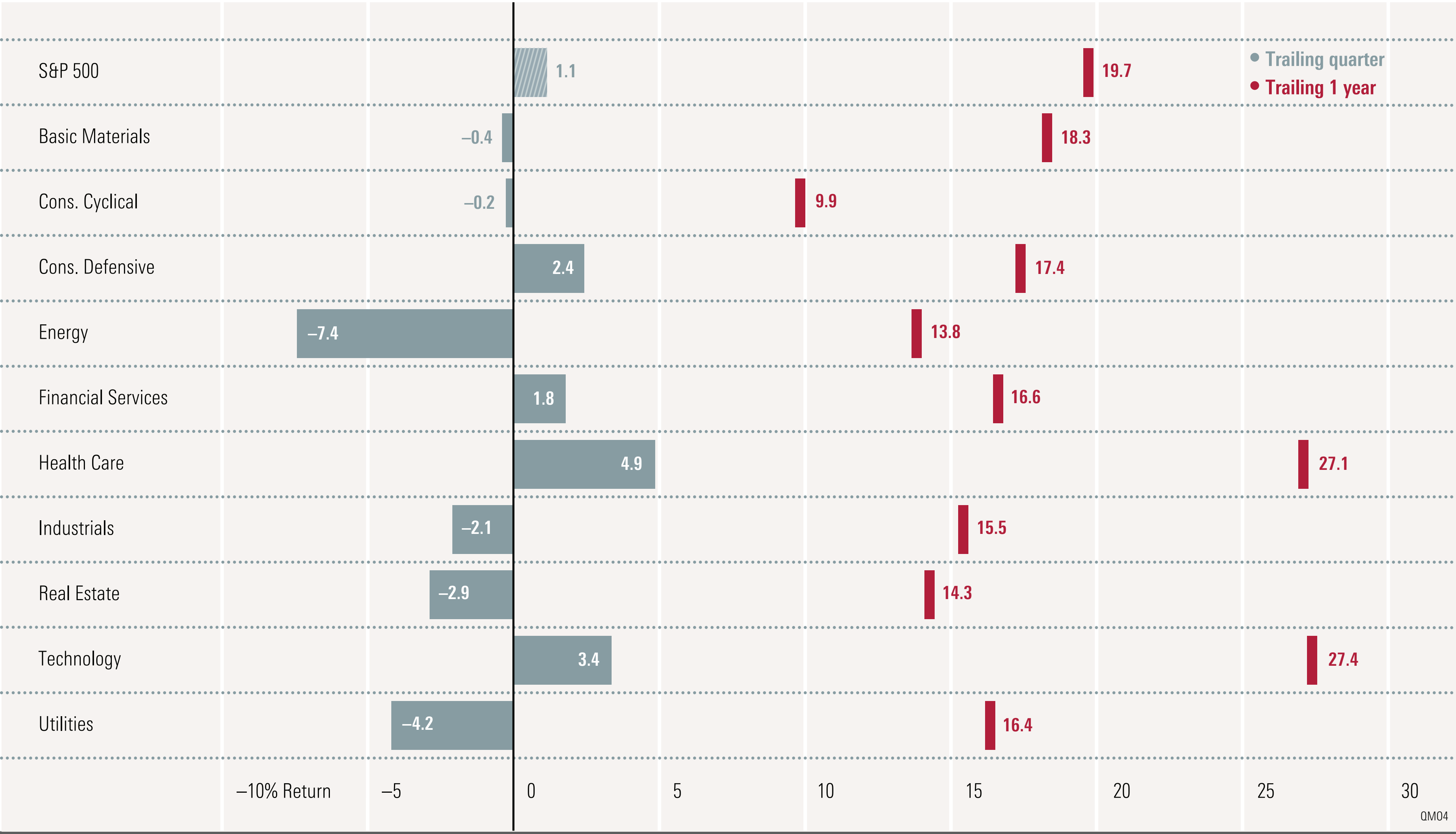
U.S. Sector Performance

As oil prices dropped, the energy sector posted the largest negative return for the third quarter. On the positive side, health care and technology have outperformed all other sectors, both over the past year and in the past quarter, in anticipation of aging baby-boomer demand and continued innovation from technology companies.



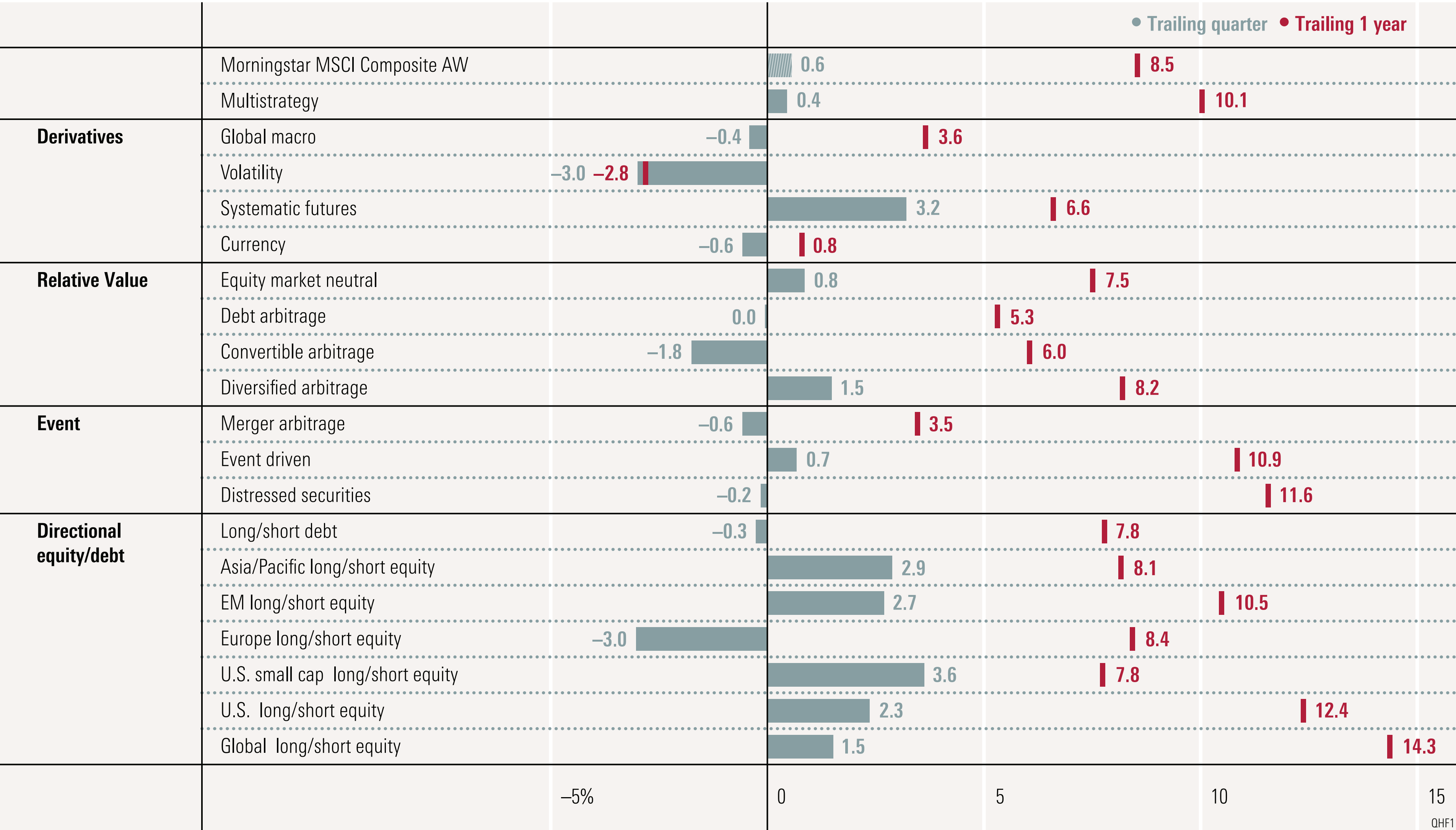
Source: Morningstar Sector Indexes.

Emerging Markets Weakening Amid Global Growth Concerns

After a strong Q1 and Q2, both emerging and developed markets turned negative in Q3 because of slowing growth in China and worries of another European recession. There is no clear consensus in Europe as to whether the negative run will continue through to year-end. Ongoing macro negativity will strengthen financial markets' belief that QE by the European Central Bank is the only way forward.

Hedge Fund Category Returns

Europe long/short equity and volatility posted negative returns for the second quarter. Over the past year, global and U.S. long/short strategies were the best performers.



Asset-Class Winners and Losers

In 2013, U.S. and international developed-market equities crushed all other investment categories. However, in 2014, only U.S. large stocks maintained strong performance. U.S. small stocks and international developed-market stocks registered dramatic performance reversals year-to-date. Commodities continued their losing streak of the last few years.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 YTD	Entire Period
Highest return	66.4%	42.2	10.8	34.0	56.3	26.0	34.5	32.6	39.8	14.1	79.0	28.4	9.4	18.6	37.9	8.3	10.9
	31.1	12.3	8.5	13.5	47.7	20.7	25.5	26.9	31.8	–3.2	58.2	23.6	5.2	17.9	32.4	3.7	9.3
	27.3	9.7	5.3	11.1	39.2	20.4	14.0	17.0	11.6	–26.2	37.7	19.2	5.0	16.5	23.3	3.5	9.3
	21.0	7.7	5.3	–1.4	29.0	17.6	5.8	15.8	10.3	–33.8	32.5	15.1	2.1	16.0	7.4	2.7	7.3
	17.8	–5.9	–2.4	–6.0	28.7	11.1	4.9	11.8	6.0	–36.1	26.5	15.1	–2.6	15.8	0.6	2.3	6.3
	2.4	–9.1	–11.9	–15.7	24.7	10.9	2.7	4.9	5.5	–37.0	20.9	8.5	–5.3	11.2	–2.3	–1.0	5.2
	–0.7	–14.0	–21.2	–20.4	7.9	4.9	1.1	3.6	1.9	–43.1	19.5	8.2	–11.7	3.7	–2.7	–1.1	5.0
Lowest return	–1.5	–30.6	–23.1	–22.1	2.7	3.0	0.7	–0.2	–0.7	–53.2	–1.4	7.1	–18.2	2.5	–3.7	–7.0	4.7

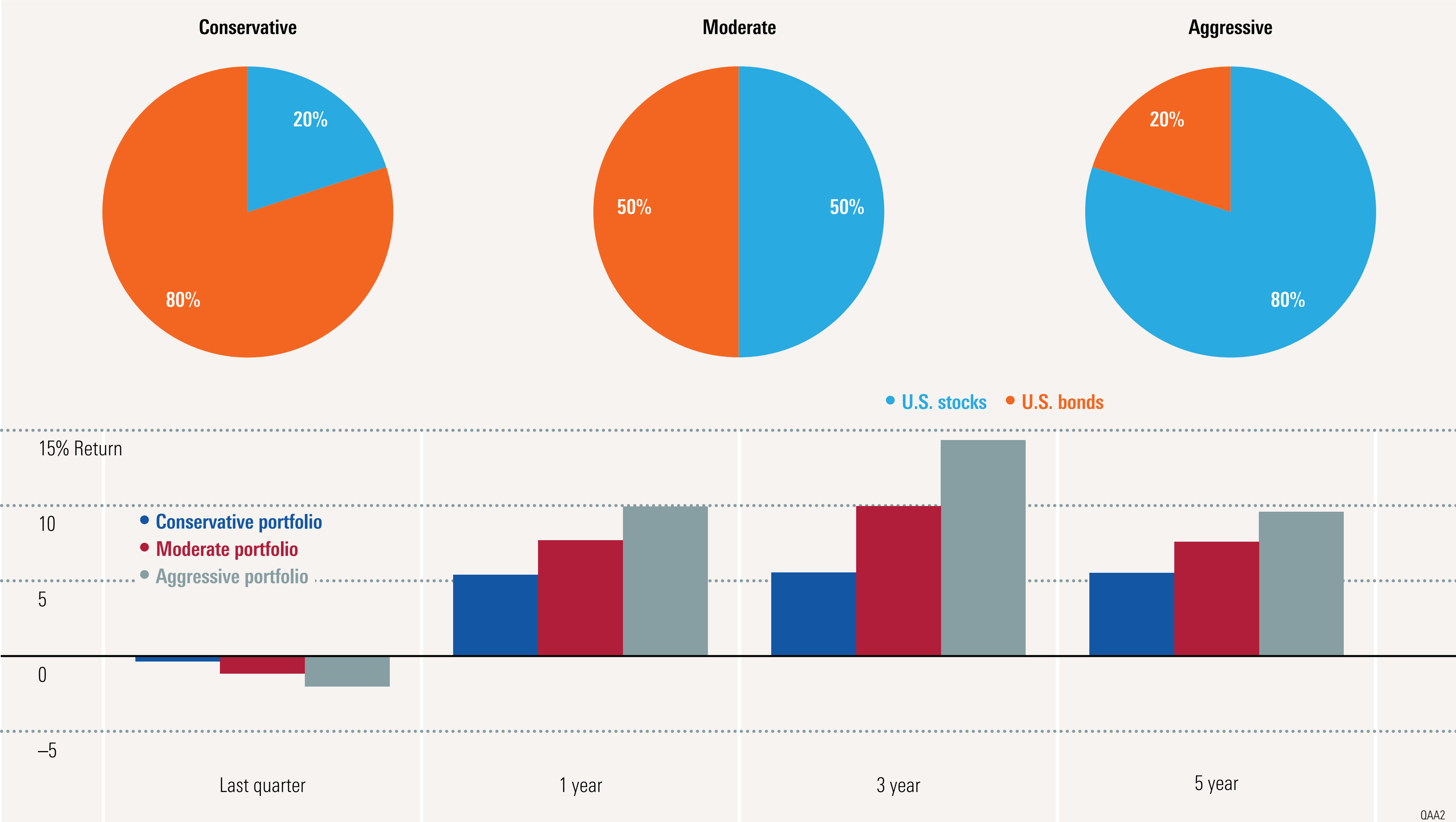
- Small stocks
- Large stocks
- International-developed stocks
- Emerging-market stocks
- Intermediate-term government bonds
- Intermediate-term corporate bonds
- High-yield bonds
- Commodities

QAA1

Source: Small stocks—Ibbotson® Small Company Stock Index. Large stocks—S&P 500®. International-developed stocks—MSCI EAFE®. Emerging-market stocks—MSCI Emerging Markets Index. Intermediate-term government bonds—Morningstar Intermediate U.S. Government Bond Index. Intermediate-term corporate bonds—Morningstar Intermediate Corporate Bond Index. High-yield bonds—Barclays U.S. High Yield Corporate Bond Index. Commodities—Morningstar Long-Only Commodity Index.

Performance of Risk-Based Portfolios

Strong stock market performance has caused the aggressive portfolio to approximately double the return of the conservative portfolio over 1-, 3-, and 5-year periods. However, the rewards for taking more risk may not always be as apparent over shorter time periods.



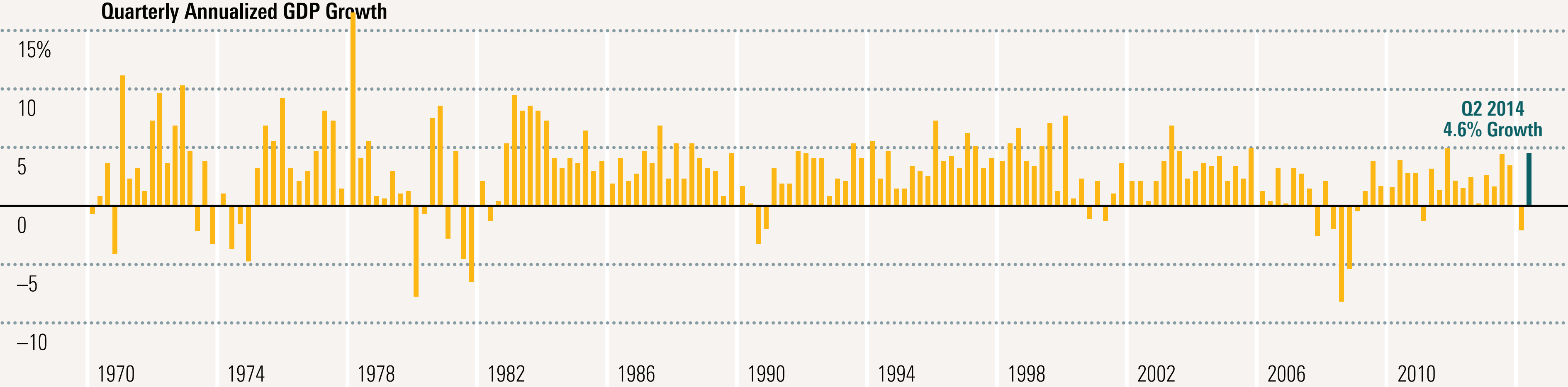
Source: Stocks—Morningstar Global Total Return Index. Bonds—Morningstar Core Bond Total Return Index. Returns for periods longer than 1 year are annualized. Portfolios are rebalanced annually.

Economic Indicators

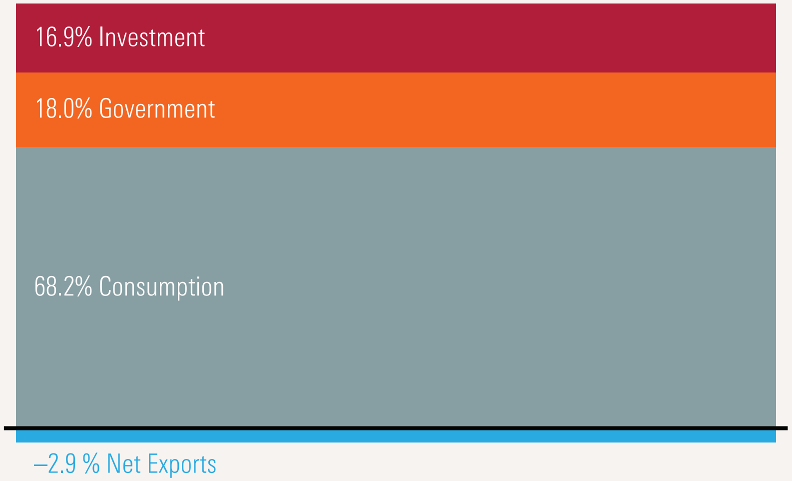
Real U.S. GDP Growth Stuck in the 2.0–2.5% Range

The U.S. economy bounced back in the second quarter, growing 4.6%, more than recovering the 2.1% decline of the first quarter. It appears that weather and massive inventory adjustments accounted for most of the large swing. Despite the volatile first half performance, the U.S. is expected to grow 2.0%–2.5% for the full year, about the same as in the last four years.

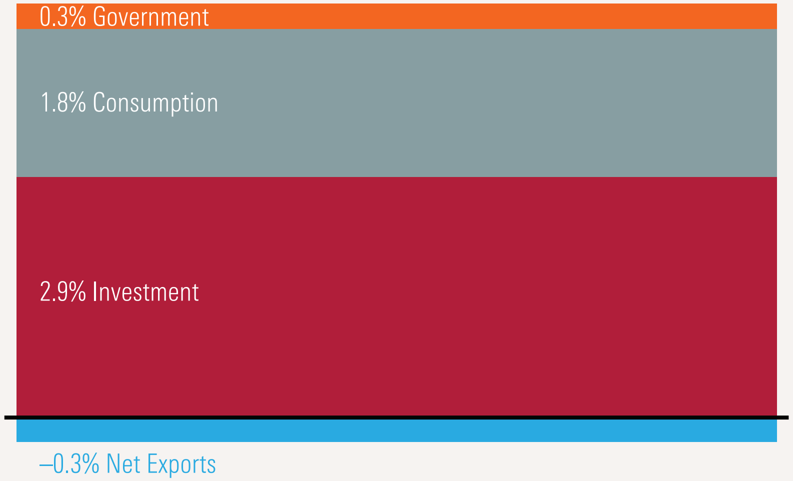
Quarterly Annualized GDP Growth



GDP Breakdown: $16,010 billion



GDP Growth Contributions : 4.6% total growth



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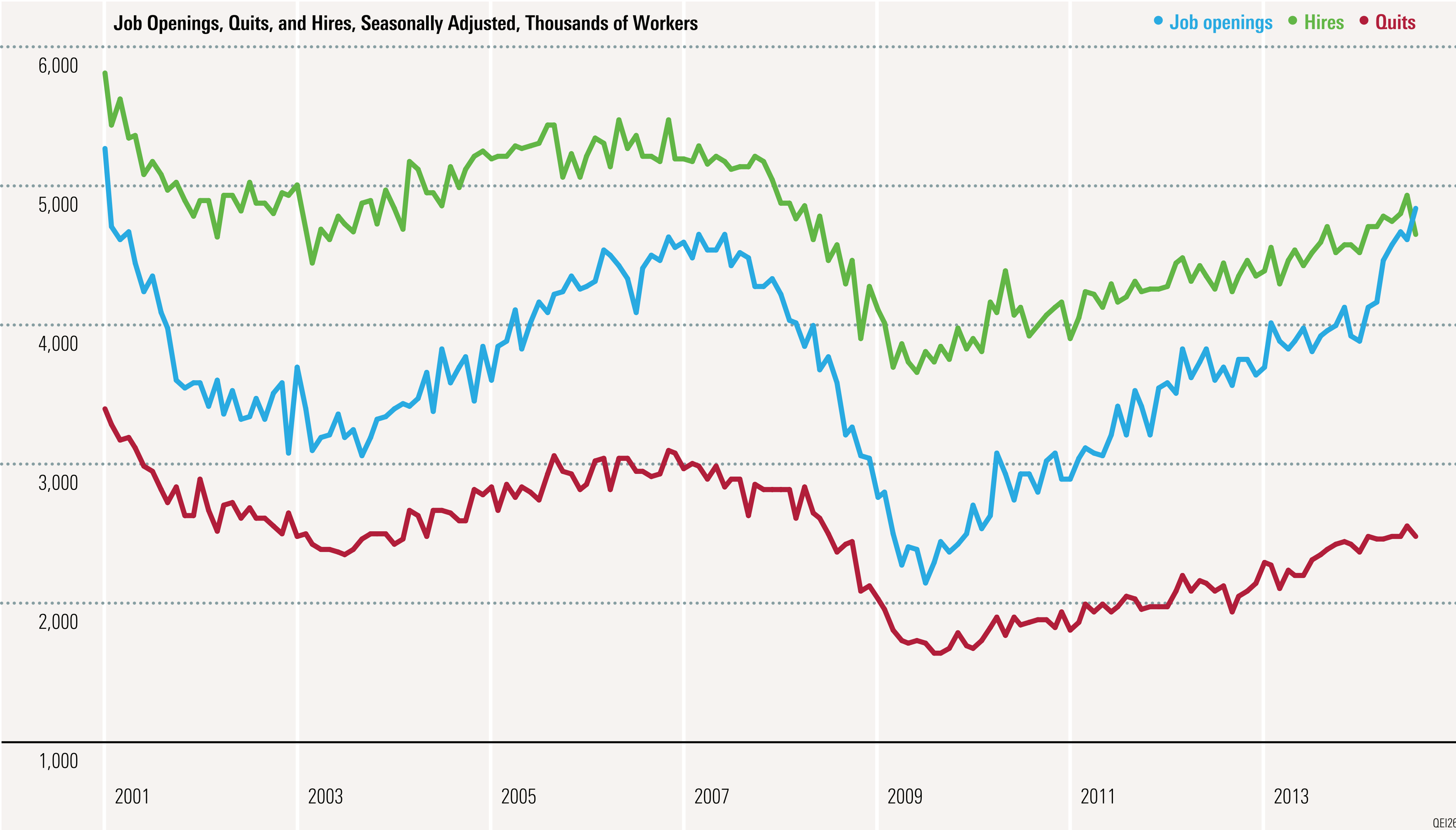
Source: Bureau of Economic Analysis, Morningstar Calculations. Percentage breakdowns might not add up to their totals due to rounding differences.

