Morningstar Guide to Mutual Funds

Five-Star Strategies for Success

Second Edition

Christine Benz

WILEY

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Foreword

We all know that if you invest wisely, you can increase your wealth, but it's easy to overlook the lessons that investing can teach us about ourselves. Money is a difficult subject to discuss. Emotions run deep when it comes to our finances, causing most of us to shy away from deep thoughts on how we save or invest. Sure, we might boast to our friends about a particular stock purchase that went through the roof, or tell tales of an IPO opportunity that got away, but we seldom speak honestly or openly about our overall financial experiences, even with those closest to us. That's unfortunate. Ultimately, to know oneself as an investor goes a long way toward knowing oneself as a person.

I know that's been true for me. I started investing in mutual funds as a teenager. My father bought me 100 shares of the Templeton Growth Fund when I was in my early teens. He showed me the fund's prospectus and annual report and explained that I was now an owner of a little piece of each of the companies listed in the report. It was a wonderful introduction—not only to mutual funds, but also to the world of adult activities. I'm not saying I stopped reading *Boy's Life* the next day and switched to the *Wall Street Journal*, but an introduction had been made. Over time, I read more about investing and particularly about mutual funds. I paid special attention to Sir John Templeton's advice, reading his annual reports and watching him on his visits to *Wall $treet Week* with Louis Rukeyser. In short, I had started down the path to becoming an investor.

As time has gone by, I've realized that the real lesson from those first few shares of Templeton Growth wasn't how a mutual fund works, but how a responsible adult acts. In effect, my Dad was showing me that investing was something he did to help provide for our family. He wasn't jumping in and out of hot stocks. He was systematically setting a little bit aside each month to build for a better future, and he wanted me to know that I could do the same. He taught me that investing, by its very nature, is a responsible act. It's deferring the instant gratification of consuming today in hopes of providing a more secure future for yourself and for your loved ones. How different that message was from the messages on television (save those of Rukeyser's show) that portrayed investing as something only for the snobbish elite. The same shows that disparaged investing were supported by countless commercials touting the immediate satisfaction to be derived from spending!

Fortunately, our collective attitude toward investing has improved since the days when J. R. Ewing was the only one on television you saw making investments—and doing so to hurt people, I might add. The rise of personal financial journalism, led by *Money* magazine, has opened up investing to a much wider audience. There's never been a time when an individual investor had as many resources at his or her disposal as today. If anything, the challenge has shifted from finding information to making sense of an overload of information!

The 1990s, in particular, saw a surge of interest in the investment markets. Unfortunately, it wasn't always a mature or well-grounded interest. To a large extent, big market returns drove people to trade the instant gratification of consumption for the seemingly instant gratification of investment riches. I had an advantage many investors didn't have in that market: over 20 years of investing experience, albeit almost all of it with very small sums at stake. Nevertheless, I'd seen my shares both rise and fall; I'd weathered a number of down markets and had learned that staying the course paid off in the end. I especially knew from my readings on John Templeton that investing was never as easy as it appeared to be in the heady days of the Internet-led bull market. While Templeton has enjoyed enormous success as an investor, he always stresses the importance of humility, recognizing that even with thorough research there is still a significant chance that your stocks will lose money. He has warned repeatedly that even your best-researched stock pick may well decline in value by 30%, 50%, even 70% or more. Pointedly, he also notes that investors who get rich quickly are usually the same ones who get poor quickly. How truly his words played out after the technology bubble of the late 1990s.

Still, even with sharp market losses from 2000 through 2002, our generation is making progress as investors. We're learning important lessons not only about investments, but also about how we respond personally to both gains and setbacks. In so doing, we lay the foundation for better results ahead. Bear markets shouldn't cause you to lose faith in the markets. Rather, they should be seen as a part of the inexorable cycle of the market. Sure, they can damage investor portfolios, but they also bring opportunities. The test is whether you have the fortitude to withstand the inevitable downturns and unearth the values they create. How odd it is that many of the same investors who bemoaned being late to the game in the 1990s, but plunged in anyway, later turned their backs on stocks at much more attractive prices. Clearly, the path to investment success requires a discipline that's easier to grasp than to master.

Fortunately, you don't have to go it alone. I learned much about patience and the benefits of weathering bad markets through the lessons of owning the Templeton fund. I've learned even more by working at Morningstar® with a group of people who genuinely like investing and want to learn more. Having smart people to share ideas with is a great benefit during tough markets. Sadly, many investors have no choice but to go it alone, having few friends or colleagues with whom they feel comfortable discussing their finances. That was certainly the case for me prior to joining Morningstar. I didn't find many fellow investors in high school or even in college. I remember long nights in graduate school poring over personal finance magazines trying to make sense of the bewildering world of mutual funds to begin to put together a financial plan for my family. What a joy to join a community of fellow investors.