Job Openings Showing Rapid Acceleration

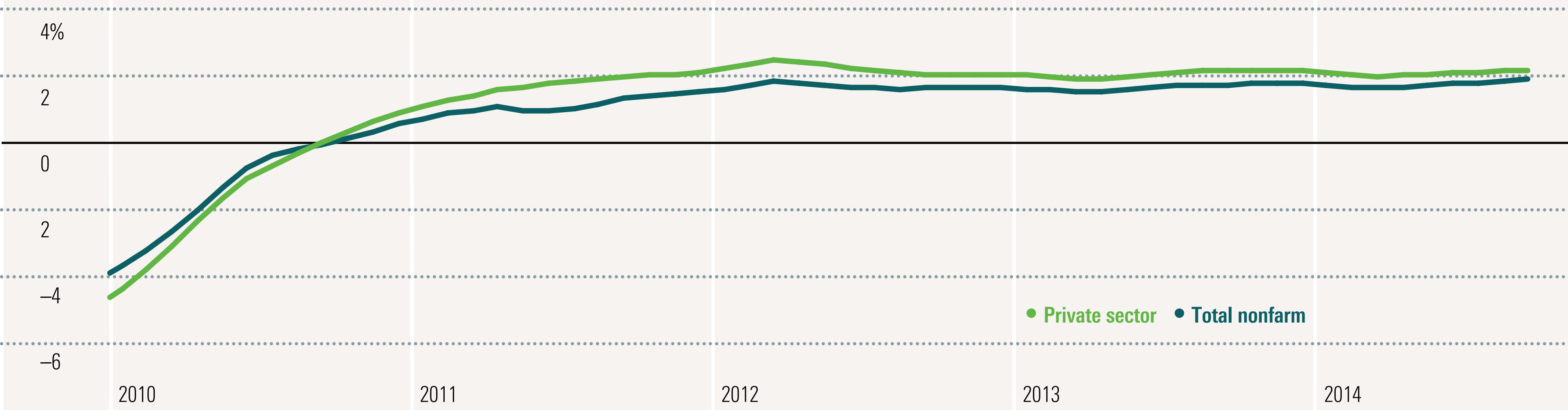
Job openings are now at their highest level since 2001, which should portend better job growth in the near future. A new job must be posted before someone is hired, making this a great leading indicator. Unfortunately, new hires have not increased nearly as quickly, indicating a problematic mismatch of skills and salary expectations. Employees remain too scared to quit for a better job.



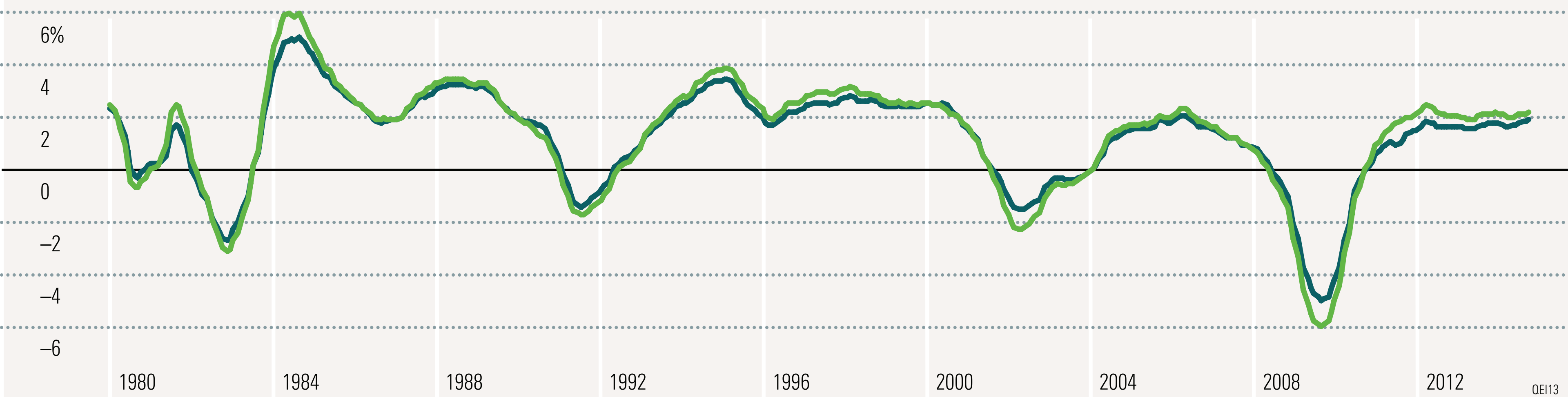
Employment Outlook Positive as Payrolls Continue to Grow at a Steady Pace

Despite volatility in the monthly jobs report, the year-over-year, 3-month average employment growth has picked up modestly to 1.9%. Excluding the poorly performing government sector, the private sector has been growing at 2.2%. Moreover, larger-than-expected increases in job openings in recent months may point to modestly higher employment growth in the near future.

Employment Growth Since 2010, Year-Over-Year, 3-Month Average

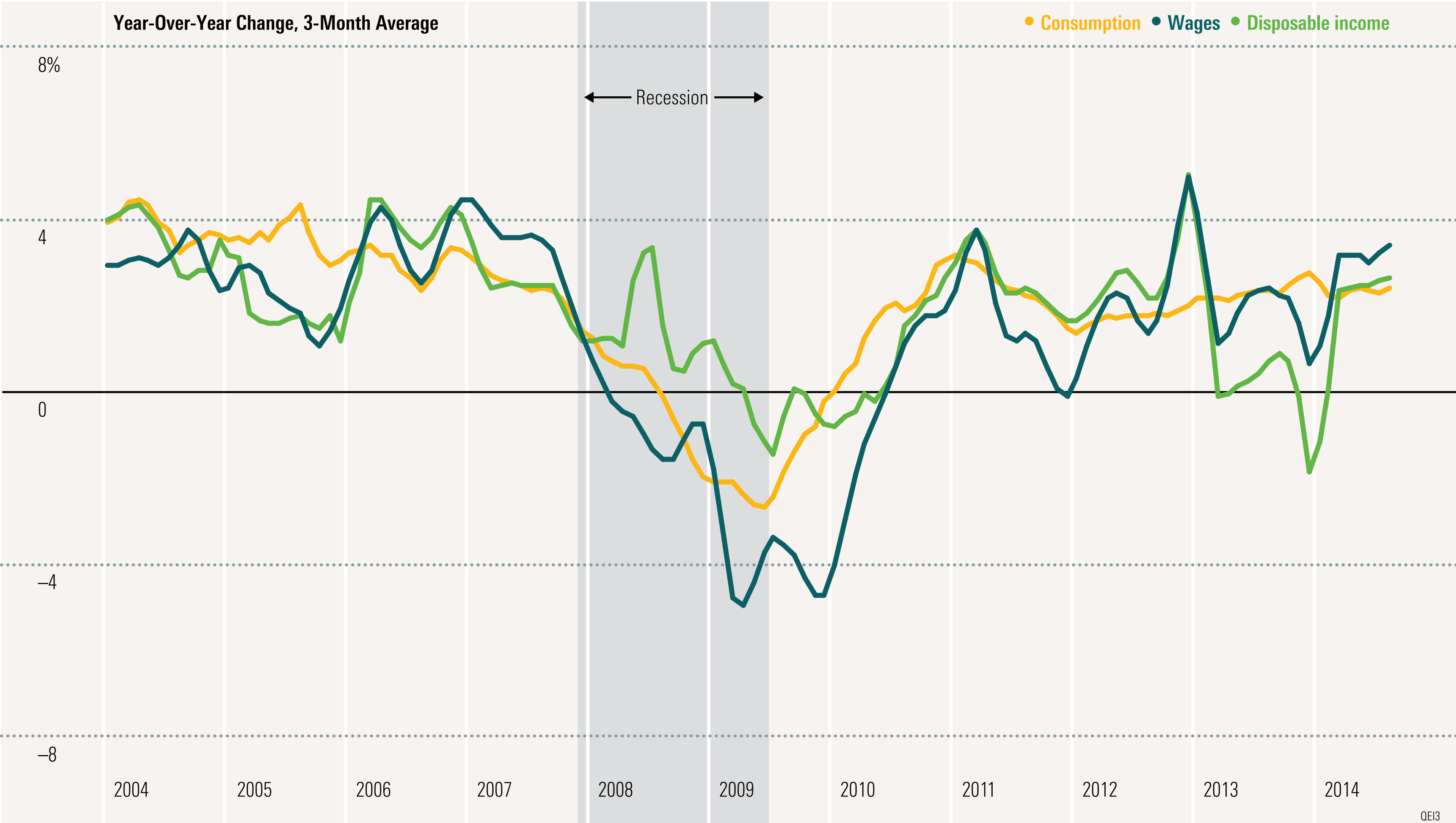


Since 1980



As Wages and Incomes Edge Higher, Consumer Spending Will Follow

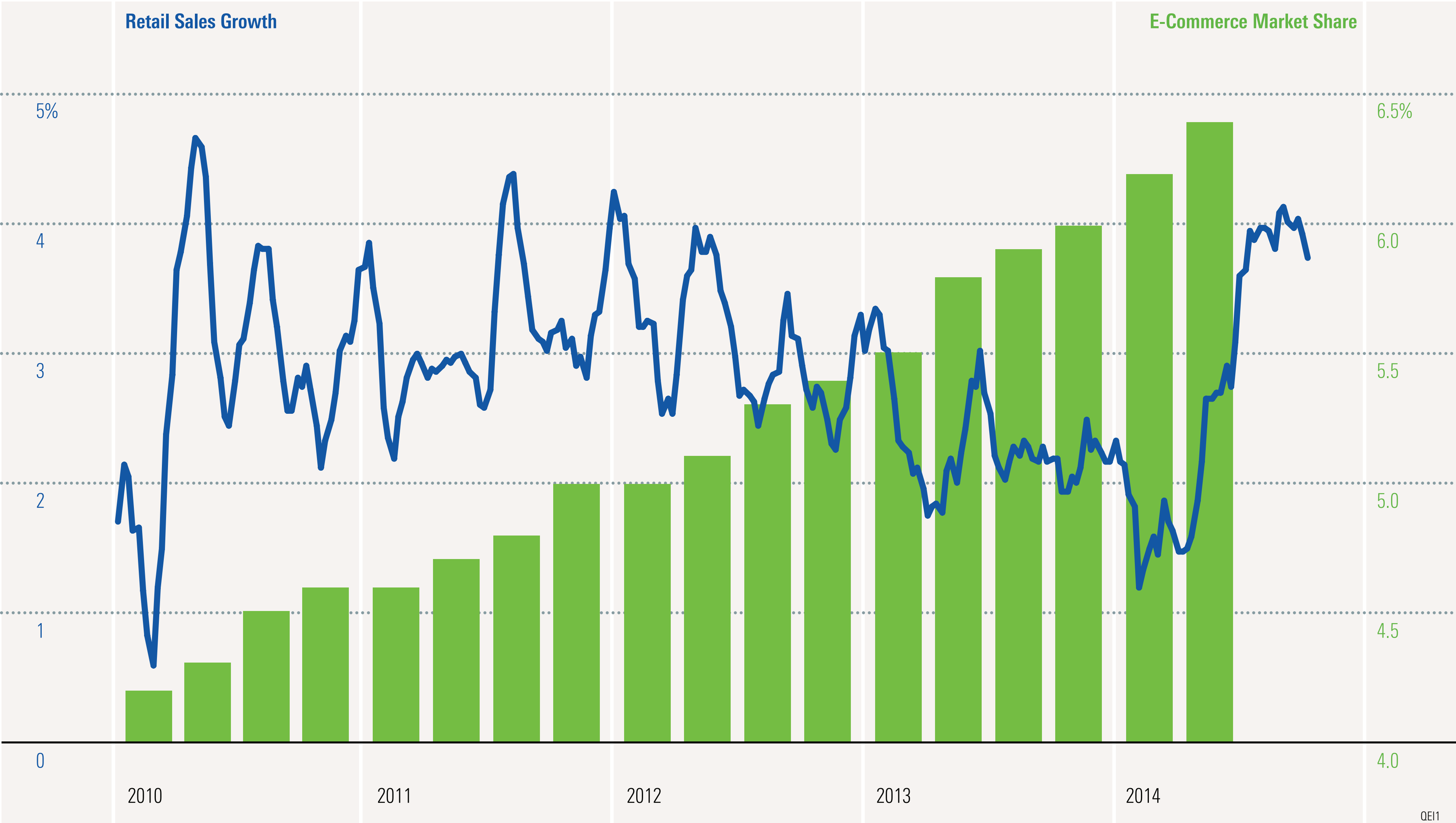
Both real disposable income and wage income are now well above their 2% trend lines after inflation, tax-law change, and related income avoidance techniques caused huge fluctuations. Consumers have been afraid of spending that extra income this year, as wage growth has dramatically outpaced spending for most of 2014. Those savings should fuel consumer spending in the last quarter of 2014 and all of 2015.



Source: Bureau of Economic Analysis, Morningstar Calculations.

Weekly Shopping Center Sales Spike Up, E-Commerce Continues to Grow

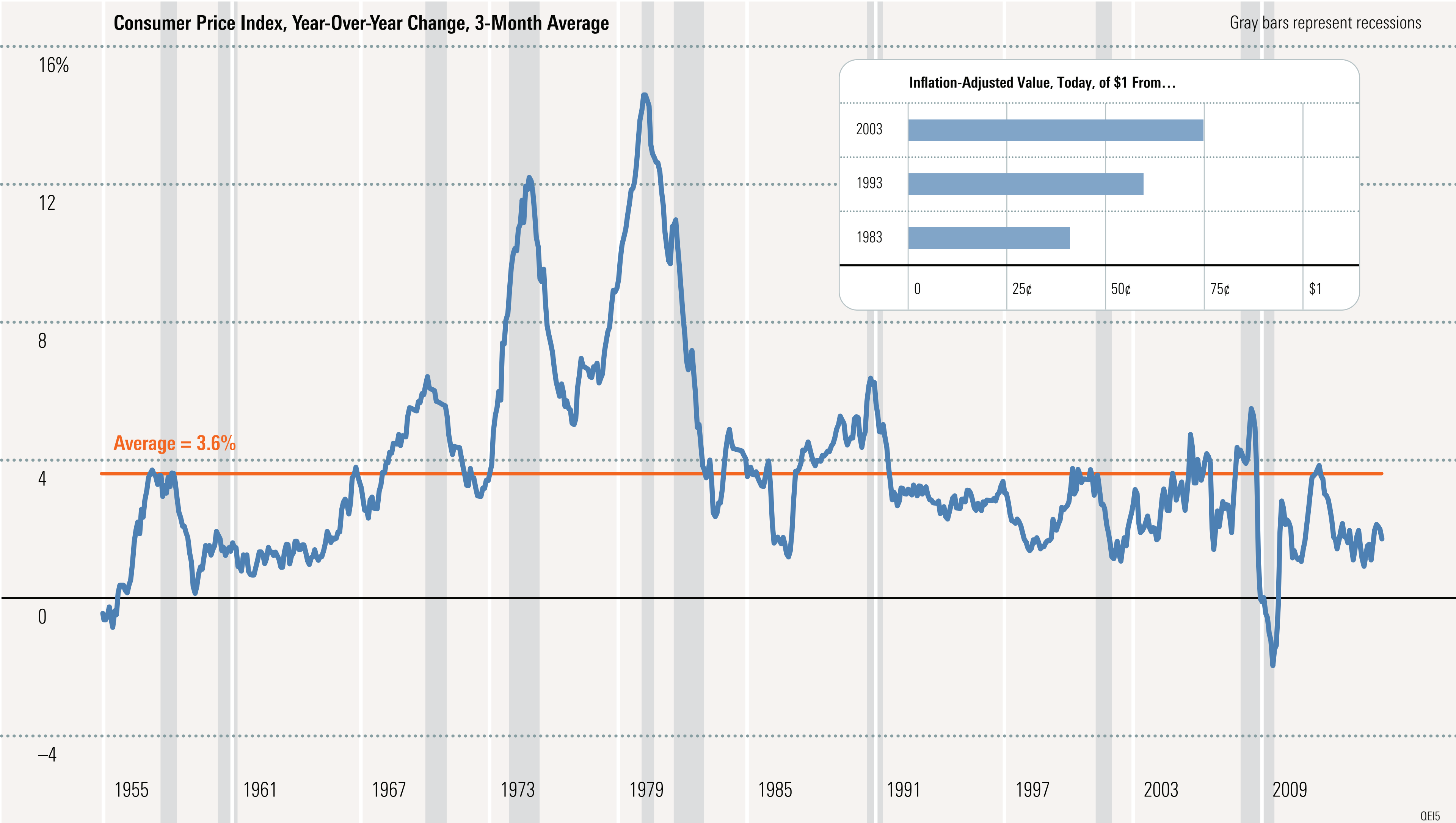
After poor weather conditions in the first quarter, brick-and-mortar retailers have finally found a way to attract more customers. According to the International Council of Shopping Centers, mall retail sales saw rapidly accelerating growth in both the second and third quarters, reaching 4.6%, finally breaking a three-year down trend. As brick-and-mortar retailers bounce back, e-commerce continues to thrive.



Source: Census Bureau, International Council of Shopping Centers, Morningstar Calculations. Retails sales calculated as year-over-year, 5-week average change.

Inflation Slowing Again as Energy Prices Fall

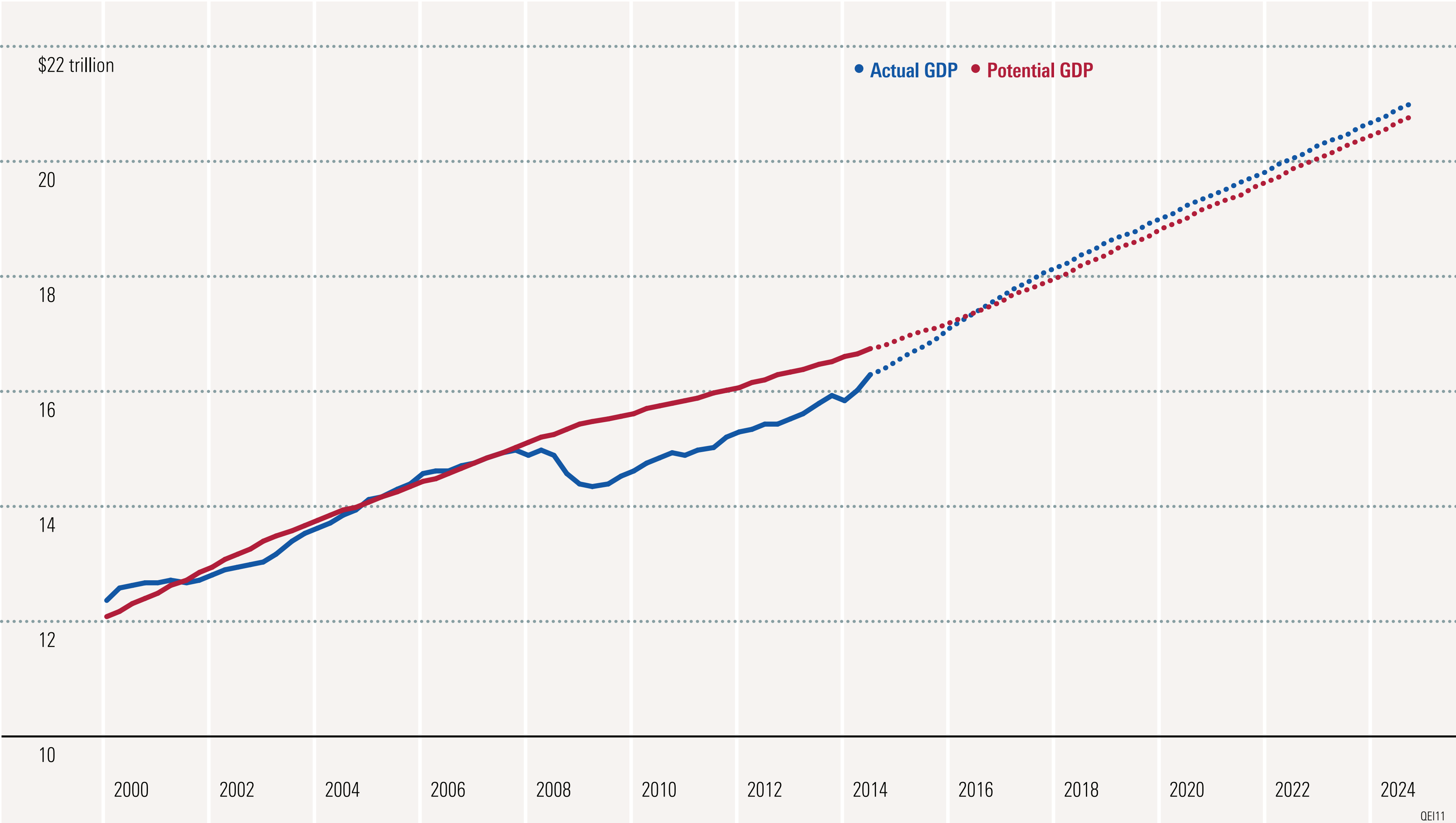
High inflation has been the number one recovery killer in the past. As prices surge and wage adjustments fail to keep pace, consumption slows and businesses begin to slow production. After a commodities-related spike in the spring of 2014, inflation has fallen back from an interim peak of 2.1% to 1.7% currently. Falling energy prices could drive price growth even lower.



Source: Bureau of Labor Statistics, The National Bureau of Economic Research, Morningstar Calculations.

Output Potential Gap Suggests Limited Inflation Risk

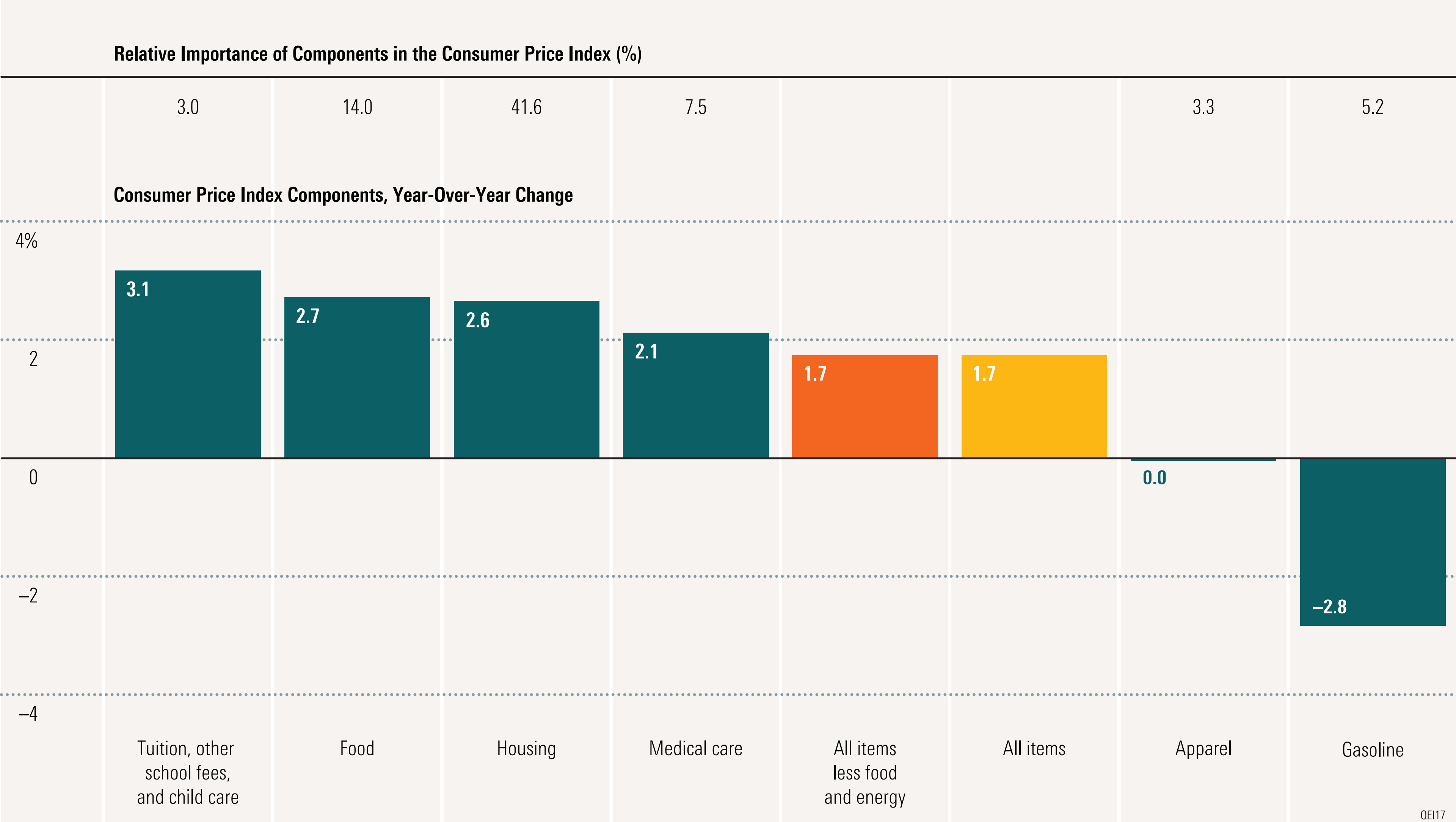
The output gap is at one of its widest levels in history. Every major, sustained bout of inflation in the Post-War era occurred when the economy was running above its theoretical capacity. Therefore, outside of food and drugs, the prospect of high inflation remains dim. The Congressional Budget Office estimates that the gap won't close until 2017.



Source: The Congressional Budget Office.

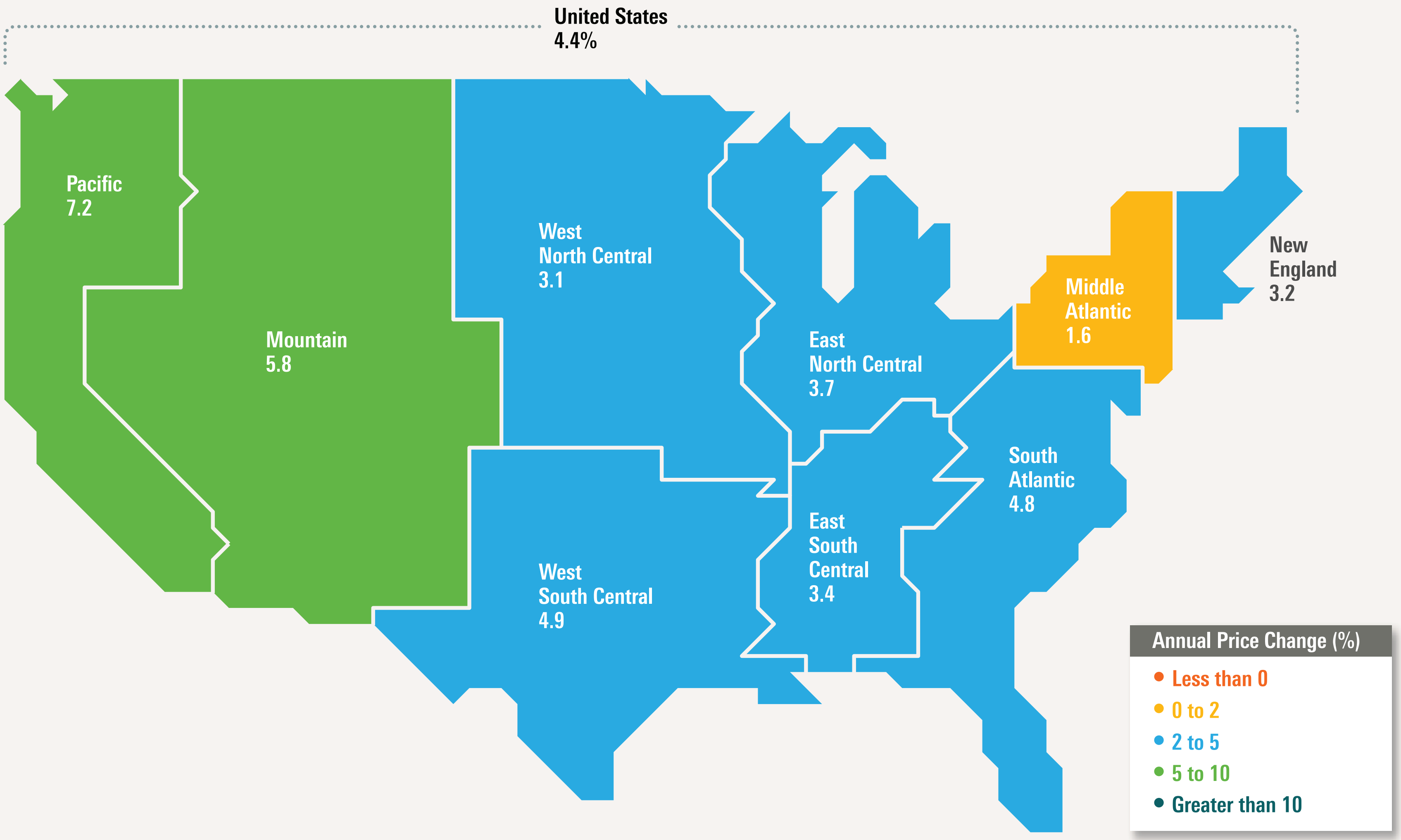
Higher Prices Not so Good News for Consumers; Tuition Rates Soar

Despite some monthly ups and downs, inflation rates are little changed from a year ago. However, some categories within the CPI have been rising much faster than the headline number. Tuition, food, and housing have all experienced price increases upwards of 2.5%. Gasoline prices are declining again and are now near four-year lows, potentially boosting the holiday season.



FHFA Home Prices Slow Down

According to the FHFA, U.S. home price growth slowed to 4.4% in July, year-over-year, the slowest pace in 19 months. Regions that experienced the largest housing bubbles, namely the Pacific and Mountain areas, continue to record the largest price gains. After nationwide growth peaked at 8.3% last year, price growth is expected to be limited to 4% to 6% over the next year or two.

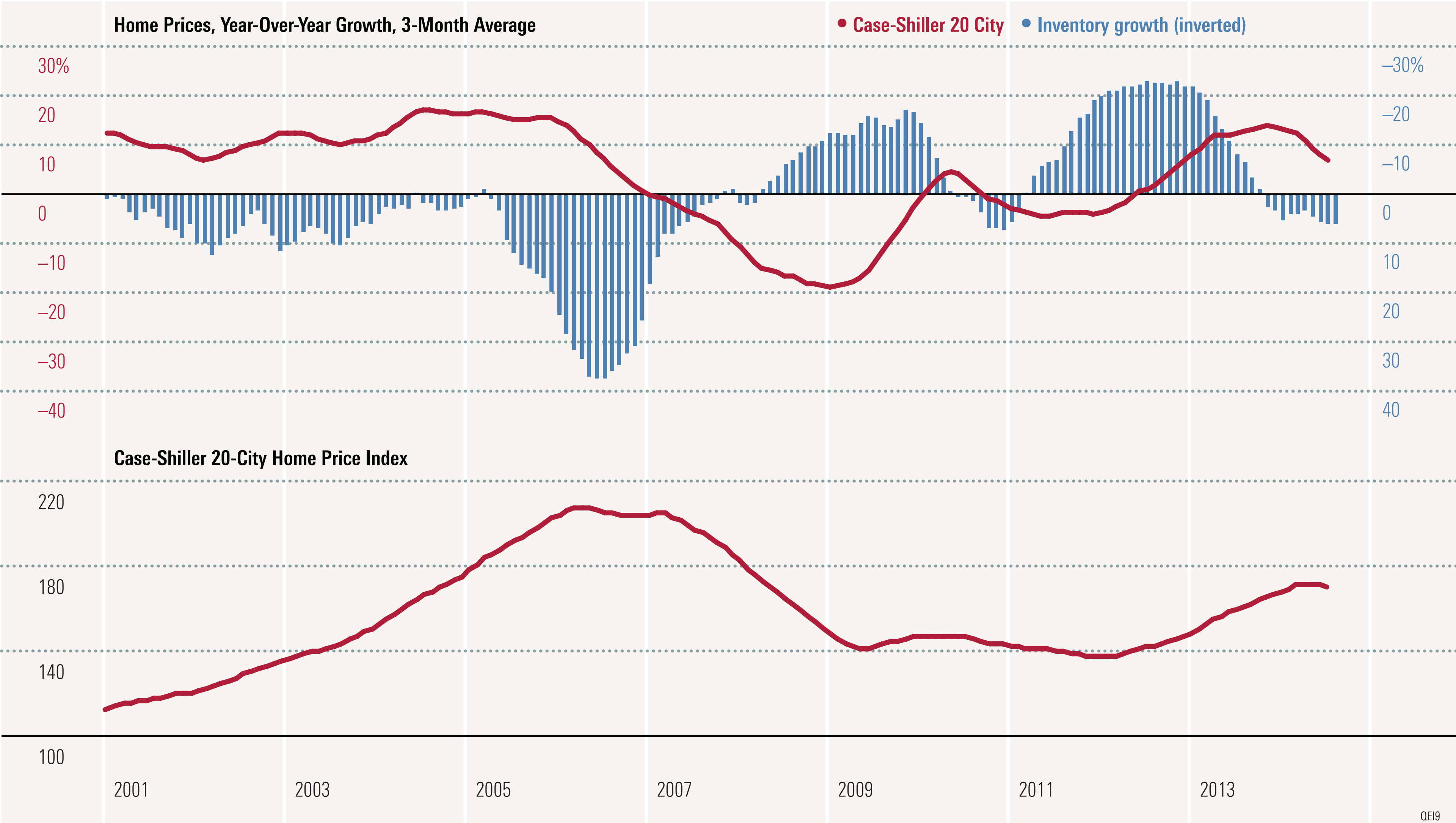


QEI2

Source: Federal Housing Finance Agency.

Slowing Price Growth and Lower Rates Should Fuel Housing Recovery

Better home prices have been important to improving both the mood and the financial condition of the consumer. However, home price increases are slowing down considerably. Slower price gains should, nevertheless, improve home affordability, especially if prices were to slow to a more sustainable 4–6% growth rate in 2014 and 2015, as higher home inventories keep a lid on prices.



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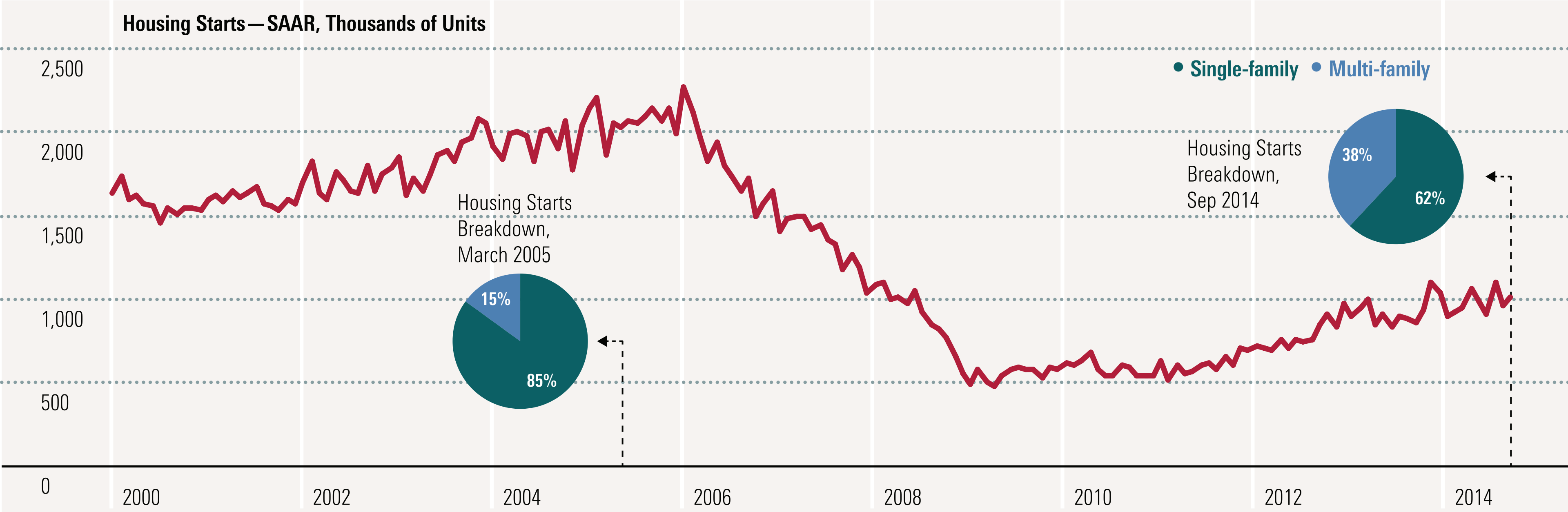
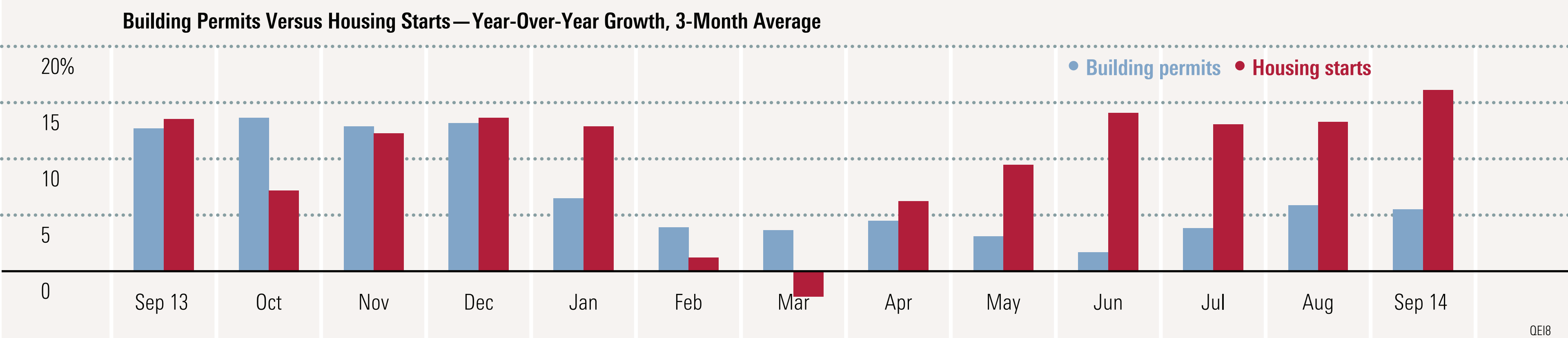
Housing Recovery Remains Muted, but Outlook Stays Positive

Although housing starts continue to grow year-over-year, the growth rates have stabilized so far in 2014. Compared with the year before, the combination of higher interest rates, rapid price increases, tight credit, and lack of available land have all contributed to the housing recovery slowdown. Many of these factors have now begun to improve, which indicates that the future outlook remains positive.

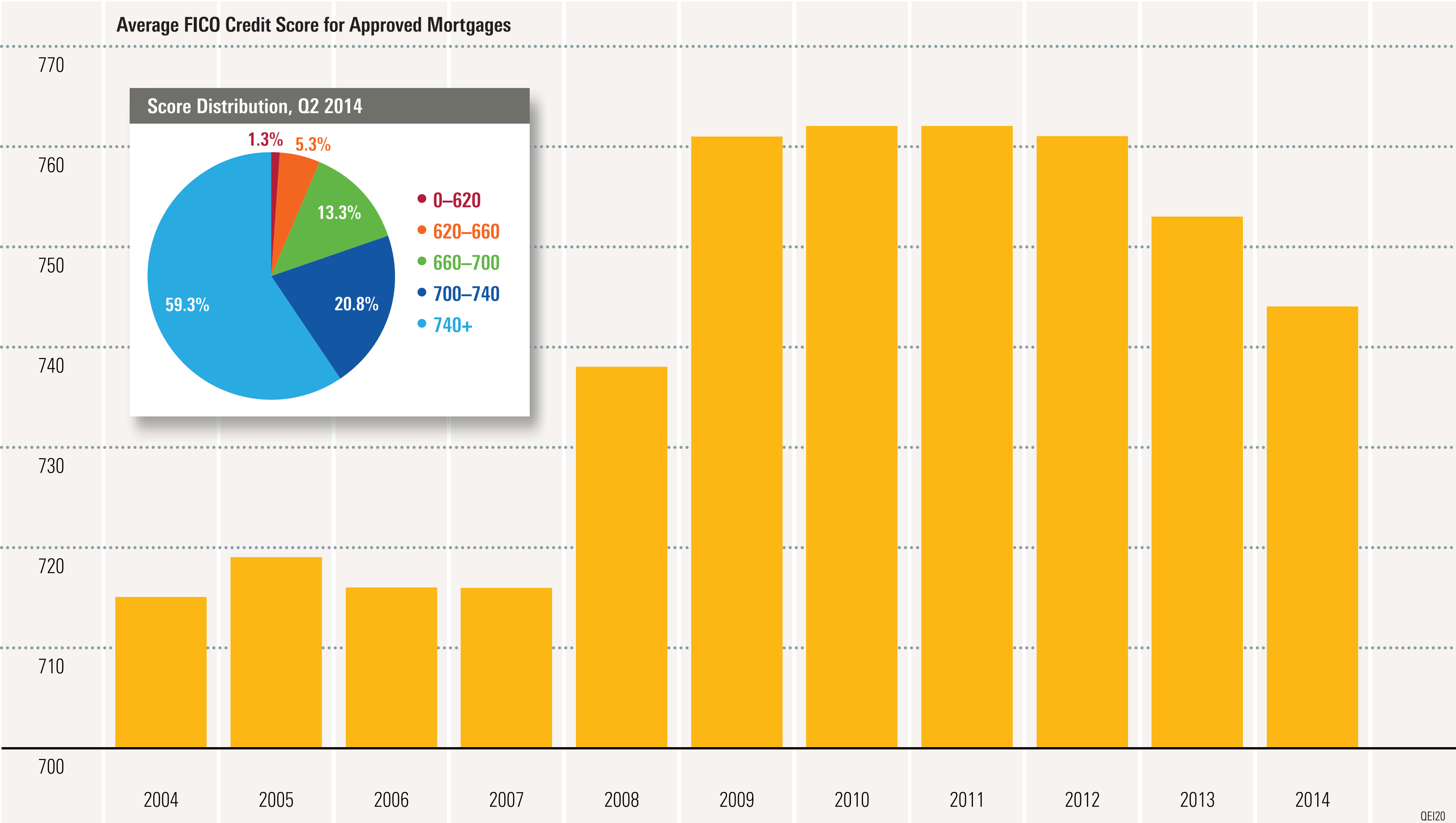




Source: Census Bureau, Morningstar Calculations.