Now that opportunity is open to everyone. The *Morningstar Guide to Mutual Funds* is an invitation for you to join a community of investors who want to better understand what makes funds tick and what separates the top managers from the rest of the pack. You'll learn the lessons we've found most valuable over the years—everything from how to read fund documents to assembling a well-balanced portfolio. In short, you'll get the on-ramp introduction you need to get moving along the road to better investment results.

Even if you're a seasoned investor, I think there's much in these pages that will help you hone your skills as an investor. I hope that you'll also become a part of an investing discussion that continues daily on Morningstar.com. Among our editors and readers, you'll find a group of independent thinkers who trade ideas in a shared quest to help people make better investment decisions. It's a lively and rewarding discussion, one that's evolving as its participants, both in print and on the Web, have grown. I value what I learn from our writers and readers about investment opportunities, but even more so I admire the spirit and spark they bring to the endeavor. They help me keep my feet on the ground during good markets and my head up during bad ones.

Please join us on this journey toward better investment results and greater financial independence. I think you'll learn a lot about investments and possibly a little about yourself along the way. Maybe you'll even use this book to introduce the young people in your life to the world of investing and set them on their own journey. In any case, I wish you well.

DON PHILLIPS
Managing Director, Morningstar

Acknowledgments

Many people played important roles in putting together the second edition of this book. Gregg Wolper, Scott Berry, and Bridget Hughes, all of whom are seasoned mutual fund analysts and superb editors, provided invaluable editorial guidance on each and every chapter and greatly improved the quality of the finished product. Alla Spivak, as product manager, kept the book revision on schedule, coordinating the efforts of our team of writers, editors, and designers with her usual patience and good humor. Morningstar designer Lisa Lindsay put in long hours revising all of the tables, charts, and graphics that appear throughout the book, while Joseph Nasr helped update all of the information in the graphics. Morningstar's Director of Fund Analysis, Kunal Kapoor, and Securities Chief Haywood Kelly, along with senior analysts Christopher Traulsen and Jeffrey Ptak, provided me with valuable guidance and moral support while I revised the book. David Pugh, our editor at John Wiley & Sons, helped bring a fresh perspective to the material.

I also owe a huge debt of gratitude to my two co-authors on the first edition of this book, Peter di Teresa and Russel Kinnel, both of whom have a tremendous gift for translating complicated investment concepts into easy-to-read prose. Amy Arnott and Erica Moor shepherded the first edition of this book from start to finish, while award-winning Morningstar designer Jason Ackley created the graphics and layout in the first edition. Scott Cooley and Tricia Rothschild, along with analysts Langdon Healy, Jeffrey Ptak, Shannon Zimmerman, Bridget Hughes, and Eric Jacobson, provided valuable content and edits for the first edition, and we were also fortunate to be able to draw on Susan Dziubinski's tremendous work in educating investors. Not only did Don Phillips write the foreword that appears in both the first and second editions, but, as Morningstar's first analyst, he has set high standards for all of us who have come after him.

Morningstar fosters collaborative efforts, and it's fair to say that our entire fund-analyst team deserves a share of the credit for this book. Morningstar founder Joe Mansueto set the spirit for Morningstar and for this book by promoting the idea that independent, objective investment analysis should be available to investors big and small. Meanwhile, Catherine Odelbo, as head of Morningstar's individual-investor division, has carried on Joe's vision by consistently encouraging Morningstar's analysts to create the best possible products for investors of all experience levels. She has been central to putting Morningstar's motto of "Investors First" into action.

Introduction

We're five years into the new millennium—and you couldn't blame most mutual-fund investors if they wanted to go back to the old one. The same goes for mutual-fund companies. Any way you look at it, the past half-decade has been a rough one for the fund industry.

First, those funds that had been riding high during the glory days of the late-1990s stock-market rally came crashing down with the brutal collapse of the technology-stock boom. As a bear market broadened beyond the tech sector, very few stock funds—even those that hadn't jumped headfirst into the tech or Internet ponds—escaped damage. Although some bond funds held up fairly well, the stock-market plunge created plenty of angry shareholders who withdrew a lot of money from their funds. Fund firms that had prospered the most in the growth-stock rally—with Janus a prime example—suffered massive outflows.