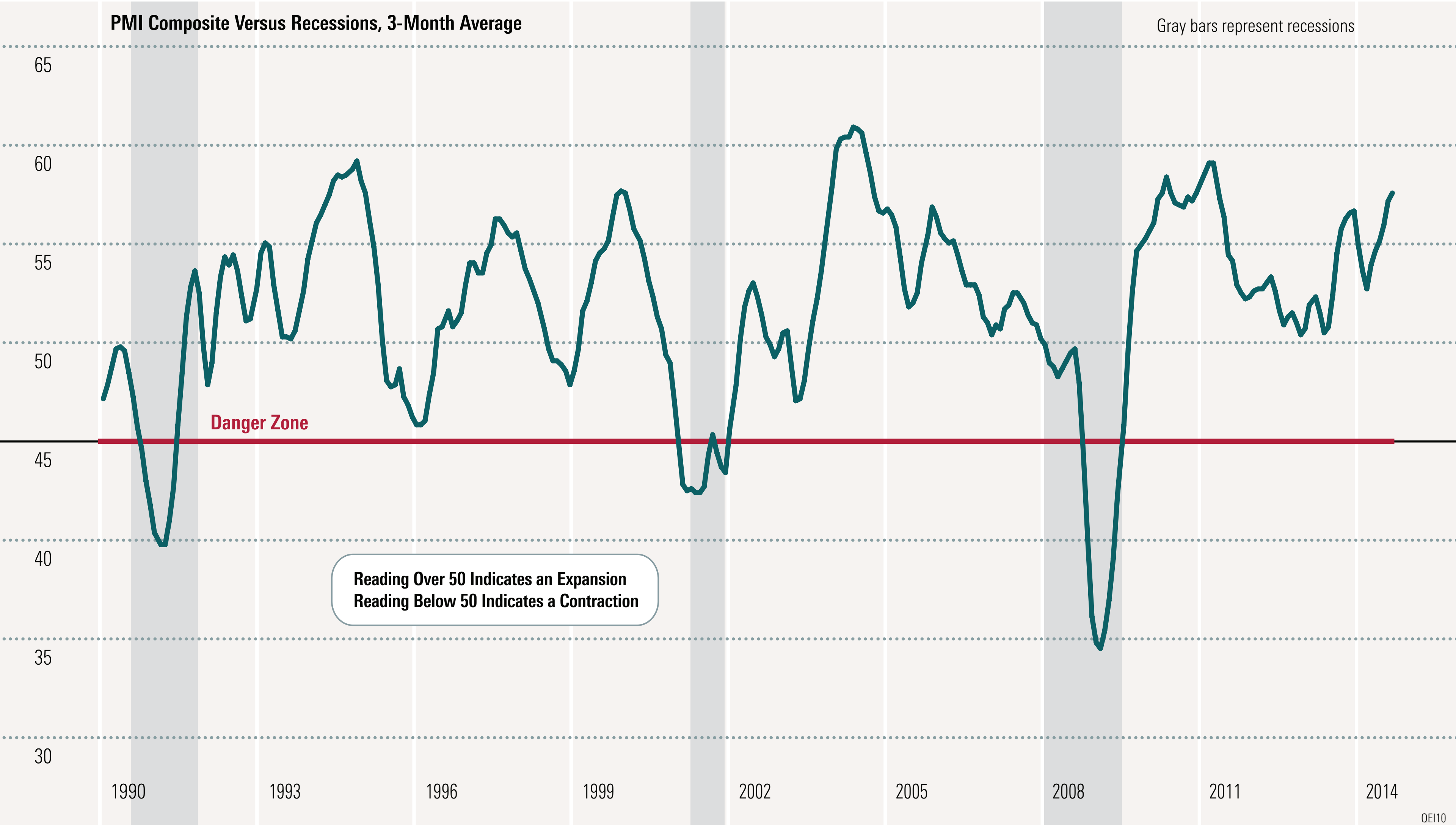
Mortgage Lending Conditions Improving, but Credit Still Tight

One of the factors holding back the housing recovery has been tight credit. The average FICO score for an approved mortgage was 753 in 2013, and now it is at a slightly lower level of 744. While less stringent mortgage requirements are definitely good news, further easing is needed in order for the housing recovery to pick up steam.



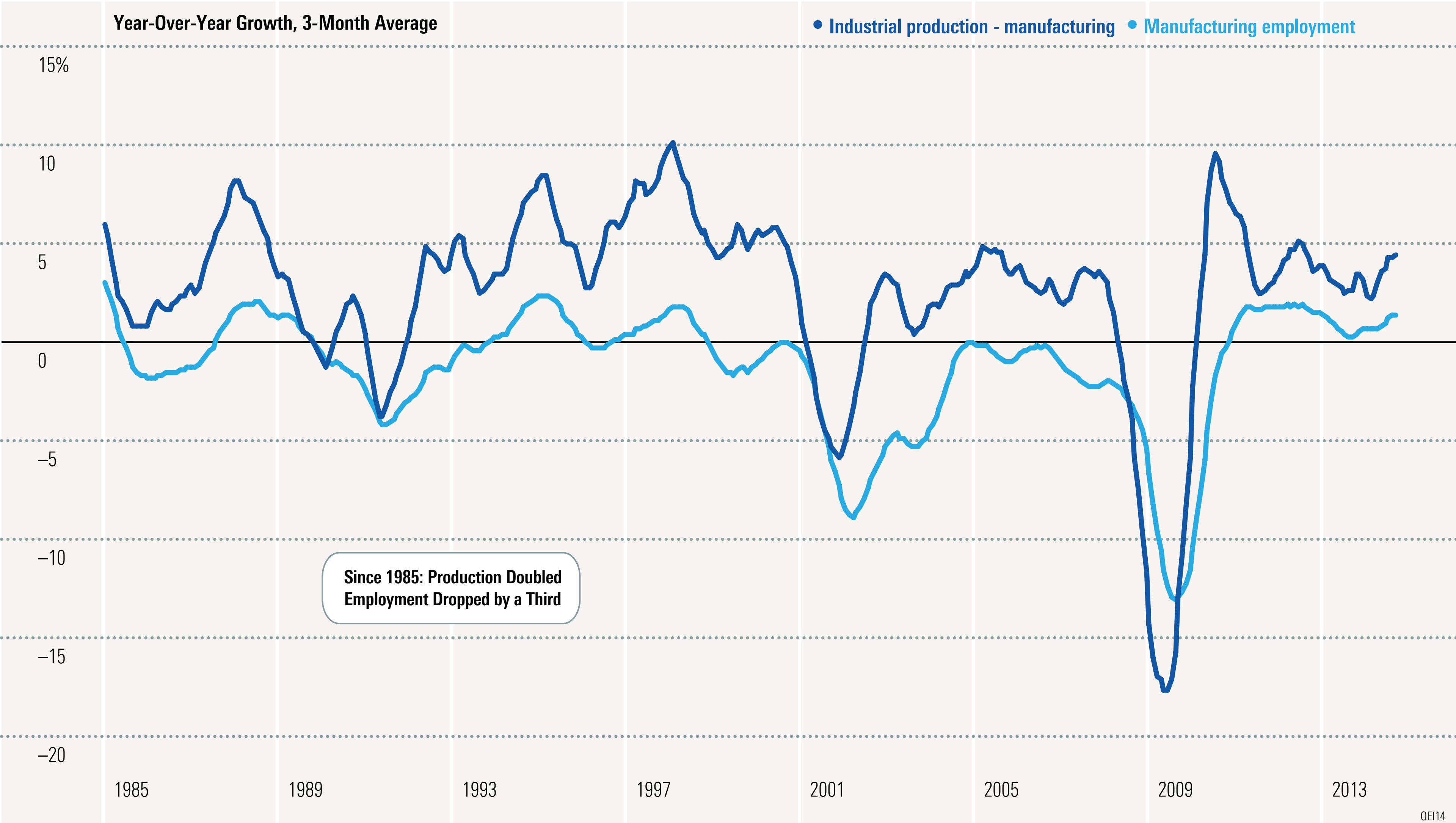
U.S. Manufacturing Continues to Grow, Picks up Steam

Manufacturing growth has accelerated considerably after an unusually harsh winter. Though autos remain an important part of the manufacturing sector, other segments are picking up steam. Unfortunately, manufacturing is a small part of total employment, suggesting that its positive impact on U.S. GDP and employment will be limited. Slowing world growth could also hurt this sector in the months ahead.



Productivity Improvements Slash Manufacturing Employment Growth

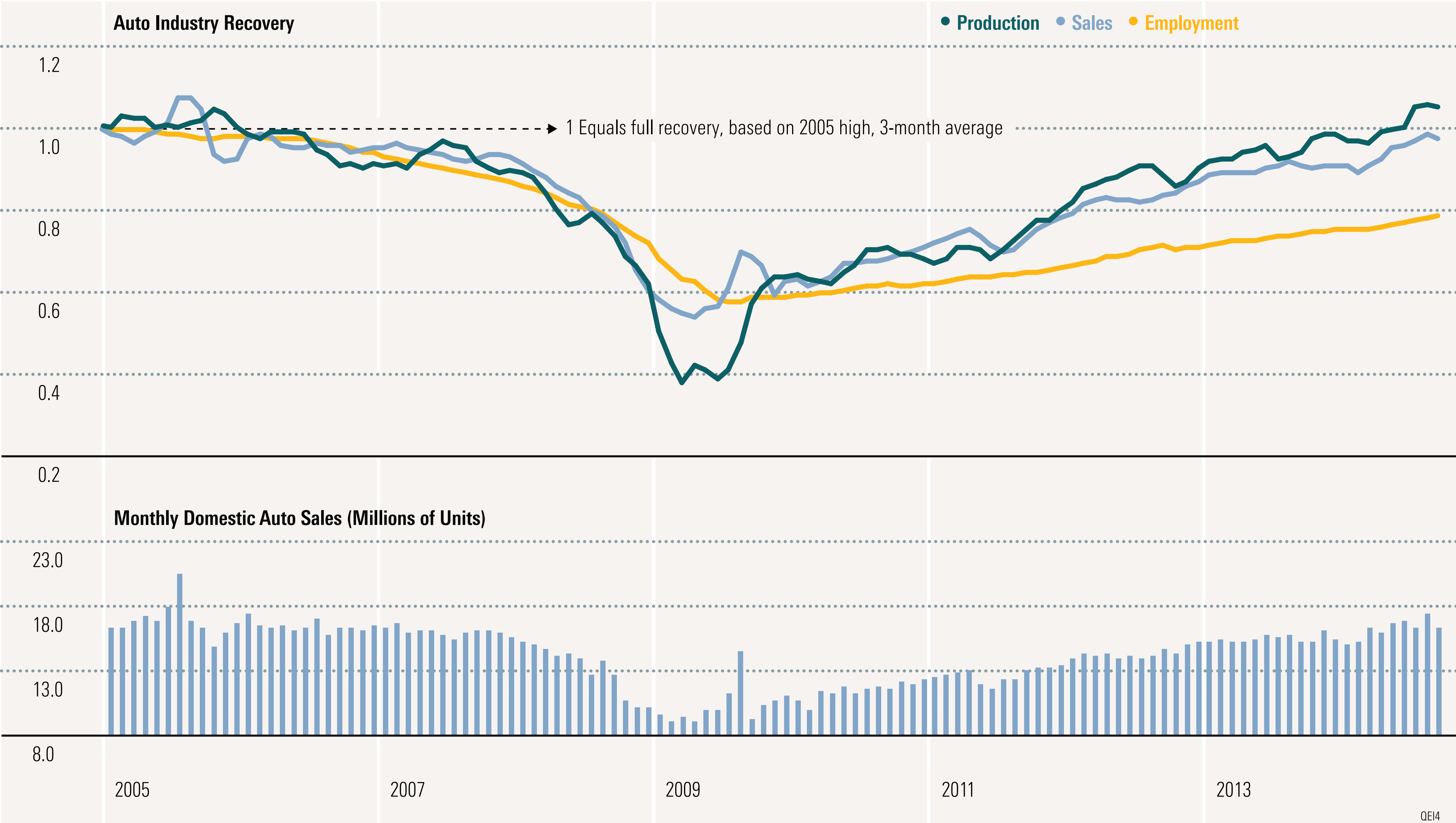
Due to efficiency and productivity improvements, factory output levels have been growing significantly faster than employment. Following past recessions, many lost manufacturing jobs were never fully recovered. As a result, manufacturing employment is only at about 67% of its 1985 level, while production has doubled since then.



Source: The Federal Reserve, Bureau of Labor Statistics, Morningstar Calculations.

Auto Sales, Production Back to Normal, Employment Still Lagging Behind

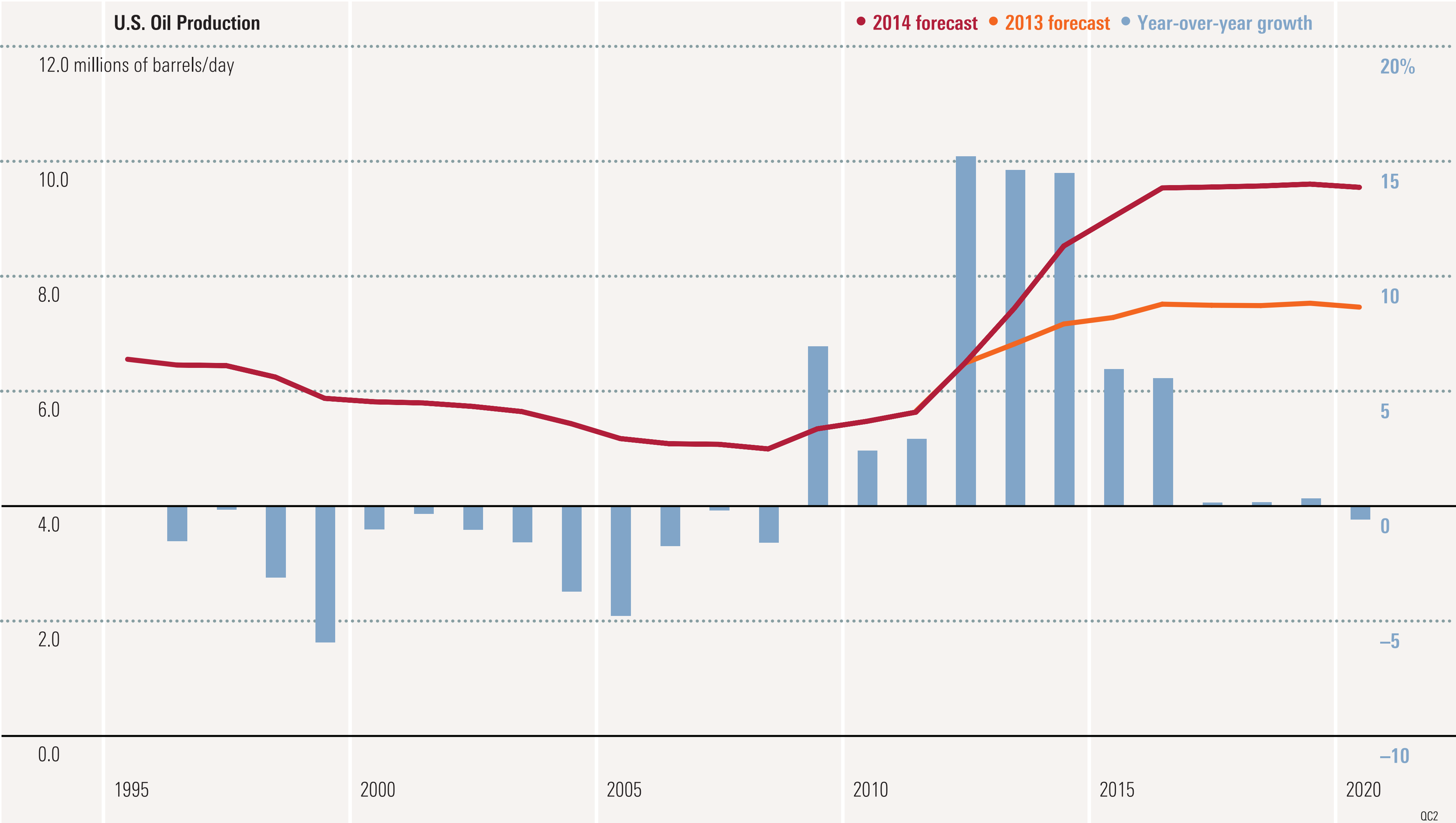
Autos are an example of a manufacturing industry with production and sales levels already approaching previous 2005 highs, while the employment growth remains stagnant. Unfortunately, the gap between sales and production is widening yet again, suggesting that the auto industry may be a smaller contributor in the months ahead.



Source: The Federal Reserve, Bureau of Economic Analysis, Bureau of Labor Statistics, Morningstar Calculations.

U.S. Oil Production Skyrockets

Growth in oil production continues to surprise even the experts and remains one of the bedrocks of the recovery. The boom has helped the U.S. economy in a number of ways. It spurred job creation, contributed to the reduction of the trade deficit, and helped to keep inflation under control. In addition, lower energy prices prompted many oil-dependent industries to move their plants back into the U.S.



Source: Energy Information Agency, Morningstar Estimates.

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Bumper Crops and a Surge in Energy Supply Drive Commodities Lower

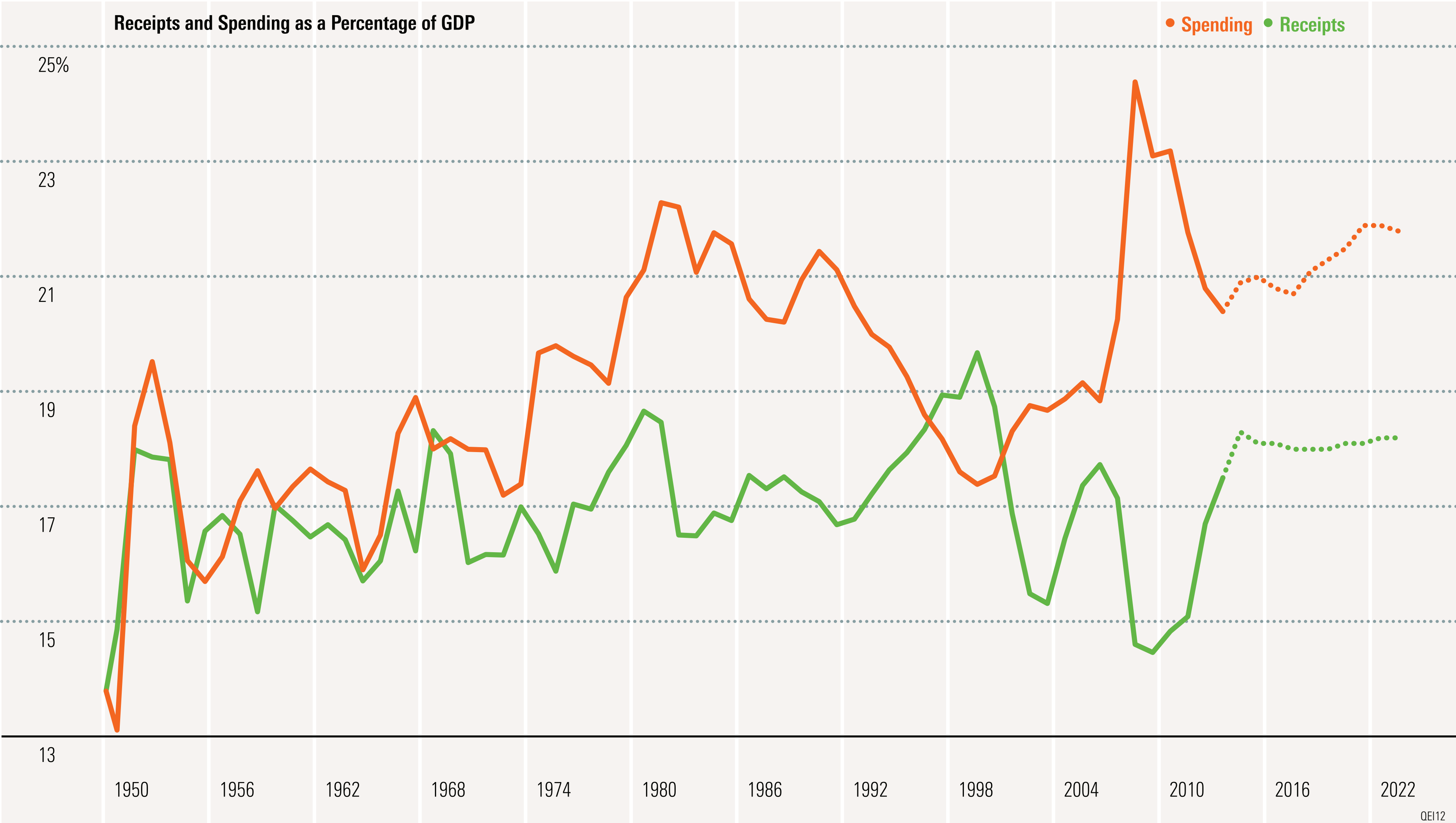
From 2011 to 2013 commodities fell sharply as U.S. oil production increased, droughts eased, and China's growth rates slowed considerably. The first quarter of 2014 saw an across-the-board increase in commodities. In the third quarter, commodities gave back those gains and then some. A stronger dollar has compounded over-supply and falling demand issues.

Total Return (%)	Trailing Quarter	Trailing Year	Trailing 5 Years
Energy	–12.1	–0.2	–6.7
Livestock	–2.2	15.8	4.0
Precious metals	–11.3	–12.5	2.5
Industrial metals	–4.1	–0.4	–2.3
Grains	–22.9	–26.5	–0.7

Source: Morningstar Direct. Data represented by Bloomberg Commodity Indexes.

Budget Problems Reappear as Baby Boomers Retire

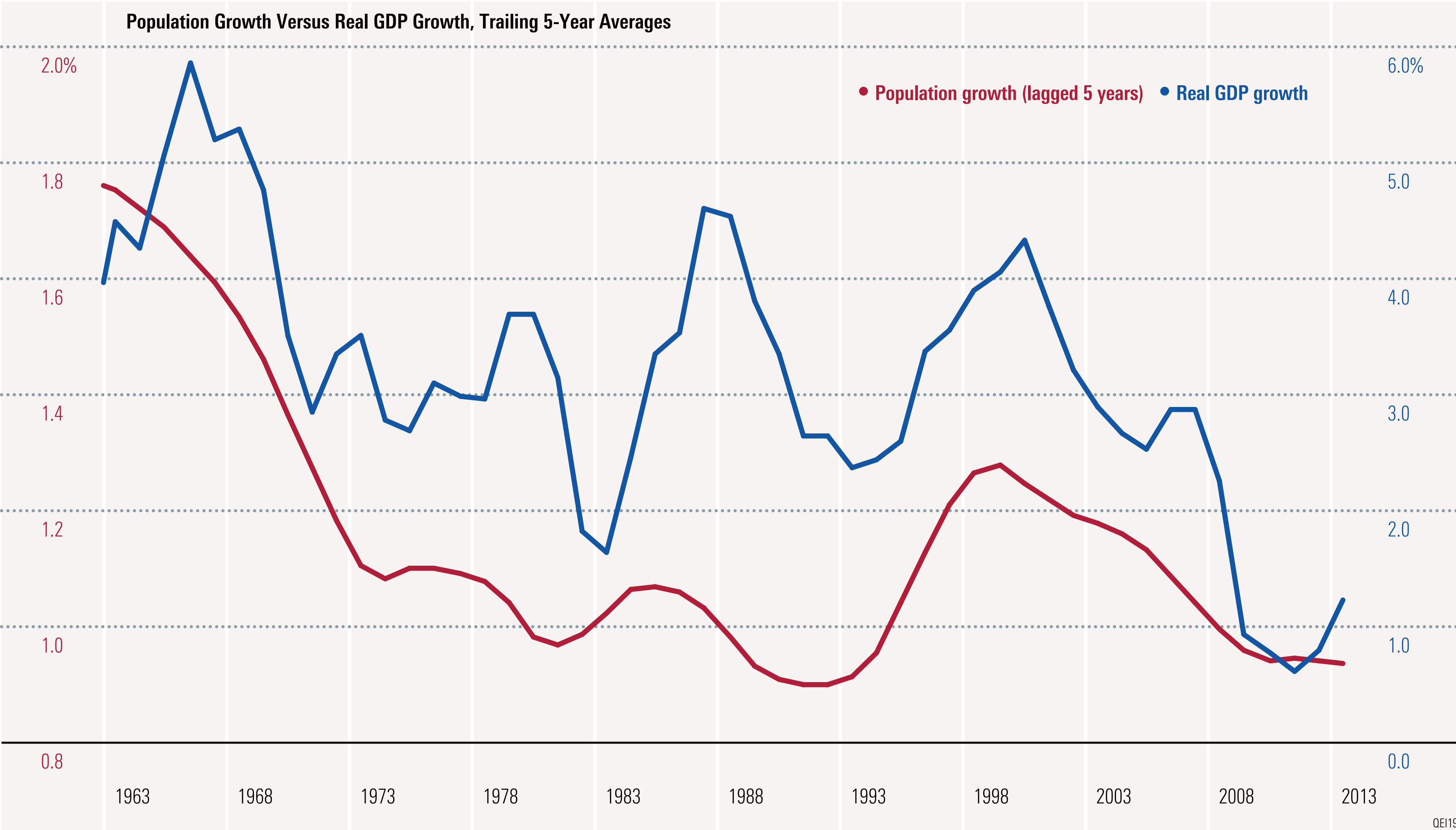
A better economy, the sequestration process, and budget agreements have greatly reduced the federal budget deficit from 10% of GDP in 2009 to just 2.8% in 2014. Less dramatic improvements are expected over the next couple of years. However, the Congressional Budget Office sees the deficit growing again in 2018 as baby boomers retire.



Source: The Congressional Budget Office.

Demographics Will Limit Longer-Term Economic Growth

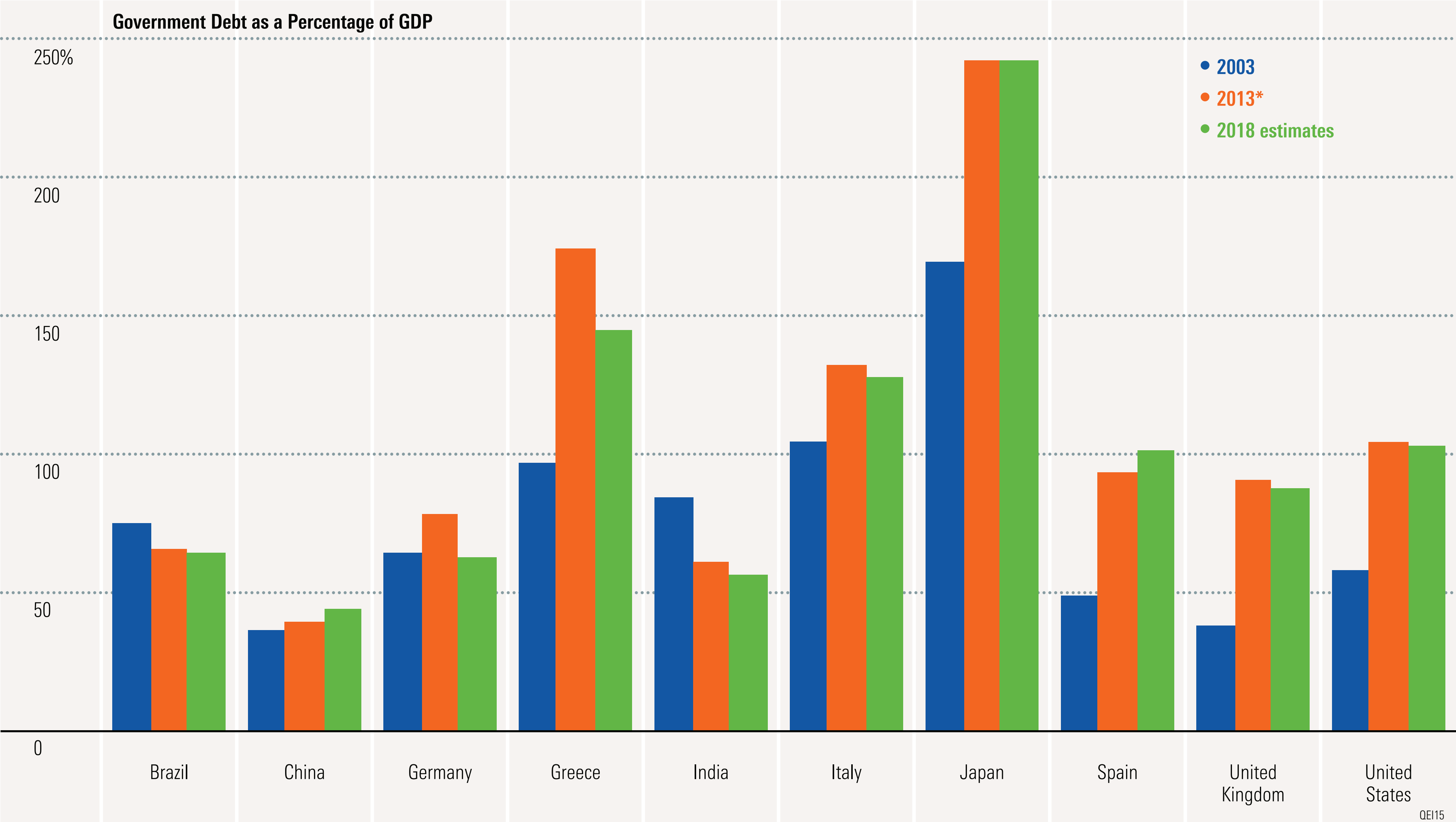
The gradual shift in demographics has been already leaving its mark on GDP growth as the U.S. has moved to a sub 1% population growth rate in recent years. Considering this trend, higher economic growth rates of 3%–4% might be a thing of the past, and investors should build their expectations around a more modest 2.0%–2.5% GDP growth over the long term.



Source: Census Bureau, Bureau of Economic Analysis.

Government Debt Projection Stable for U.S., Still Very High for Japan

High debt-to-GDP ratios make it more difficult to pay down debts and may cause creditors to demand higher interest rates. Since 2003, the major developed economies have all seen their debt-to-GDP ratios increase, while emerging countries like Brazil, India, and China currently have the three lowest ratios among all nations analyzed.



Source: International Monetary Fund, World Economic Outlook Database. *Indicates an estimate for Japan.

Maybe Next Year for Higher World Growth Rates

The IMF has consistently forecasted accelerating growth rates in the out periods for the last several years. Sadly, growth rates have been stuck at a very muted 3.3% for each of the last three years, and hopes for more growth diminished as the years unfolded. Hope springs eternal, with the latest IMF growth forecast accelerating to 3.8% in 2015. Demographics and austerity programs will continue to limit growth.

World GDP Growth Rates

	2010	2011	2012	2013	2014*	2015*
Euro area	2.0	1.6	–0.7	–0.4	0.8	1.3
Japan	4.7	–0.5	1.5	1.5	0.9	0.8
Australia	2.2	2.6	3.6	2.3	2.8	2.9
Brazil	7.5	2.7	1.0	2.5	0.3	1.4
Russia	4.5	4.3	3.4	1.3	0.2	0.5
India	10.3	6.6	4.7	5.0	5.6	6.4
China	10.4	9.3	7.7	7.7	7.4	7.1
Canada	3.4	2.5	1.7	2.0	2.3	2.4
United States	2.5	1.6	2.3	2.2	2.2	3.1
Advanced	3.1	1.7	1.2	1.4	1.8	2.3
Emerging	7.5	6.2	5.1	4.7	4.4	5.0
World	5.4	4.1	3.4	3.3	3.3	3.8

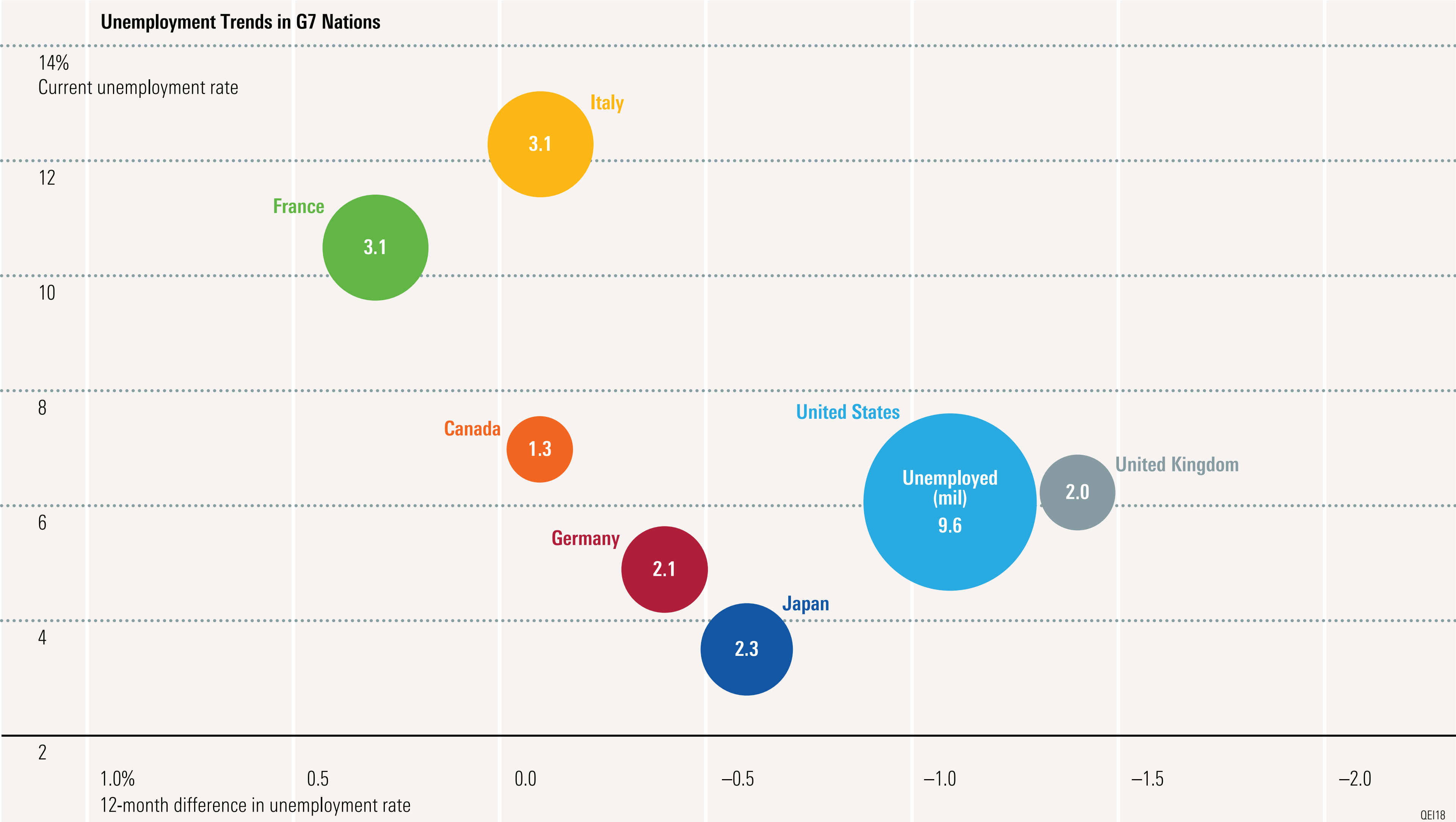
*These figures are IMF estimates

QEI16

Source: International Monetary Fund, World Economic Outlook Database.

Unemployment Rates Remain Elevated; U.S., U.K. See Biggest Improvements

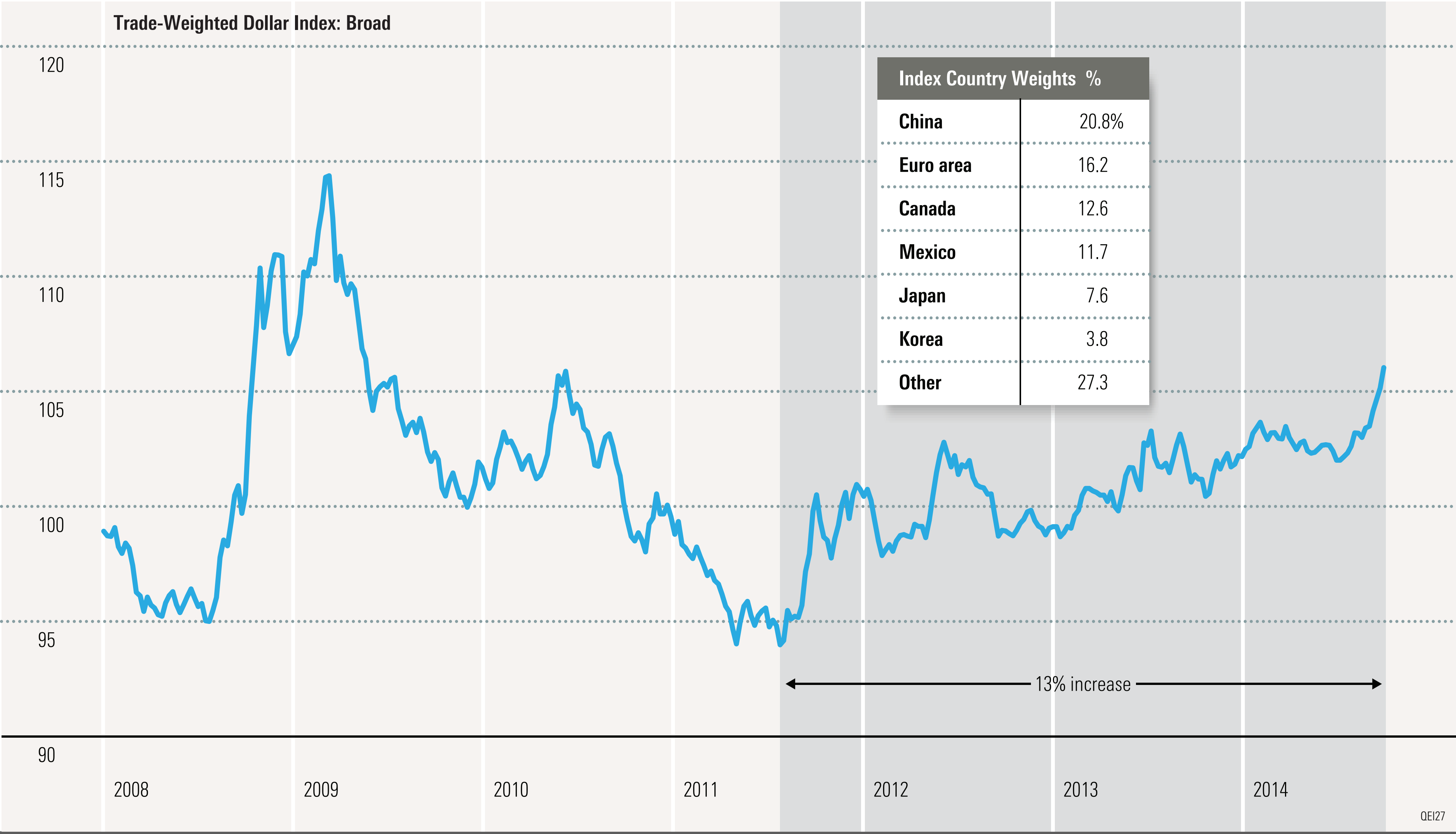
The employment situation in G7 nations remains mixed as countries such as Italy and France experience double-digit unemployment rates. The U.S. and U.K., with aggressive quantitative easing programs, have seen unemployment drop by more than 1% over the past year.



Source: Eurostat, Japan Statistics Bureau, Statistics Canada, Bureau of Labor Statistics.

U.S. Dollar Continues to Trend Higher

Since 2011, the U.S. dollar has moved up by 13%. That has helped the U.S. trade balance and has limited U.S. inflation. However, it will also hurt U.S. dollar returns on non-U.S. investments. A higher dollar also means overseas profits will turn into fewer dollars for U.S. corporations. Over time, a stronger dollar could hurt U.S. competitiveness.

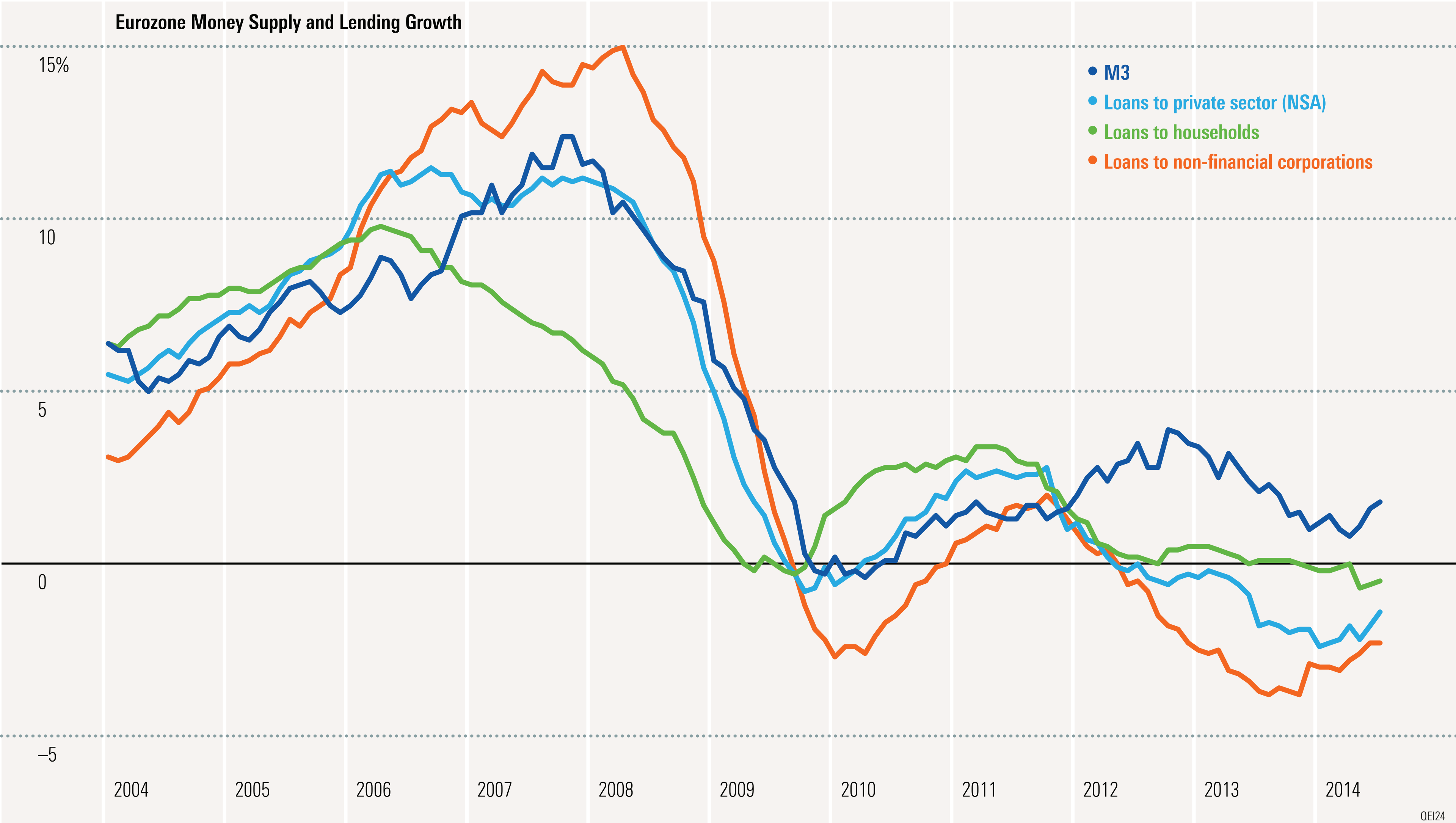


Index Country Weights	%
China	20.8%
Euro area	16.2
Canada	12.6
Mexico	11.7
Japan	7.6
Korea	3.8
Other	27.3

Source: The Federal Reserve

Lending Practices Remain Incredibly Tight in Europe

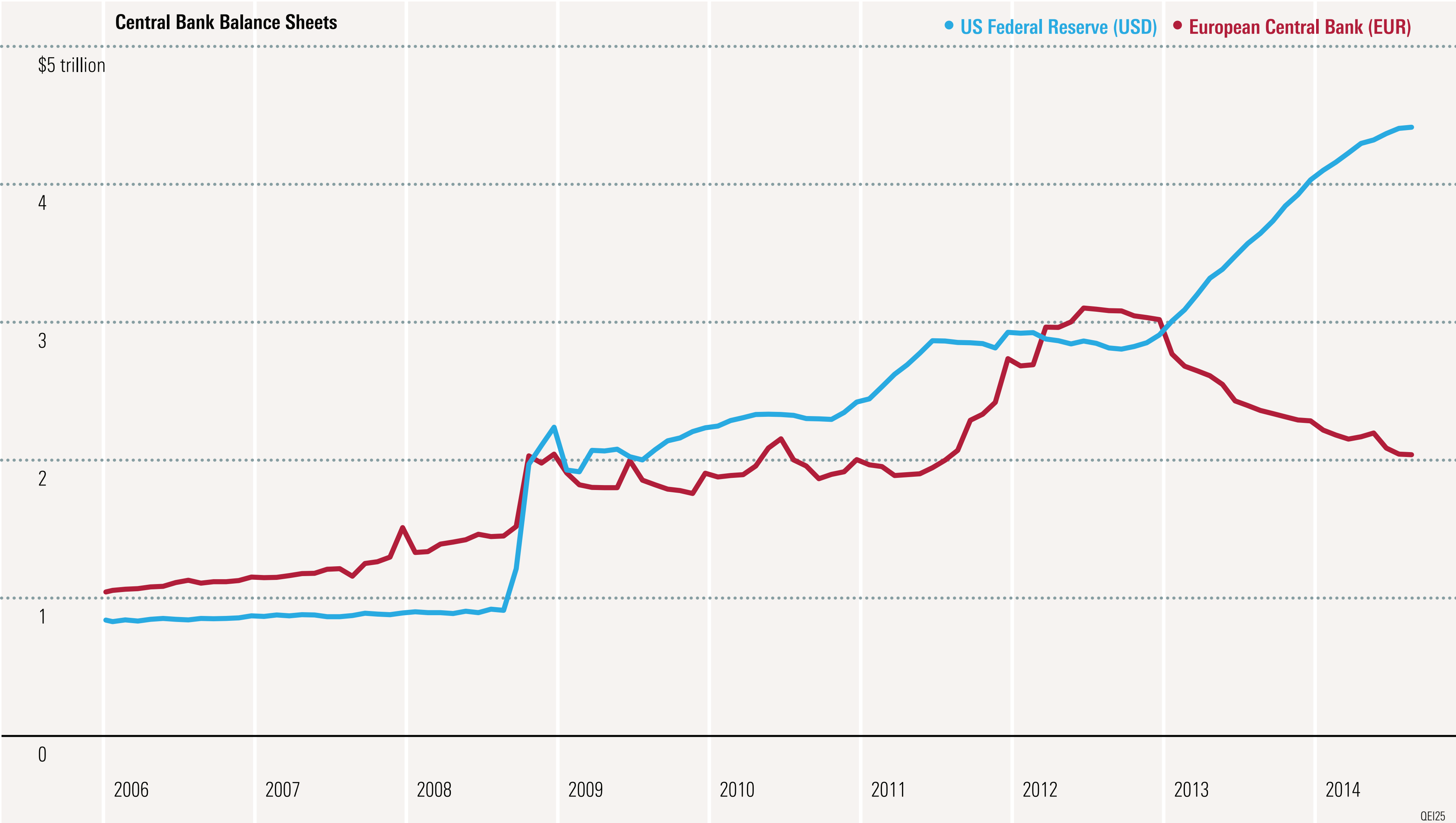
At least some of the weakness in Europe can be tied to overly restrictive lending practices. Year-over-year growth in both business and consumer lending is still negative. The European Central Bank has eased a little recently in an attempt to support the European economy, but even more easing may be needed. Structural reforms that could jump-start growth have been limited.