When it seemed things couldn't get much worse, they did. Just as the stock market was regaining its footing in the summer of 2003, Eliot Spitzer arrived on the scene. By charging several mutual funds with unsavory practices in September of that year, and following up with further actions, the New

York Attorney General set off a full-fledged scandal that sent the fund industry reeling. Some of the biggest fund companies, as well as many lesser-known firms, were tarred by accusations that they violated their own internal guidelines and in some cases, the law as well. As a result, performance woes were joined by a deeper suspicion—can mutual funds even be trusted? In this atmosphere, hedge funds began to gain assets and media attention. Some ordinary investors started wondering if those vehicles—once seen as the exclusive province of the rich and well-connected—might provide a better alternative for them as well.

So, as we set forth to revise this book in the spring of 2005, we realized that a new and important question had emerged: Are mutual funds still worth your while? At Morningstar, we firmly believe the answer is yes. And don't think we're just an industry cheerleader eager to sweep problems under the rug. Far from it. Even before the scandals hit, we were highly critical of any funds we considered overpriced, or that we considered unimpressive performers, or of those that posted shiny numbers but had relied on questionable strategies unlikely to hold up in the long run. Then, when the charges started to fly, we took a hard line on those fund companies that the regulators' investigations showed had abused shareholders' trust. We recommended that investors consider selling all their shares in funds run by the worst offenders until those firms revealed all the facts of their cases and took concrete, tangible measures to address the problems and improve their corporate cultures. That criticism did not endear us to the fund companies in question—to put it mildly.

The fact is, though, that for the vast majority of investors, mutual funds (and their cousins, exchange-traded funds, or ETFs) remain the best vehicles to use in order to achieve your long-term financial goals. For one thing, several of the industry's biggest and best firms were not implicated in the scandal in any way. And many of the scandal-plagued shops have cleaned up their acts. Just as an example, Putnam, Janus, and Alliance, three of the most prominent forces in the industry, all replaced their top executives and instituted serious reforms. Much remains to be done, both in repairing the damage from the scandals—and in addressing issues that long predated these events, such as high costs and a tendency to put marketing goals ahead of sound investing principles. Yet for gaining exposure to talented managers and a wide variety of stocks and bonds in a host of different styles, a portfolio containing the right funds and ETFs still beat the alternatives for just about everyone.

Yes, you could buy individual stocks and bonds yourself, and it's worth noting that because Morningstar provides information on stocks as well as on funds, we have no inherent interest in steering you away from them. Indeed, there's certainly nothing wrong in owning a few stocks. But to own a broadly diversified portfolio consisting *solely* of individual stocks and bonds, and to properly monitor and track all of them, would require an amount of money, a store of knowledge, and a commitment of time and energy that the overwhelming majority of people just don't have. Meanwhile, though hedge funds might seem tempting, they demand a minimum investment far beyond most folks' means and usually don't allow you to withdraw your money at will. Moreover, compared with mutual funds or stocks, uncovering detailed information on hedge funds in order to make an informed decision on which ones to buy would likely be a frustrating endeavor for the typical investor.

In general, then, mutual funds are the way to go. But not every fund deserves your money. How do you find the right ones? That's what this book can help you to do. In the following pages, we show you the various styles funds adopt, discuss the pros and cons of the different fund shops, and explain how to build a portfolio of funds that are not only better than the rest, but provide the appropriate mix for your personal situation. We also address other questions you might have, such as: What do you do if the fund manager leaves? Should you buy index funds? What role should bond funds play? What about international investing? And much more.

At this point, you might also want to pose a more specific question: Who are we? Fair enough. Morningstar was created in 1984 by Joe Mansueto (who is still our CEO today) in order to provide regular folks with something then almost completely unavailable: detailed information and candid evaluations of each individual mutual fund. Since then, we have branched out into other areas as well, but mutual-fund analysis remains one of our core activities—and our belief that we stand for the ordinary investor has never wavered.

Currently we have about 25 mutual-fund analysts who talk with portfolio managers, visit fund companies, inspect the funds' financial documents, and investigate our databases of fund portfolios and performance histories to provide the most in-depth and helpful fund research that we can. We hope that the following pages will make the knowledge we've built up over these years available to you in a detailed yet easily accessible form, and will serve as a guide to help you to navigate the thorny financial landscape over the years ahead.

PART ONE

How to Pick Mutual Funds

I

Know What Your Fund Owns

Most of us wouldn't buy a new home just because it looked good from the outside. We would do a thorough walk-through first. We'd examine the furnace, check for a leaky roof, and look for cracks in the foundation.

Mutual fund investing requires the same careful investigation. You need to give a fund more than a surface-level once-over before investing in it. Knowing that the fund has been a good performer in the past isn't enough to warrant risking your money. You need to understand what's inside its portfolio—or how it invests. You must find out what a fund owns to know if it's right for you.

The stocks and bonds in a fund's portfolio are so important that Morningstar analysts spend a lot of their time on the subject; news about what high-profile fund managers are buying is a constant source of e-mail chatter in the office. Our analysts examine fund portfolios of stocks or bonds, talk with the managers about their strategies in picking those holdings, and check on recent changes to the portfolio. Knowing what a fund owns helps you understand its past behavior, set realistic expectations for what it might do in the future, and figure out how it will work with the other investments you might own.

At the most basic level, a fund can own stocks, bonds, cash (usually money market securities), or a combination of the three. (Funds might also own other securities, including other funds and stock/bond hybrid securities, but let's stick with the basics for now.) If it invests in stocks, it could focus on U.S. companies or venture abroad. If the fund owns U.S. companies, it might invest in giants such as General Electric or Microsoft or seek out tiny companies that most of us have never heard of. If a fund invests in bonds, it could focus only on those issued by companies with rock-solid finances and a high probability that they'll make good on their debts or it could venture into higher-yielding bonds issued by firms with shaky future prospects. How a manager chooses to invest your money has a big impact on performance. For example, if your manager devotes much of the portfolio to a single volatile area such as technology stocks, your fund may generate high returns at times, but there's also a greater likelihood that you'll lose money at other times. Stocks have historically generated higher returns than cash or bonds. Because you take the least risk when you invest in cash, those securities also tend to generate lower returns than you'd get with stocks or bonds.

A fund's name doesn't always reveal what a fund owns because funds often have generic handles. Take the intriguingly named Janus Olympus and American Century Veedot funds. If you were to skim over only their names, you would be hard-pressed to glean that the former focuses on mid- and large-sized companies that are growing quickly (think Yahoo! and eBay), whereas the latter is a fund that uses computer models to help direct investments to whatever type of stocks look like they could be strong performers in the future.

Nor will a fund's prospectus—a legal document filed with the Securities and Exchange Commission (SEC) that lays out the basics of an investment—necessarily be of much help in determining what a given fund is up to. While fund prospectuses do include information about who's running a fund and its basic investment parameters, prospectuses are typically written in very broad terms to give managers the latitude to invest as they see fit.

In their prospectuses, funds are also required to state their objectives—a one- or two-word description of their basic goals, such as "Growth," "Equity-Income," "Growth & Income," and so on. You'd think these so-called prospectus objectives might help you sort out who's doing what, but in reality funds with the same prospectus objectives can be pursuing radically different investment approaches and end up with very different returns. For example, both Aegis Value Fund and AllianceBernstein Large Cap Growth have prospectus objectives of "Growth." But the former focuses on tiny, budget-priced stocks, whereas the Alliance fund focuses on fast-growing stocks of large companies. When the bear market struck between 2000 and 2002, the Aegis fund returned 18% annually, whereas the Alliance fund lost 26% over that stretch.

Understanding The Morningstar® Style Box™

A desire to help investors choose funds based on what they really own—instead of on what funds call themselves, how they classify themselves, or how they've performed recently—was precisely what inspired Morningstar to develop its investment style box in the early 1990s. The style box provides a quick visual summary of a given fund's portfolio, showing you, using a nine-box investment-style grid, where most of your fund's portfolio is invested. (To check out a fund's current style box, go to Morningstar's Web site, www.morningstar.com, and type in a fund's name or ticker.) While investors needn't own a fund from each and every square of the style box, the tool can help you know whether your portfolio is diversified. If all of your funds are huddled in a single corner of the style box, that's a tip-off that you'll probably want to spread your bets around more. The style box also helps investors keep track of whether a fund has changed its approach, because we update each fund's style-box placement every time we receive a new portfolio. If a fund that you bought to bring your portfolio exposure to the fast-moving technology and telecom industries is suddenly delving into the securities of small manufacturing firms, you'll see that change reflected in your fund's style-box placement.