Source: European Central Bank. Year-over-year growth. Loans to private sector are not seasonally adjusted.

U.S. and European Monetary Policy Going Opposite Direction Time Lines

As employment data has improved dramatically in the U.S., the Fed has begun to reduce its bond and mortgage purchases following a period of large acquisitions that appear to have successfully stimulated growth. Meanwhile, until recently, Europe had been reducing its balance sheet, limiting European growth. Recent policy pronouncements suggest Europe is expanding its balance sheet just as the U.S. limits growth.



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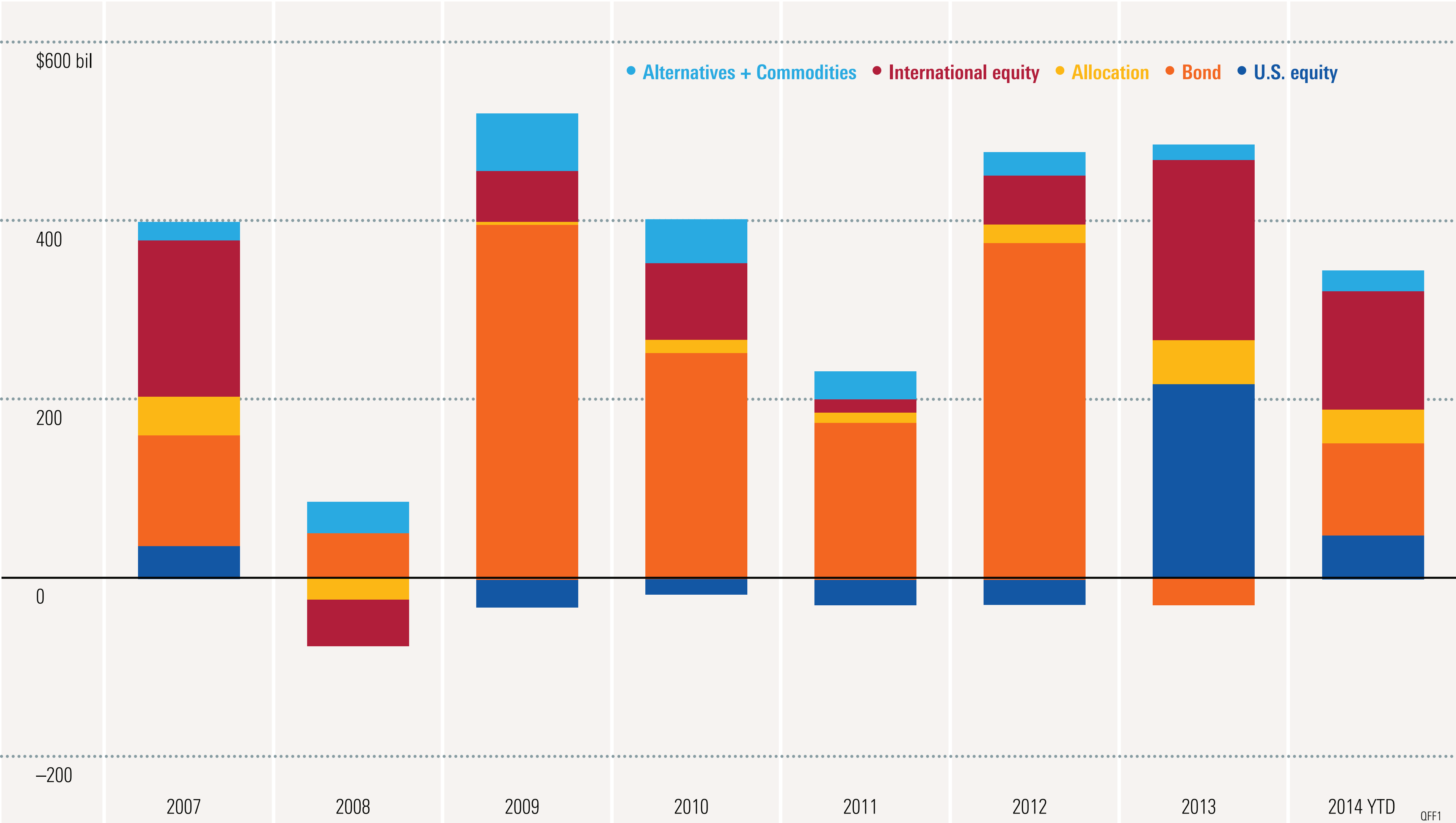
Funds

Annual Asset Flows

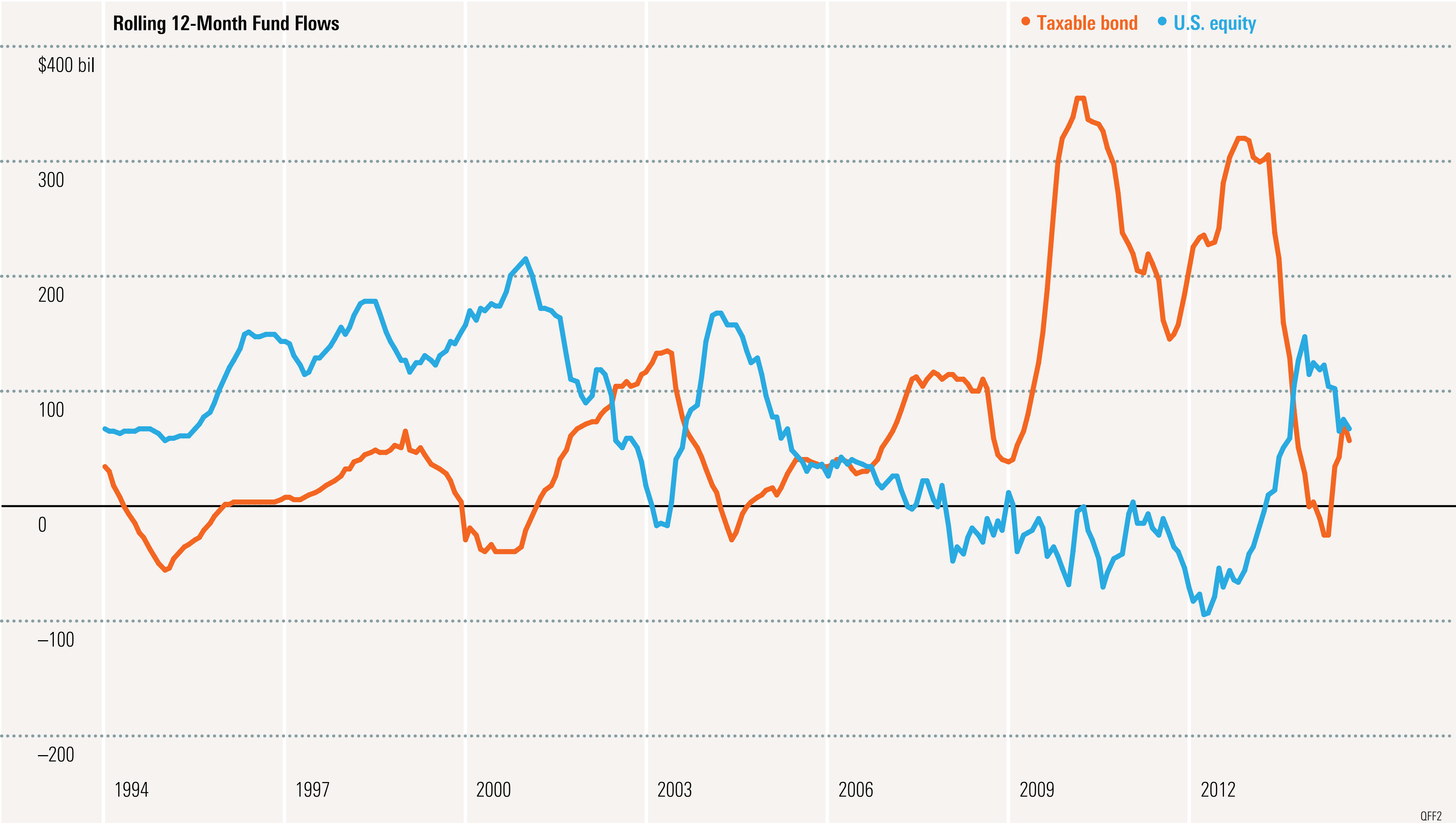
From 2009 to 2012, fixed income got the great majority of investor money. That trend switched in 2013, as U.S. and international stock categories received strong investor flows. So far in 2014, flows have been fairly balanced, with international stock and U.S. fixed income leading the way.



Source: Morningstar Direct. Funds analyzed include U.S. open-end mutual funds and ETFs.

Bond Versus Equity Fund Flows

Investor behavior is tied to market performance, but the timing may not always be right. In 2009, as the stock market hit bottom, investors should have been buying cheap stocks, but instead bond flows increased. In 2012, stock inflows started to climb up again for the first time since 2003. So far this year the trend reversed one more time, with stock inflows down and bond inflows up.

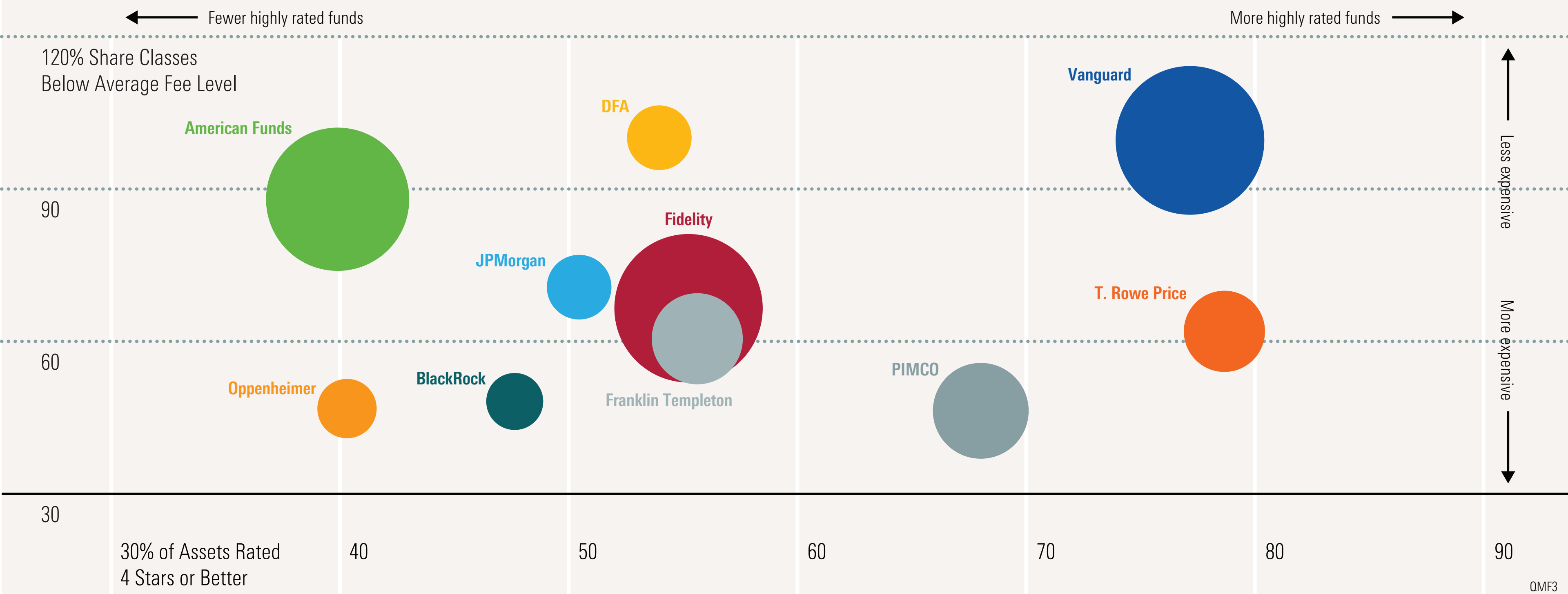


Source: Morningstar Direct. Funds analyzed include U.S. open-end mutual funds and ETFs.

Top 10 Mutual Fund Companies by Assets

For mutual funds, performance is closely linked with expenses. From the bottom left, representing weaker risk-adjusted returns and higher costs, the bubbles tend to move up and to the right, toward higher returns and lower costs. The largest company, Vanguard, had the highest asset inflows this year, while investors withdrew a large amount of assets from PIMCO.

		New Asset Flow ($ mil), YTD	Morningstar Stewardship Grade	Manager Retention Rate	Success Ratio	Manager Investment >$500,000
1	Vanguard	96,077	A	91	75	31
2	Fidelity	–9,920	B	91	49	60
3	American Funds	144	A	96	60	99
4	PIMCO	–60,858	C	92	55	4
5	Franklin Templeton	3,438	B	96	39	62
6	T. Rowe Price	11,577	A	95	78	42
7	JPMorgan	20,707	C	94	52	64
8	DFA	21,421	B	95	69	5
9	BlackRock	9,026	C	86	29	73
10	Oppenheimer	4,344	C	88	46	62



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Active Versus Passive Fund Strategies

There is a strong correlation between active manager outperformance and the relative returns of each style index. When a style index has bad performance relative to the other indexes, active managers tend to outperform that category in greater numbers.

Last Quarter

	Value	Core	Growth
Large	22 0.2	9 1.7	13 2.2
Mid	46 –3.2	15 –1.1	26 –1.3
Small	31 –6.4	39 –6.0	61 –6.1

1-Year

	Value	Core	Growth
Large	27 18.3	30 18.6	4 22.7
Mid	14 17.1	7 18.6	34 16.7
Small	10 11.1	12 9.5	49 15.9

5-Year

	Value	Core	Growth
Large	63 13.5	10 16.3	15 16.6
Mid	13 17.1	3 18.5	16 16.7
Small	9 16.2	35 15.3	27 15.9

% of active funds outperforming their respective Morningstar style index

Index returns (%)

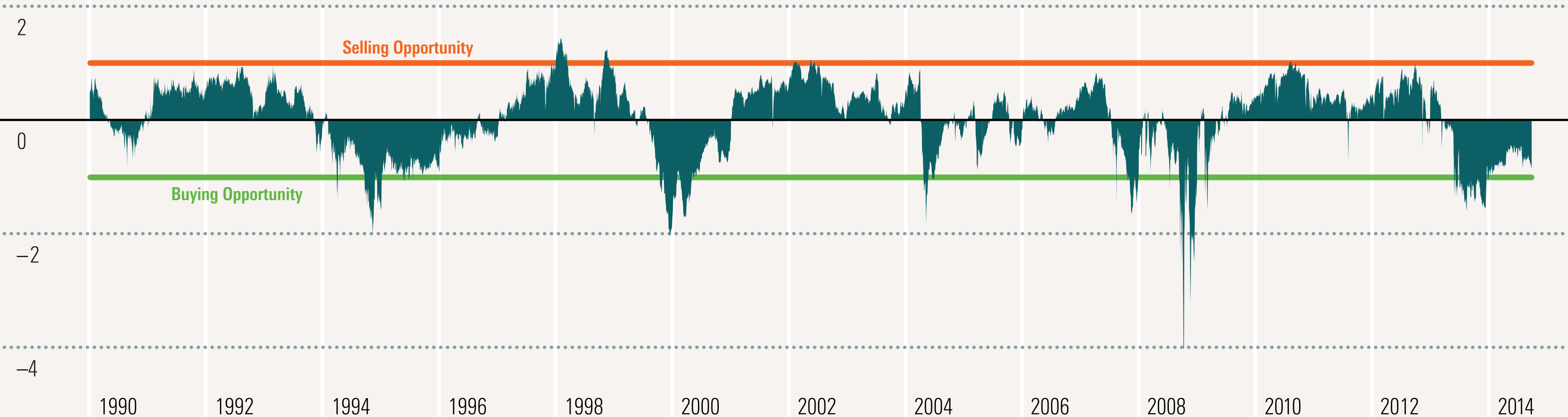
QMF2

Closed-End Funds Trading at Above Average Discounts

All closed-end fund categories are currently trading below fair value, and discounts have widened in the last quarter, reflecting higher market volatility. The closed-end fund universe has been trading with a negative z-statistic since April 2013. As you can see in the chart, buying below –1 and selling above 1 has historically been a good strategy.

Broad Category	3 Year Z-Statistic	Current Avg. Discount (%)	Avg. Distribution Rate (%)	Number of IPOs in 2014	Total Assets ($ mil)	% of Funds Using Leverage	3 Month Total Return (%)	1 Year Total Return (%)
Allocation	0.0	–8.9	10.0	0	18,173	74	–2.9	12.0
Alternative	0.2	–10.4	8.9	0	691	0	–0.1	3.5
Commodities	–0.7	–6.8	4.6	0	3,195	0	–9.8	–7.9
International Equity	–0.1	–8.4	4.9	1	19,596	28	–3.5	6.5
U.S. Equity	0.6	–10.4	7.3	0	26,069	33	–0.7	13.0
U.S. Sector Equity	–0.8	–5.8	7.2	5	46,850	76	–2.0	18.5
Taxable Bond	–1.1	–8.1	7.3	2	78,887	87	–0.9	9.2
Municipal Bond	–1.3	–8.9	5.7	0	65,309	97	3.0	15.8

3 Year Z-Statistic of Closed-End Fund Universe



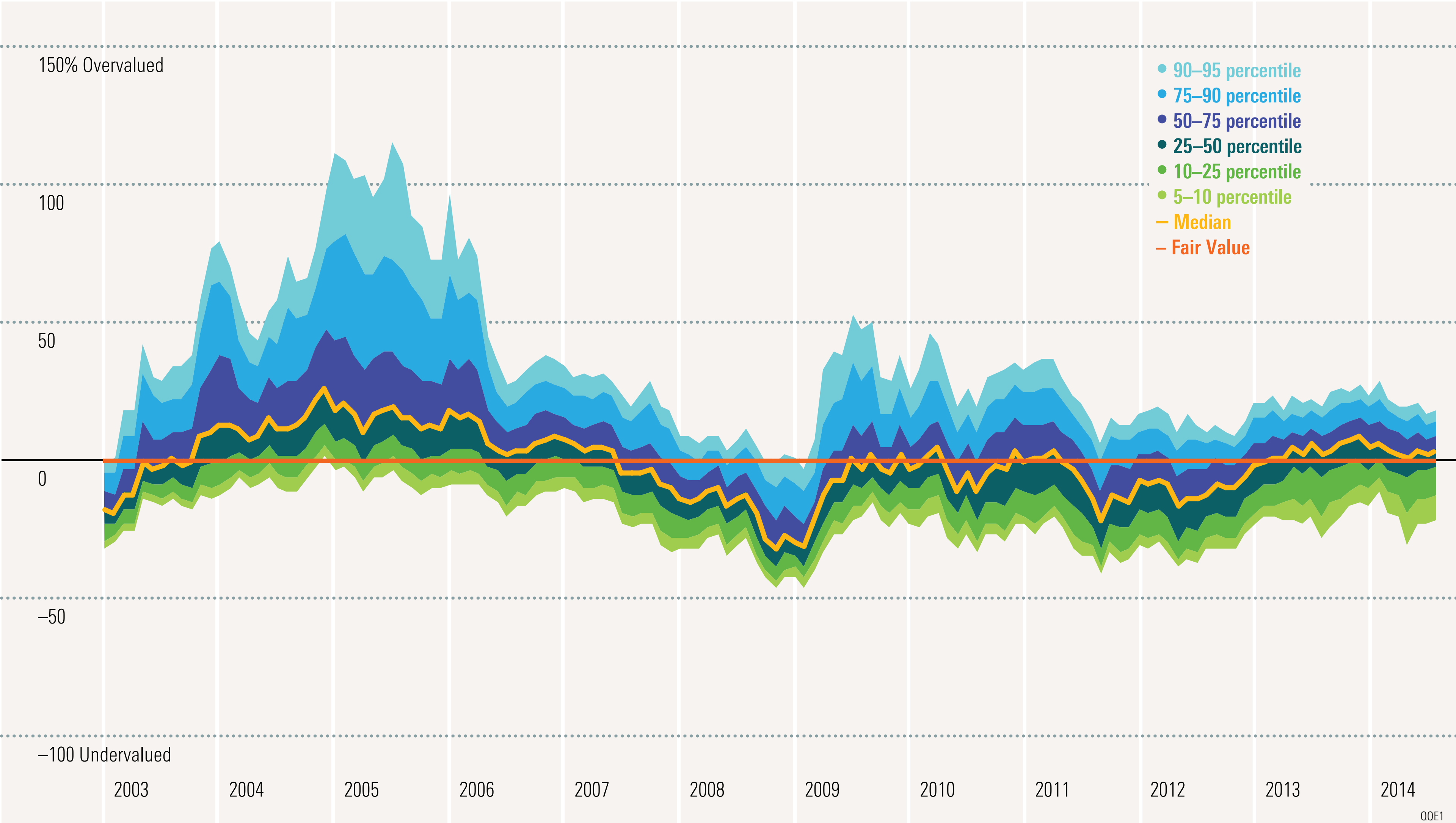
QCEF1

Source: Morningstar Direct. The z-statistic result is the number of standard deviations away from the average discount over the time period measured.
Z-statistic = (Current discount–Average discount)/Standard deviation of discount.

Equities

Morningstar Quantitative Price to Fair Value Distribution, U.S. Equity

The distribution of Quantitative Price to Fair Value can yield a richer interpretation of market valuation than simple averages. At times, the median U.S. stock may be slightly overvalued, but the full extent of the overvaluation can be substantial. Today, U.S. equities (on a median basis) appear to be fairly valued with a narrow distribution by historical standards.