For stock funds, the style box isolates two key factors that drive its performance: the size of the stocks the fund invests in and the type of companies it buys—rapidly growing companies for which investors are willing to pay a pretty penny, slower growers that trade at lower prices, or a combination of the two (see Figure 1.1). Those two factors—company size and investment style—form the two axes of the stock, or equity, style box. For bond funds, the style box focuses on the two key determinants of bond-fund behavior: a fund's sensitivity to changes in interest rates and the credit quality of the bonds in which it invests. Those two factors form the axes of the bond-fund

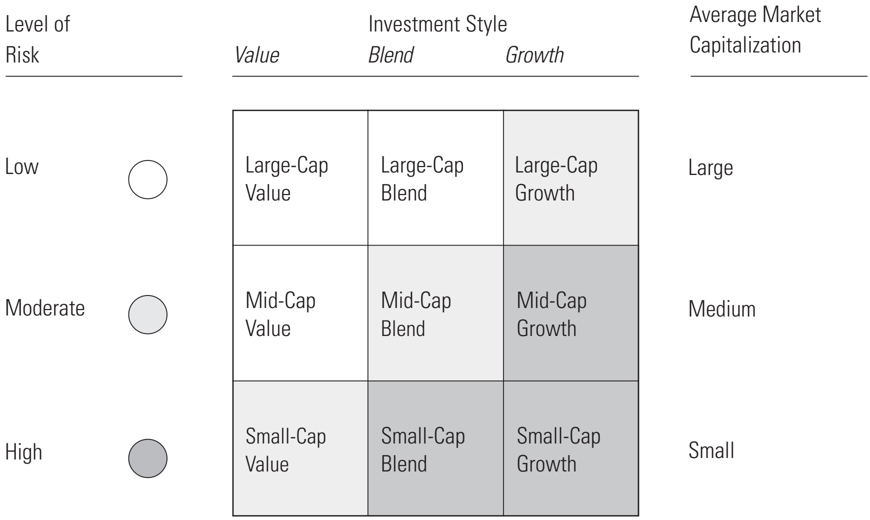

Figure 1.1 The Morningstar stock style box is a nine-square grid that provides a quick and clear picture of a stock fund's investment style.

style box (see Figure 1.2). Once we have determined the size and investment-style coordinates for a stock fund and the interest-rate sensitivity and credit-quality coordinates for a bond fund, we can use our nine-square style box grid to show investors—visually—where their fund lands.

Using the Stock-Fund Style Box

To figure out which square of our stock style box a fund portfolio lands in, we first analyze each and every stock in that portfolio. We begin by grouping each stock in a portfolio into one of seven regions: the United States, Latin America, Canada, Europe, Japan, Asia ex-Japan, and Australia/New Zealand.

Once we've placed a stock within one of our regional zones, we then go on to evaluate how it stacks up relative to other firms within that same zone. We start that process by determining whether a security is small, medium, or large within its region. In investing parlance, stock size is often called market capitalization, or market cap. Market cap sounds like a technical term, but it's not particularly hard to understand—essentially, it's the current dollar value of all of a given company's stock shares. So if a stock is selling for $30 and there are

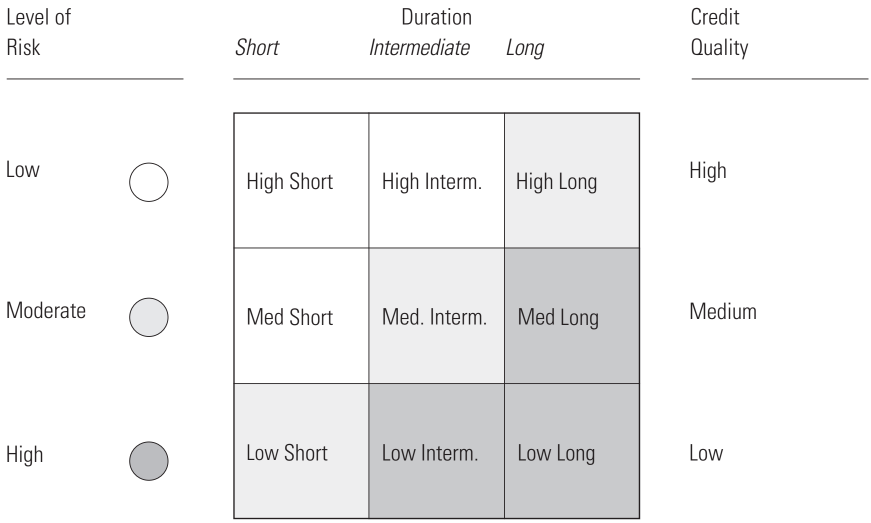

Figure 1.2 The Morningstar bond style box is a nine-square grid that provides a quick and clear picture of a bond fund's investment style.

a million shares of it floating around in the market, the company has a market cap of $30 million. We consider companies whose market caps land within the largest 70% of their region to be large cap; the next 20% are midcap; and the smallest 10% are small caps. Although small-cap stocks only account for 10% of each region's market, there are actually many more of them than there are large-cap companies.