Morningstar Quantitative Price to Fair Value, U.S. Equity

Current market valuations seem to present few attractive buying opportunities. Value stocks of all sizes appear to be trading at slight discounts. In the uncertainty/moat style box, the cheapest category consists of high-uncertainty, no-moat companies. These tend to be the riskiest stocks, which investors are moving away from because of increased market volatility.

Style / **Size**

Total Market 1.1%		–2.7	1.8	3.3
		Value	Blend	Growth
0.6	Large	–3.3	1.9	2.9
2.9	Mid	–0.3	2.8	5.9
–0.8	Small	–3.0	–0.6	1.4

Uncertainty / **Moat**

		2.0	1.0	–0.3
		Low	Medium	High
1.5	Wide	1.9	0.7	2.0
1.4	Narrow	2.4	1.2	0.7
–1.5	None	–0.5	2.3	–3.4

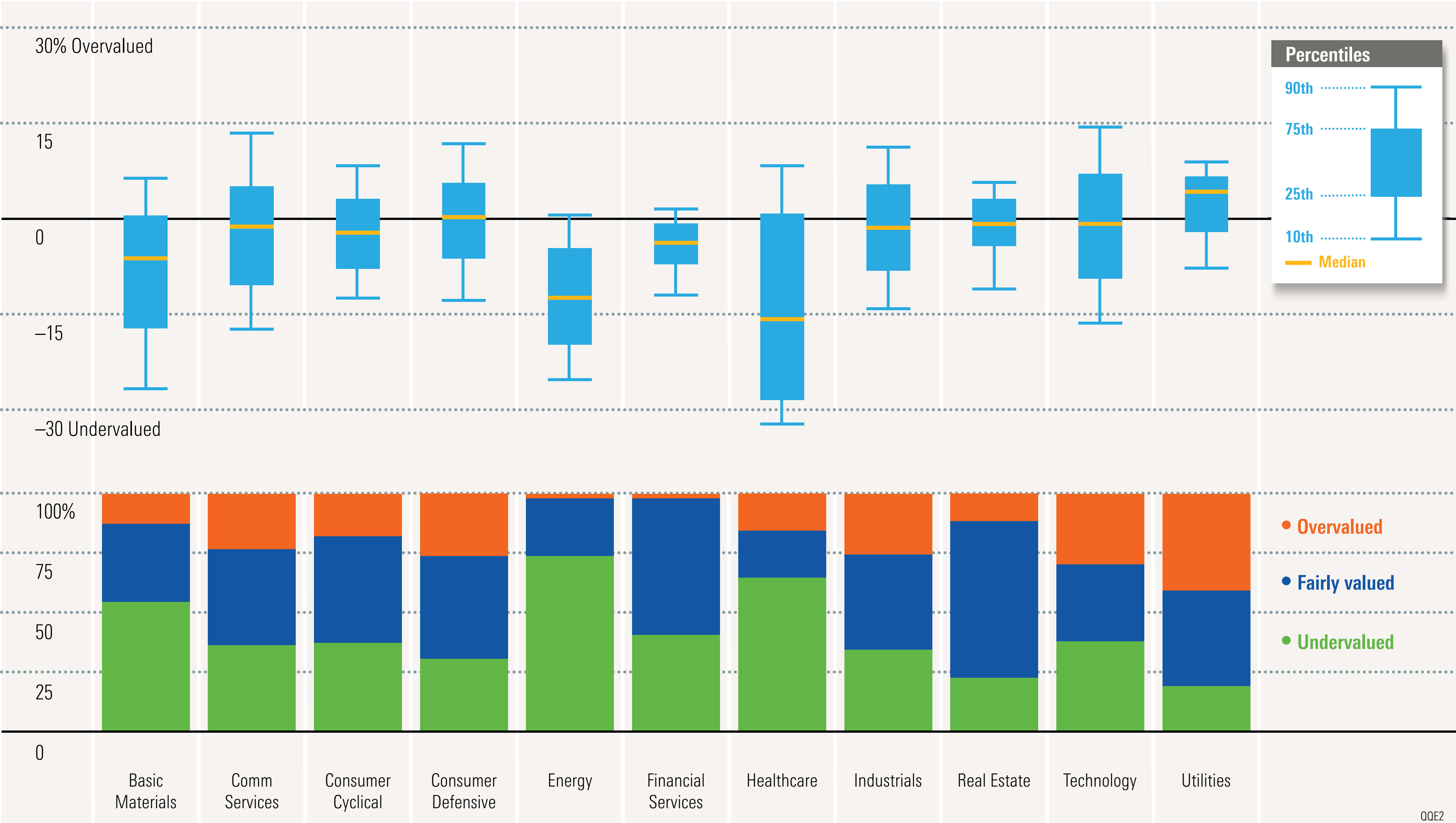
Undervalued		Fairly valued			Overvalued	
< –10	–10 to –5	–5 to 0	0	0 to 5	5 to10	> 10

QQE4

Source: Morningstar Quantitative Equity Data. Style boxes based on market-cap weighted data.

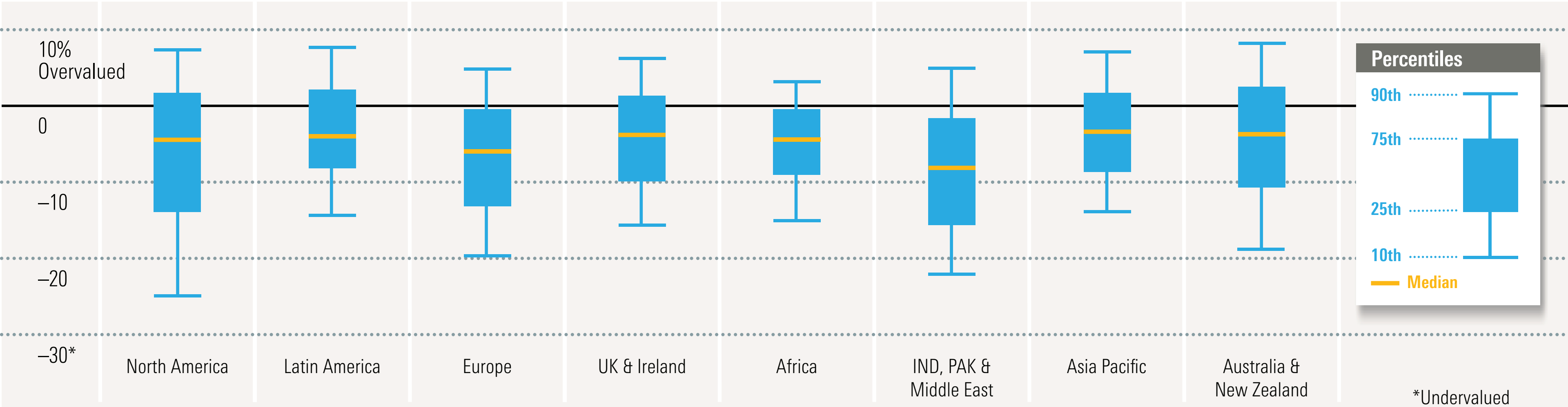
Morningstar Quantitative Price to Fair Value Distribution by U.S. Sector

At the end of the second quarter, most U.S. equity sectors were fairly valued. However, at the end of the third quarter, valuations decreased with the recent market sell-off. Utilities stocks are still the most overvalued at the median. Healthcare continues to have the cheapest median valuation at -16%, but energy has the most undervalued companies.



Morningstar Quantitative Price to Fair Value Distribution by Region

Markets have been pricing in the risks of lower global economic growth expectations. Geopolitical risks continue to weigh on equity valuations for many of the undervalued countries (a majority of them emerging). All regions are undervalued at the median, with the Middle East offering the cheapest valuations.



Top 10 Most Undervalued Countries

Country	Undervalued By (%)	Uncertainty Rating	Number of Companies
Nigeria	–10.6	Very High	91
Colombia	–10.1	High	29
Russia	–10.1	High	104
Iraq	–9.7	Very High	37
Bangladesh	–8.4	Very High	243
Brazil	–8.0	High	226
Pakistan	–5.1	Very High	325
Greece	–4.9	Very High	78
Turkey	–4.4	High	348
Portugal	–4.0	High	27

Top 10 Most Overvalued Countries

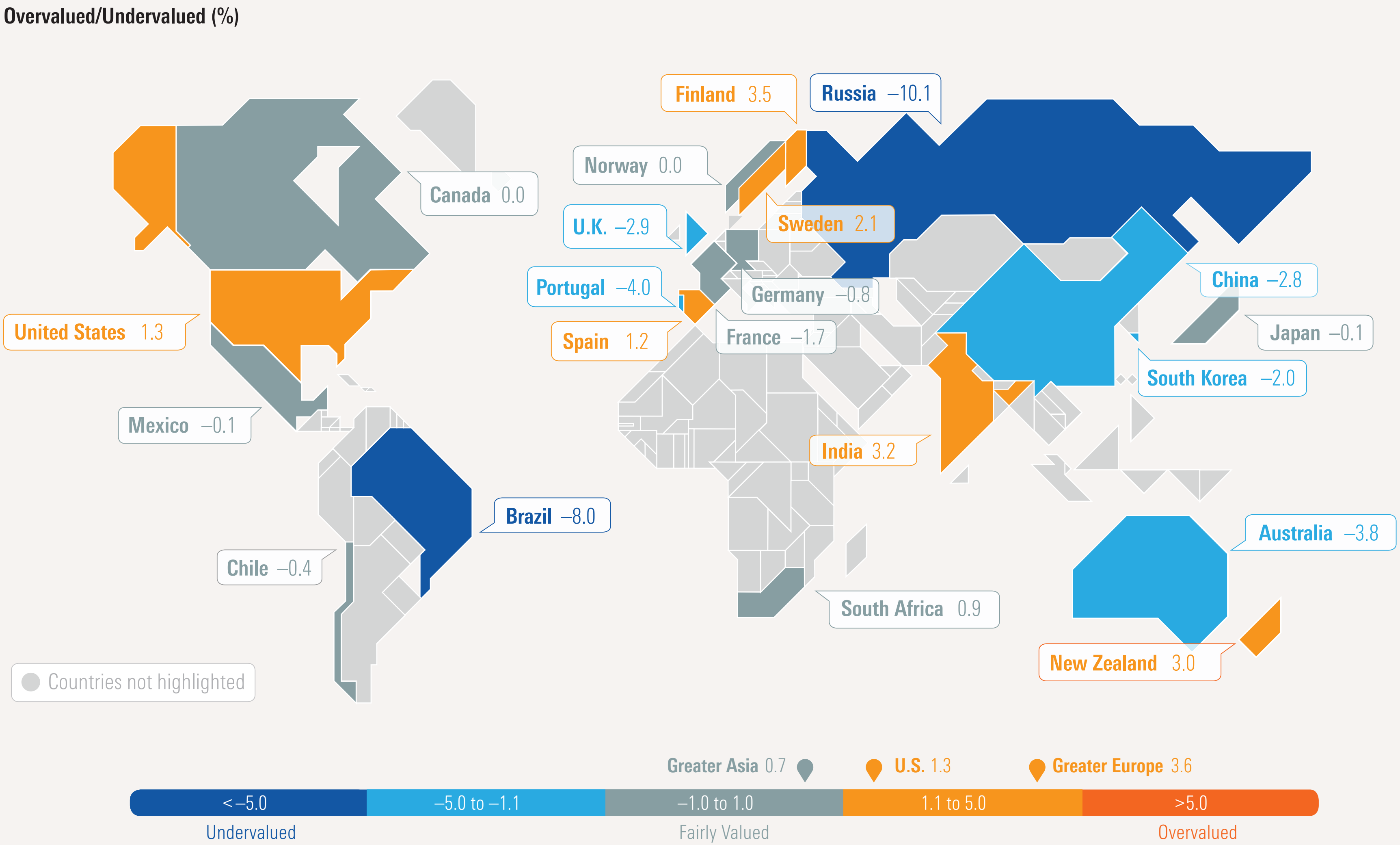
Country	Overvalued By (%)	Uncertainty Rating	Number of Companies
Denmark	6.3	Medium	116
Argentina	6.3	High	43
Belgium	4.6	Medium	97
Indonesia	4.2	High	364
Philippines	4.0	High	178
Finland	3.5	Medium	102
India	3.2	High	2,618
Saudia Arabia	3.1	High	156
New Zealand	3.0	Medium	80
Netherlands	2.7	Medium	118

QQE3

Source: Morningstar Quantitative Equity Data.

Morningstar Quantitative Price to Fair Value by Country

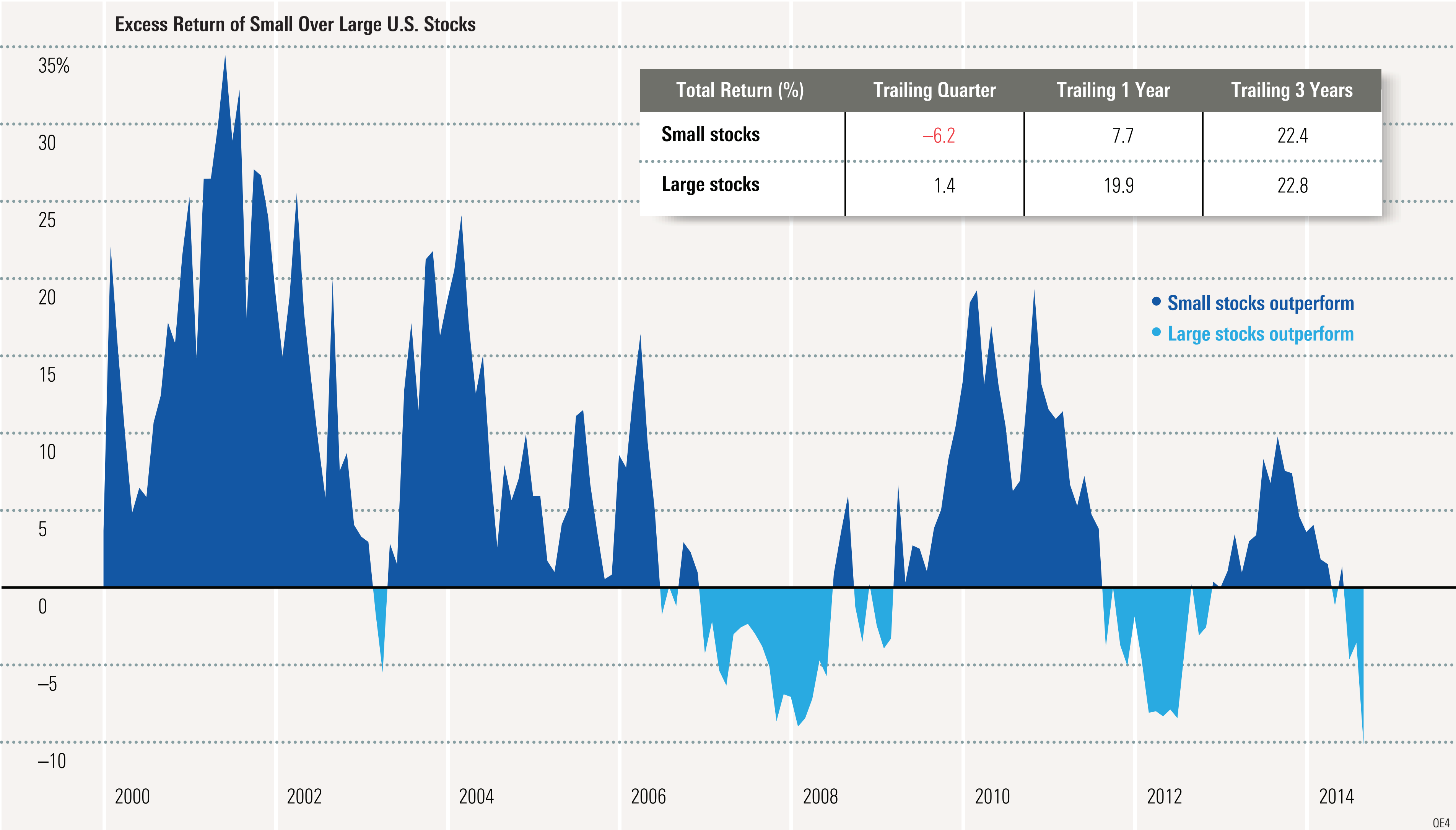
Many emerging-market countries are currently undervalued, and some of them by a significant margin. Russia's military intervention in the Ukraine has scared off investors, while Brazil's exports to China suffered in light of decreased demand for raw materials. A worsening economic outlook in Europe has caused many European countries to move from overvalued last quarter to undervalued today.



QQE5

U.S. Large Caps Outperforming Small Caps Since May 2014

Since 2000, small stocks have outperformed large stocks a majority of the time. The two periods of small-stock underperformance before the current one happened during market downturns, because of small stocks' higher volatility. It is too early to tell whether this marks the beginning of a new trend of large-cap outperformance or is only a short-term anomaly.

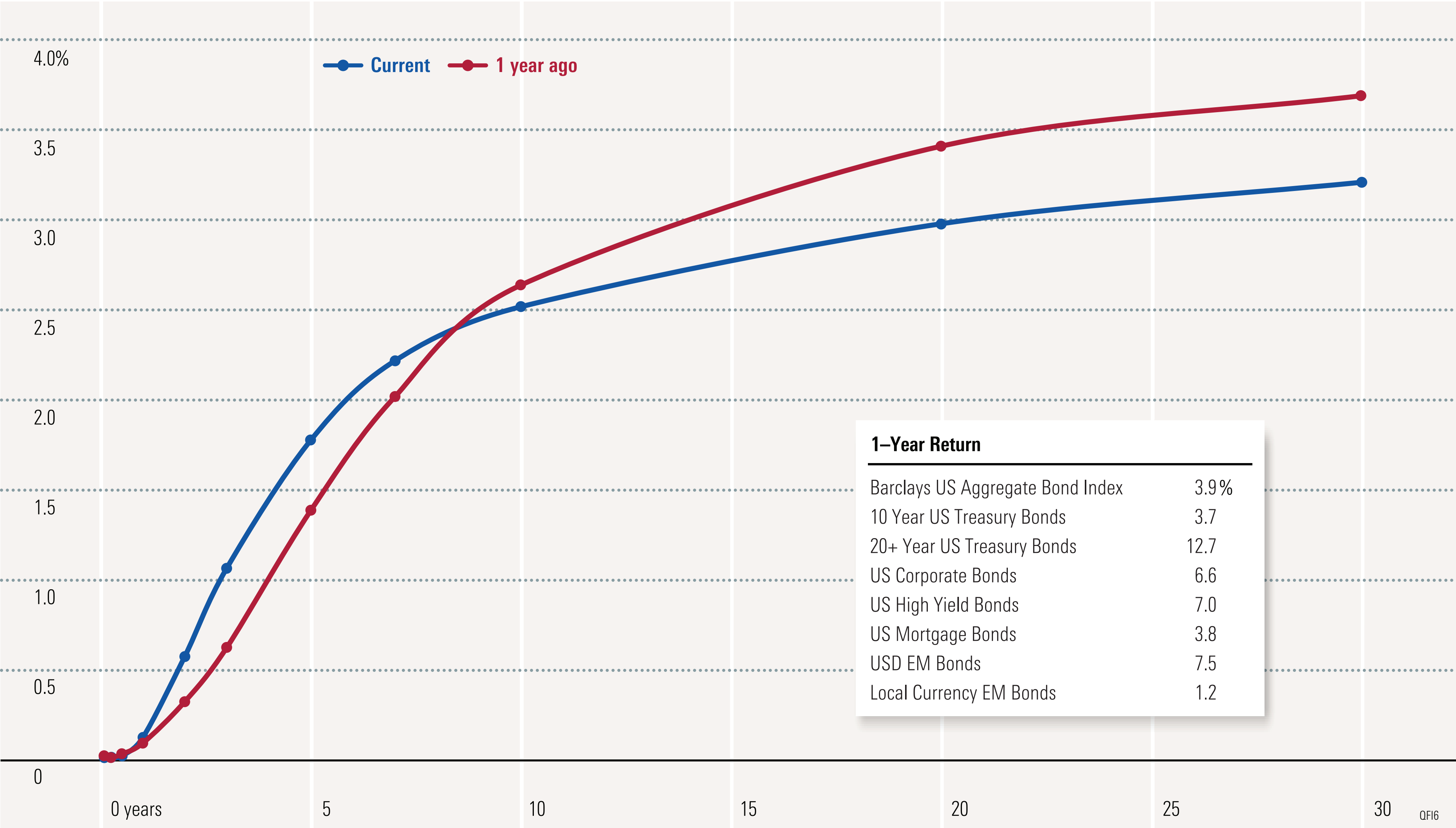


Total Return (%)	Trailing Quarter	Trailing 1 Year	Trailing 3 Years
Small stocks	–6.2	7.7	22.4
Large stocks	1.4	19.9	22.8

Fixed Income

Interest Rates Relatively Unchanged in the Last Year

During the past year, the U.S. Treasury yield curve steepened at the short end and flattened at the long end, reflecting investors' expectations that short-term rates will rise and that inflation will stay below average in the long term. Since the end of the quarter, the curve has flattened even further, as increased stock-market volatility has driven investors to the safety of U.S. Treasuries.



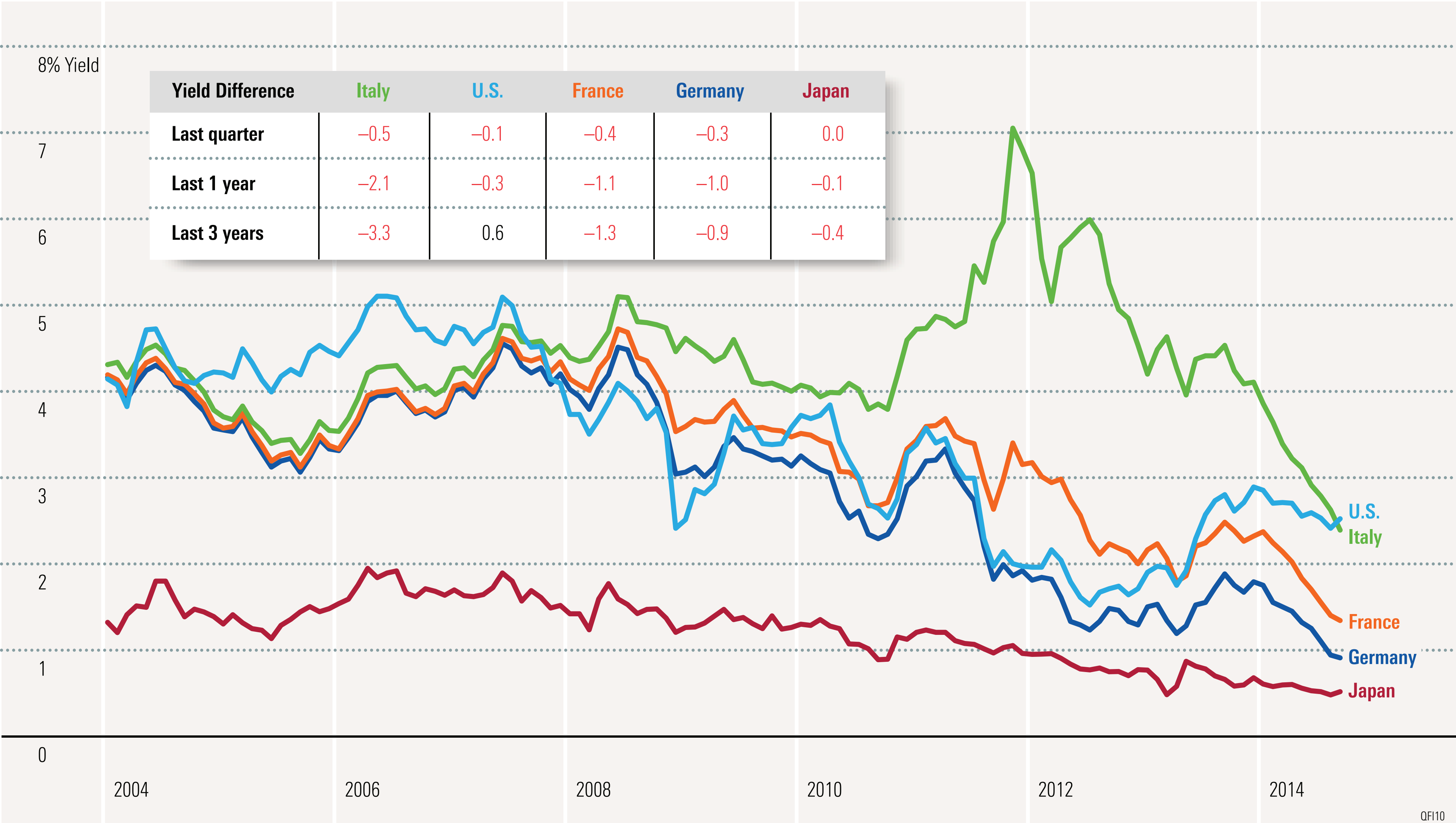
1–Year Return	
Barclays US Aggregate Bond Index	3.9 %
10 Year US Treasury Bonds	3.7
20+ Year US Treasury Bonds	12.7
US Corporate Bonds	6.6
US High Yield Bonds	7.0
US Mortgage Bonds	3.8
USD EM Bonds	7.5
Local Currency EM Bonds	1.2

Source: 10-Year US Treasury Bonds—Barclays US Treasury 7-10 Year Bond Index. 20+ Year US Treasury Bonds—Barclays US Treasury 20+ Year Bond Index. US Corporate Bonds—Morningstar Corporate Bond Index. US High Yield Bonds—Barclays US Corporate High Yield Bond Index. US Mortgage Bonds—Morningstar Mortgage Bond Index. USD EM Bonds—Morningstar EM Composite Bond Index. Local Currency EM Bonds—Barclays EM Local Currency Broad Bond Index.

World Government Bond Yields

For an international investor, the U.S. is actually a pretty good value. U.S. yields have actually climbed over the last three years. The Federal Reserve has been reducing its stimulus efforts since spring 2013, potentially edging U.S. rates higher in the future. On the other hand, the European Central Bank is only beginning its own QE initiative, which should keep European rates low going forward.

Yield Difference	Italy	U.S.	France	Germany	Japan
Last quarter	–0.5	–0.1	–0.4	–0.3	0.0
Last 1 year	–2.1	–0.3	–1.1	–1.0	–0.1
Last 3 years	–3.3	0.6	–1.3	–0.9	–0.4



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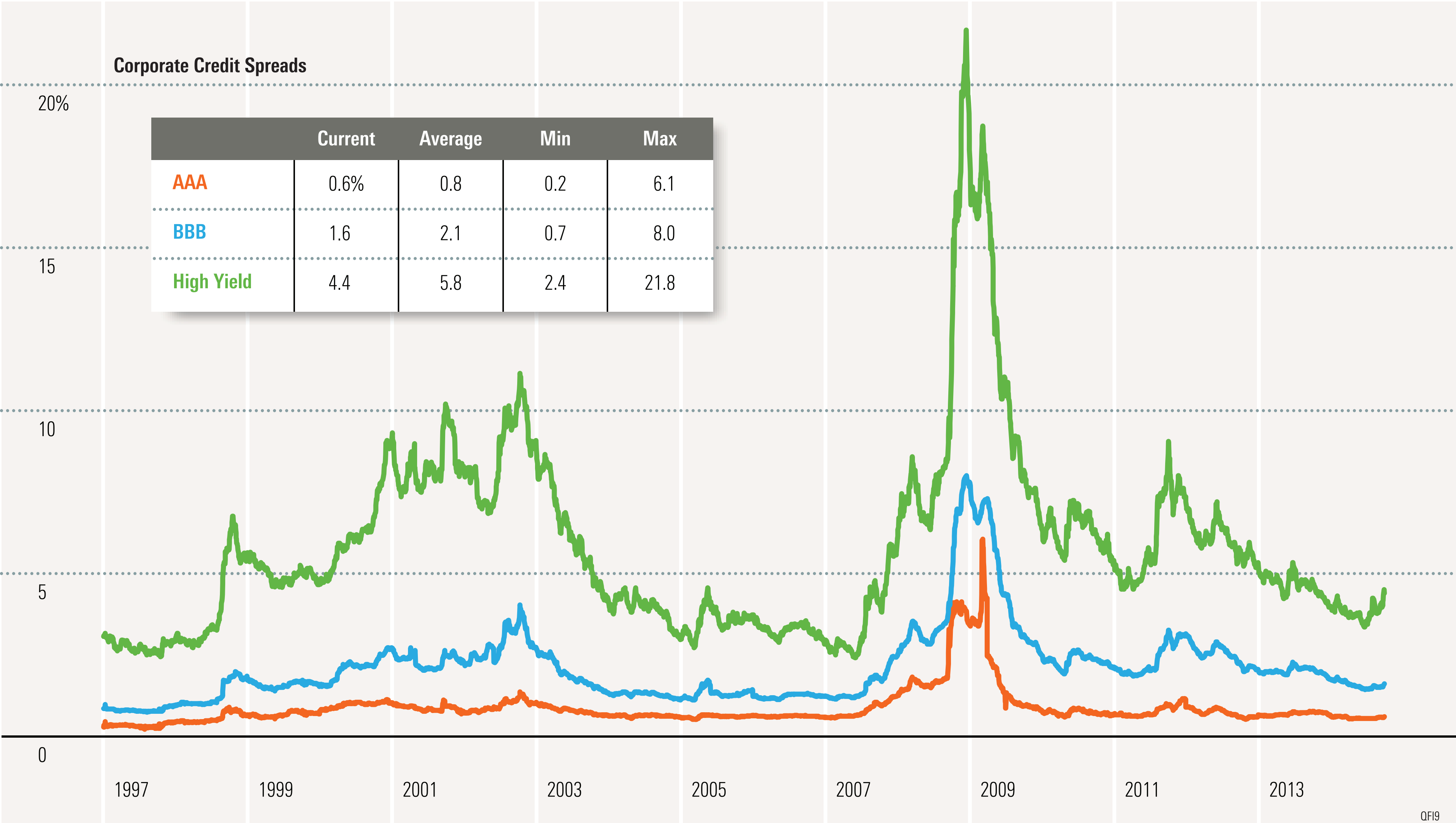
Corporate Credit Spreads

All corporate credit spreads spiked in 2007–2009 during the financial crisis, but have been on the decline until recently. All spreads are still below their long-term averages. However, there has been an uptick in the past few months, especially in high-yield spreads, as investors perceive higher risk.



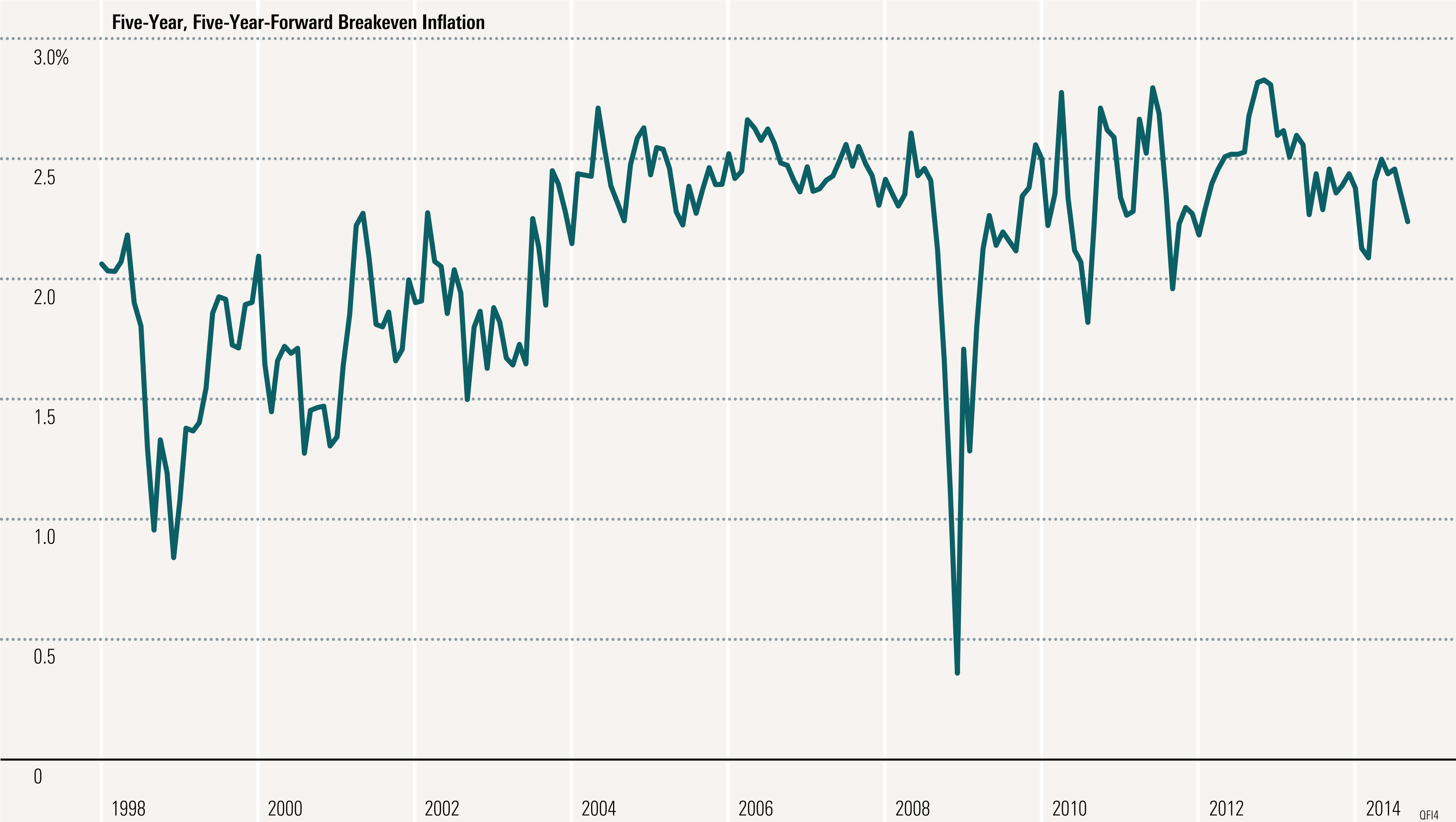
	Current	Average	Min	Max
AAA	0.6%	0.8	0.2	6.1
BBB	1.6	2.1	0.7	8.0
High Yield	4.4	5.8	2.4	21.8

QFI9

Source: Federal Reserve, Morningstar Calculations.

Long-Term Inflation Expectations Rising Again

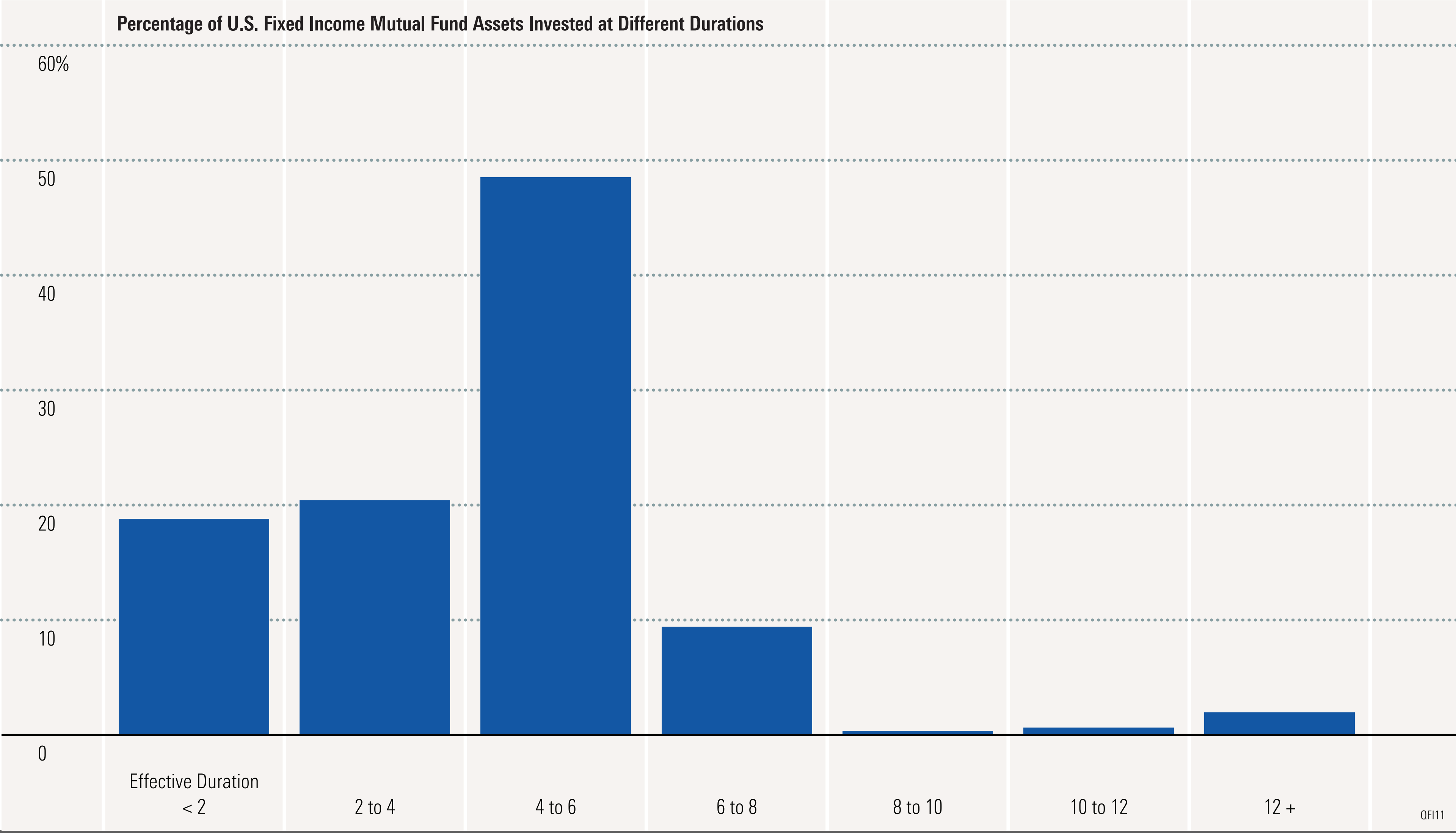
After peaking in November 2012 — a few months after the most recent quantitative easing program had been launched — market-implied inflation expectations have been declining and took a sharp leg down once the Federal Reserve officially announced it would begin tapering. In Q3 2014, inflation expectations dropped to 2.2%, below the long-term trend of around 2.5%.



Source: Bloomberg, Morningstar Calculations.

Fixed Income Mutual Fund Assets by Duration

Not surprisingly, the highest concentration of assets can be found in the medium-duration category (4 to 6 years). The longer-duration categories attract fewer assets, reflecting investors' aversion for the higher risk these categories carry. Especially in an uncertain interest-rate environment, low and medium-duration bonds tend to be the most popular.



Fixed-Income Winners and Losers

Interest rates rose in 2013, so low duration categories like high-yield, bank loans, and short-term bonds posted the only positive returns. In 2014, interest rates have actually fallen, so the longer duration categories are the top performers. At the same time, falling interest rates and rising credit spreads hurt bank-loan returns.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 YTD	Entire Period
Highest return	24.2%	21.5	10.6	24.8	29.0	14.6	10.7	11.8	10.8	25.9	58.2	15.1	28.2	18.5	7.4	13.6	10.6
	3.7	14.4	8.8	17.8	25.7	11.7	7.8	9.9	10.1	13.1	51.6	12.4	17.9	15.8	5.3	10.7	7.3
	3.3	12.9	8.4	16.3	18.7	11.1	5.9	6.8	9.9	10.3	28.2	12.0	10.7	10.7	0.7	7.6	7.0
	2.4	12.6	7.6	13.1	10.0	8.7	5.1	6.7	7.0	8.8	12.9	10.1	9.5	9.7	–1.1	7.3	6.8
	–0.8	11.7	5.3	12.9	5.3	8.5	3.5	4.8	6.8	5.2	5.9	10.1	8.5	6.8	–2.0	4.1	5.3
	–1.8	11.6	5.1	10.3	5.3	5.2	2.7	4.3	6.3	5.0	4.2	7.1	7.8	4.2	–2.6	3.5	5.2
	–2.1	8.2	4.2	9.6	4.1	4.5	2.4	4.3	3.4	–2.5	3.8	6.5	6.9	3.5	–4.5	3.4	5.1
	–5.3	4.9	3.7	6.2	2.9	4.3	1.8	3.2	2.6	–10.9	3.0	5.8	5.0	3.3	–6.6	2.1	5.0
	–7.4	–1.3	1.4	1.9	2.4	2.3	1.4	3.1	2.1	–26.2	–2.4	2.7	1.6	2.1	–7.1	1.3	5.0
Lowest return	–9.0	–5.9	–3.0	–1.4	1.4	1.3	–7.3	1.2	1.9	–29.1	–14.9	2.4	1.5	1.2	–11.4	0.5	3.7

Bonds:
- Long-term gov't
- Intermediate-term gov't
- Long-term corp
- Short-term
- Municipal
- International
- Emerging-market
- High-yield
- Bank loans
- Aggregate

QFI8

Source: Long-term gov't—Ibbotson SBBI U.S. LT Gov't Bond Index. Intermediate-term gov't—Ibbotson SBBI U.S. IT Gov't Bond Index. Long-term corp—Ibbotson SBBI U.S. LT Corp Bond Index. Short-term—Citigroup USBIG Gov't/Corp 1-3 Year Bond Index. Municipal—Barclays Municipal Bond Index. International—Citigroup WGBI Non-USD 5+ Year Bond Index. Emerging-market—JPM EMBI Global Bond Index. High-yield—Barclays U.S. Corp High Yield Bond Index. Bank loans—S&P/LSTA Leveraged Loan Index. Aggregate—Barclays U.S. Aggregate Bond ..Index.

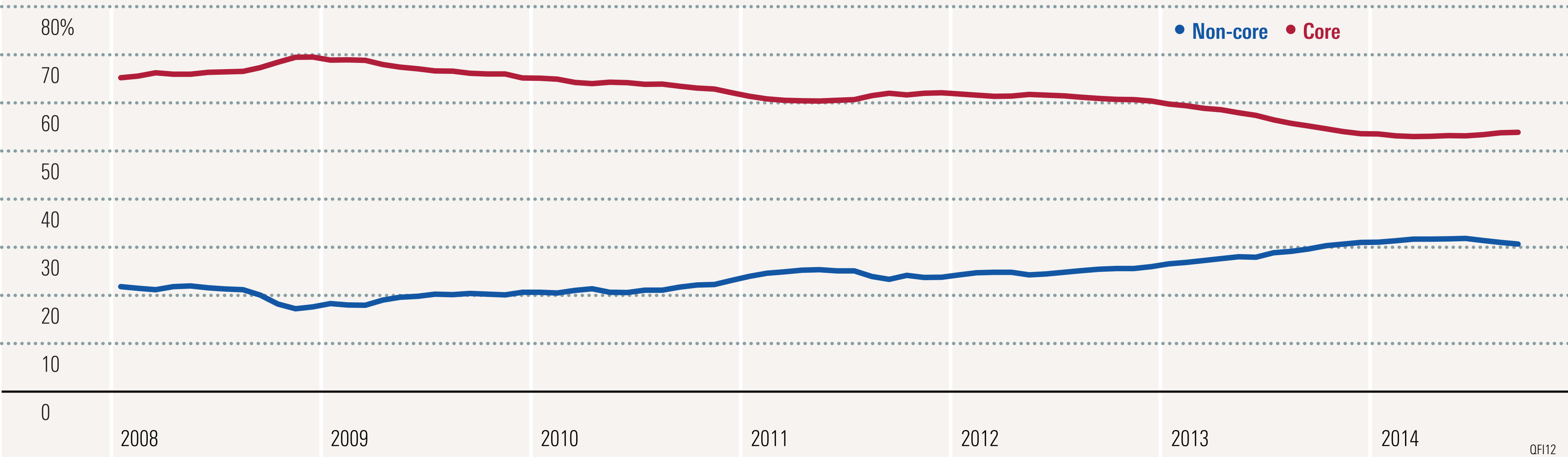
Core Versus Non-Core Fixed-Income Assets

Since 2008, assets have been trickling away from core and into non-core fixed-income categories as investors continued to search for yield. As illustrated by the correlation tables, non-core categories tend to have higher correlations with stocks and therefore may carry more risk than their core counterparts. In Q3 2014, the trend reversed as the stock market dipped and investors moved back into core bonds.

	Correlation	
Core Bond Categories	**S&P 500**	**Barclays Aggregate Bond**
Intermediate-Term Bond	0.47	0.83
Intermediate Government	–0.06	0.94
Inflation-Protected Bond	0.33	0.75
Corporate Bond	0.51	0.76
Long-Term Bond	0.40	0.86
Long Government	–0.28	0.79
World Bond	0.58	0.67

	Correlation	
Non-Core Bond Categories	**S&P 500**	**Barclays Aggregate Bond**
High Yield Bond	0.76	0.25
Multisector Bond	0.75	0.47
Bank Loan	0.61	0.02
Nontraditional Bond	0.71	0.26
Emerging Markets Bond	0.71	0.53
Preferred Stock	0.66	0.38

Percentage of Fixed-Income Mutual Fund and ETF Assets by Category



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