Having determined a security's regional and size classification, we turn our attention to its investment style. Investing aficionados typically group stocks into one of two major buckets—growth stocks or value stocks—and often identify themselves as growth investors or value investors. Understanding the difference between the two styles is critical to understanding what makes a fund tick.

Growth stocks typically enjoy strong growth in earnings or revenues because they've got a hot new product or service. Because the market expects good things from these fast growers, and earnings growth usually drives a higher share price, investors are willing to pay more for the shares than they will pay for slower growers.

Value stocks, conversely, look like growth stocks' less successful cousins. These companies' earnings are usually growing slowly, if at all, and they often operate in industries that are prone to boom-and-bust cycles. So why does anyone bother with these underachievers? The answer is, because they're cheap. Fund managers who focus on value stocks are willing to put up with lackluster earnings growth because they think the market is being overly pessimistic about the company's future. Should things turn out better than the market thinks, the bargain-hunting fund stands to profit.

Some companies display a mixture of both growth and value characteristics—we call these *core stocks*. Many pharmaceuticals stocks currently fit the core designation. Historically, these firms have been terrific growers, as new drug launches and stepped-up demand from aging baby boomers have driven high profits and, in turn, high stock prices. But lately, problems with a few high-profile drugs as well as chatter about lackluster new products and drug-price controls have depressed the prices for drug stocks.

To help classify a stock as growth, value, or core, we look at 10 separate factors, including dividend yields, price/earnings ratios (a company's current share price divided by its earnings), and historical and projected earnings growth.

Once we have classified each stock's investment style, we then classify the entire portfolio, based on which square of our style box most of its stocks land in. Securities that the manager has weighted the most heavily will play a bigger role in determining a fund's investment style than will smaller positions. For example, a stock that takes up 10% of a portfolio will be a much bigger determinant of a fund's style-box positioning than will a stock that takes up 2%.

Funds that devote most of their assets to stocks with strong growth characteristics will land in the growth column of our style box, while those with a higher concentration of value stocks will land in our value column. Funds that hold both growth and value stocks, or those that focus mainly on so-called core stocks, will land in the blend column of our style box.

Using the Bond-Fund Style Box

The bond-fund style box, like the stock style box, is also a nine-square grid. Whereas the stock style box has a growth/value axis and a small/large axis, however, the two axes of the bond style box are interest-rate sensitivity (or duration, which we define in the following discussion) and credit quality. Unlike the equity style box, we arrive at a bond portfolio's style box not by drilling into each and every security, but instead by measuring the average weighted characteristics of the portfolio. (Average weighted means that our calculation gives greater weight to a portfolio's big positions than its small ones.)

Knowing a bond fund's interest-rate sensitivity helps you determine how much it will react when interest rates go up or down. When interest rates go up, that typically depresses the price of already-existing bonds, particularly those with longer maturities, because investors would rather buy a newer bond with a higher interest payment, or yield, than get locked into a long-term bond that happens to have a lower yield. The reverse happens when interest rates go down. Investors would rather buy an existing bond with a higher yield than they would opt for a new, lower-yielding bond. That demand drives up the price of existing bonds.

To help measure a bond fund's interest-rate sensitivity, we rely on a figure called *duration*. Duration is a pretty knotty concept; it's defined as the average time it takes a bondholder to receive the interest and the principal payments from a bond. Because it's a measure of time, duration is expressed in years. As a general rule of thumb, every one-percentage-point change in interest rates will cause a fund to gain or lose the amount of its duration. For example, a bond fund with a duration of 8 years is apt to lose 8% of its value if interest rates go up by one percentage point. For the purpose of our fixed-income style box, we classify bond funds with average durations of less than 3.5 years as short term, those with durations between 3.5 and 6 years as intermediate term, and those with durations of 6 years or more as long term. (We use a slightly different framework for classifying municipal-bond funds' interest-rate sensitivity. Municipal bond funds with durations of less than 4.5 years are short; those with durations between 4.5 and 7 years are intermediate term; and those with durations of 7 years or more are long.)

A bond portfolio's average duration helps us plot a fund on the horizontal axis of the style box. To determine its placement on the vertical axis, we examine the average credit quality of the bonds in the portfolio. Third parties such as Moody's and Standard & Poor's assign credit qualities to bonds. By looking at a bond's credit quality, you can get a sense of how likely it is that a bond's issuer will be able to continue making its interest payments to bondholders—an important consideration if you're looking for regular income, as many bond investors are. Morningstar considers bond funds with average credit qualities of AAA or AA to be high quality, those with credit qualities that are lower than AA but greater than or equal to BBB to be of medium quality, and those with average credit qualities below BBB to be low quality.

Armed with both a portfolio's interest-rate sensitivity and its average credit quality, we can plot that fund in our style box.

Using Morningstar's Category System

Despite the usefulness of the Morningstar style box, it's just a snapshot of the fund's most recent portfolio. When you are selecting a fund to play a particular role, such as adding a high-quality bond fund because you want stability and regular income, you want to be confident that it actually has played that role over time. That's what we have in mind when we plug funds into Morningstar categories. We assign funds to categories based on the past three years' worth of style boxes. (Fund firms are required to provide shareholders with a list of their funds' portfolio holdings every quarter, but some fund shops make their portfolios available even more frequently than that.) A single portfolio could reflect a temporary aberration—maybe the fund's holdings have been doing really well, so they have grown from small- to mid-cap as stock prices have gone up. But because a fund's category assignment is based on three years' worth of portfolios, it gives you a better handle on how the fund typically invests.

You'll see that our category system for U.S. and foreign-stock funds is closely related to our style box. On the U.S. stock side, we have categories corresponding with each of the nine squares of the style box, ranging from large value in the upper left corner to small growth in the lower right corner. Similarly, we have five style-based categories for diversified foreign-stock funds (i.e., those that don't focus on a single region), ranging from foreign large-value to foreign small/mid-growth. (Because there aren't quite as many foreign-stock funds in the U.S. as there are domestically focused funds, we don't have separate foreign-stock categories corresponding with all nine squares of the style box.) We also carve out some categories for specialized stock funds. To name a few, there are categories for health-care offerings, Japan funds, and energy funds. Morningstar slots funds into about 50 categories (see Figure 1.3).

Diversified Domestic Stock	Large Value Large Blend Large Growth Mid-Cap Value Mid-Cap Blend	Mid-Cap Growth Small Value Small Blend Small Growth
International Stock	Europe Stock Latin America Stock Diversified Emerging Markets Diversified Pacific Stock Pacific Stock ex-Japan Japan Stock	Foreign Large Blend Foreign Large Growth Foreign Large Value Foreign Small/Mid Growth Foreign Small/Mid Value World Stock
Specialty Stock	Communications Financial Health Natural Resources	Precious Metals Real Estate Technology Utilities
Hybrid	Conservative Allocation Moderate Allocation	Bear Market Convertibles
Specialty Bond	High-Yield Bond Multisector Bond International Bond	Emerging Markets Bond Bank Loan
General Bond	Long-Term Bond Intermediate-Term Bond	Short-Term Bond Ultrashort Bond
Government Bond	Long-Term Government Intermediate-Term Gov't.	Short-Term Government
Municipal Bond	Muni National Long Muni National Intermediate Muni National Short Muni High-Yield Muni Single-State Long Muni Single-State Intermediate Muni Single-State Short Muni CA Long	Muni CA Intermediate/Short Muni NY Long Muni NY Intermediate/Short Muni Florida Muni Massachusetts Muni Minnesota Muni New Jersey Muni Ohio Muni Pennsylvania

Figure 1.3 Morningstar's fund-category system.

On the bond side, our categories also relate back to the style-box system. For example, the high-yield bond category—home to so-called junk-bond funds—captures most of the funds that land in the low-credit-quality row of the style box. Meanwhile, our long-term government category includes all of the funds that buy U.S. Treasury and agency bonds with long durations.

As with the style box, Morningstar categories pick up where fund names and prospectus objectives leave off. They help you figure out how a fund actually invests, which in turn lets you know how to use it in your portfolio. If you're looking for a good core stock fund, you might begin your search within the large-blend category. Funds that land there usually invest in the biggest, best-established U.S. companies and buy stocks with a mix of growth and value characteristics. Thus, large-blend funds tend to be a decent bet in varied market and economic conditions. Although they may not lead the pack too often, neither are they apt to be left completely behind. (We discuss this subject in detail in Part Two.)

By targeting funds in different categories, you are much more likely to pull together a diversified portfolio than if you rely on funds' prospectus objectives to show you the way. An investor focusing exclusively on prospectus objectives might think he or she had a diversified mix in a portfolio that consisted of Dreyfus Premier Value (with a prospectus objective of growth), American Funds Investment Company of America (growth and income), and USAA Income Stock (equity-income). Diversified? Not so fast. According to their Morningstar categories, which take their underlying holdings into account, all three funds are actually large-cap value offerings.

As you might expect, different-style funds tend to behave differently in various market and economic environments, which is why the style-box and category system can be so handy. Knowing a fund's category can give you some indication of how it might perform in good markets and in bad. As a rule of thumb, the large-cap value group is considered the safest category because large-cap companies typically are more stable than small ones (the high-profile blowups of giants like Worldcom and Enron notwithstanding). And in down markets, when investors are concerned that stock prices could be too high across the board, large-value funds' budget-priced stocks don't have very far to fall.

Funds that land in the small-growth category, however, are usually the riskiest. The success of a single product or service can make or break a small company, and because small-growth stocks often trade at lofty prices, they can take a disastrous tumble if one of the company's products or services fails to take off as the market expects. These funds can deliver glittering riches in up markets, though: In 2004, the average small-growth fund returned 45%. (For more on the correlation between investment style and risk, see Chapter 3.)

Examining Sector Weightings

Checking a fund's style-box and category placement can go a long way toward helping you know what a fund is all about, but it may not tell the whole story. Not all funds that land in the same style box or even the same category will behave the same way. For example, both Marsico Growth and Fidelity OTC are popular funds that land in the large-cap growth category. Yet they have tended to own very different kinds of large-growth stocks. In the late 1990s, the Fidelity fund often dedicated more than half of its assets to technology-related stocks—as much as 75% at one point. Marsico Growth also staked a sizable amount in tech, but its position topped out at 40% of the portfolio.

What a difference those two approaches made! A heavy weighting in the tech sector was a boon in 1999, when investors adored technology stocks. Fidelity OTC soared an amazing 73% that year, whereas Marsico Growth gained 53%. A 53% gain is an impressive return in its own right, but if you had put $10,000 in each fund at the start of the year, your Fidelity OTC investment would have been worth $2,000 more than Marsico Growth at the end of 1999. But anything that produces such strong returns can also prove an Achilles' heel, and that's exactly what happened to Fidelity OTC. When tech collapsed in 2000, the Fidelity fund lost 26%, whereas Marsico Growth lost 16%. The moral of the story isn't that a technology-heavy fund like Fidelity OTC is automatically a bad idea, but that if your fund is inclined to make big bets on certain sectors, there's also a greater likelihood that your fund will suffer losses.

Morningstar calculates a fund's sector exposure based on the percentage of its portfolio that is committed to stocks in each of 12 industry groupings. We also cluster those 12 sectors into one of three supersectors: information, services, and manufacturing (see Figure 1.4). We developed the broader classification system because the sectors within our supersector groupings tend to behave in a similar way in various stock market environments. In the recent market downturn of 2000 through 2002, for example, every sector in our

Information Economy	Service Economy	Manufacturing Economy
Software	Health Care	Consumer Goods
Hardware	Consumer Services	Industrial Materials
Telecommunications	Business Services	Energy
Media	Financial Services	Utilities

Figure 1.4 Morningstar's sector breakdown. Twelve sectors are divided into three supersectors representing broader parts of the economy.

information supersector—hardware, software, telecommunications, and media—incurred terrible losses. If all the funds in your portfolio heavily concentrate their holdings in a certain supersector, it can be a strong indication that your portfolio needs exposure to other parts of the economy. Similarly, if you have a job in a technology-related field, you will want your portfolio to have plenty of exposure outside the information supersector because much of your economic well-being (through your job) is already tied to that area.

Examining Number of Holdings

To understand what a particular fund is up to, knowing the number of stocks it owns can be just as important as any of the other factors we have discussed. Whether your fund holds 20 stocks or hundreds of them will make a big difference in its behavior. (Because Securities and Exchange Commission regulations limit the percentage of its assets that a fund can commit to a single holding, fund portfolios rarely have fewer than 20 stocks.) For example, both Fidelity Contrafund and Janus Twenty land in our large-cap growth category. But the Janus fund, which typically holds fewer than 30 stocks, is likely to see a lot more gyrations in its performance—for better and for worse—than the Fidelity fund, which spreads its money across more than 500 stocks. If Janus Twenty's top holding, at 15% of assets, has a bad week or a bad year, the whole fund's performance is also apt to be poor. Meanwhile, trouble in Fidelity Contrafund's top stock, at 2.6% of assets, won't have as big an impact on the fund's total return.

The number of holdings in bond funds tends to have less of an impact on how they behave. All else being equal, however, a bond fund with more hold-