Morningstar Market Commentary

1st Quarter 2005

Morningstar Market Barometer℠

1st Quarter Return %

	Value	Core	Growth
Large Cap	0.43	–1.93	–5.44
Mid Cap	0.44	–2.38	–1.51
Small Cap	–4.18	–3.13	–6.44

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1 Year Return %

	Value	Core	Growth
Large Cap	12.10	9.75	–4.44
Mid Cap	17.54	10.04	9.80
Small Cap	11.89	11.71	–0.01

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After an exuberant rise in 2004's fourth quarter, the U.S. stock market was stifled in 2005's first quarter by high energy costs, inflation fears, and higher interest rates. For the three months ending March 31, 2005, Morningstar's US Market Index dropped 2.06%.

Investors found little to cheer about during the period. Borrowing costs increased after the Federal Reserve, concerned about inflation, hiked interest rates twice during the period. The U.S. dollar also remained weak.

Some prominent corporate boards of directors also flexed their muscles during the period and ousted their chief executives for poor performance. Carly Fiorina of Hewlett-Packard and Michael Eisner of Walt Disney both got the boot during the quarter, as did Hank Greenberg of AIG, the insurance giant that has come under regulatory and financial scrutiny.

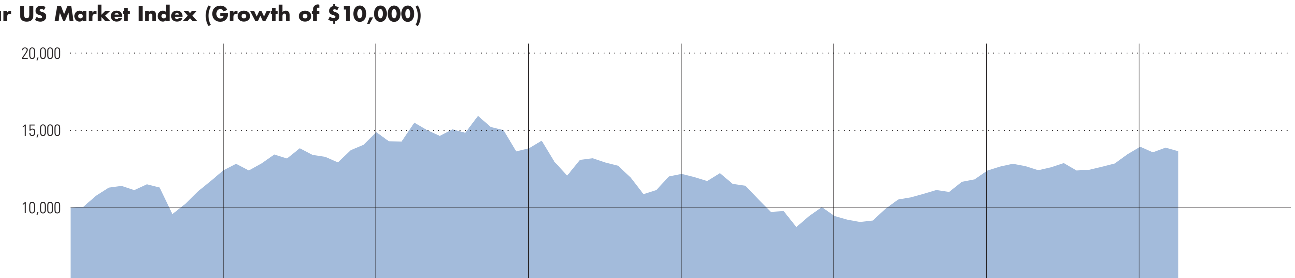
Some notable mergers also were announced during 2005's first quarter. Procter & Gamble said it would buy razor-maker Gillette, and in the telecom sector, Verizon Communications and Qwest Communications International battled it out for MCI. (Incidentally, also during the quarter Bernie Ebbers, the former CEO of WorldCom, which is MCI's previous corporate entity, was found guilty of fraud that cost investors millions and led to the largest corporate bankruptcy in U.S. history.)

But one of the biggest drivers of performance was high oil and gas prices. Although high energy costs have spelled trouble for parts of the market, record-setting crude oil prices have fueled strong earnings growth at many energy companies and sent their stocks up sharply. The average energy stock posted a double-digit gain for the period, outperforming other sectors by a wide margin.

Dragging down returns for the period were ever-volatile technology names. Big blue chips such as Microsoft, IBM, and Cisco Systems all disappointed during the period, and software and hardware stocks were the market's worst-performing sectors.

Big gains among energy stocks and losses among many tech names also help explain why value stocks outperformed growth during the period. Energy heavyweights such as ExxonMobil, ConocoPhillips, and ChevronTexaco—all prominent members of Morningstar's US Value Index—were the top three contributors to performance in the period. They helped drive the US Value Index up 0.12%, while the US Growth Index was down 4.58%. These big gains also helped large caps outperform smaller caps. The Morningstar Large Value Index ended the quarter up 0.43%, while the Morningstar Small Value Index lost 4.18%.

Morningstar US Market Index (Growth of $10,000)



	1998	1999	2000	2001	2002	2003	2004	2005-03
Total Returns	23.86	19.79	–7.02	–11.88	–22.16	30.73	12.35	–2.38
Price/Earnings	33.46	37.99	31.78	30.73	24.97	26.74	23.72	22.48
Price/Book	8.15	10.45	7.54	5.39	4.13	4.49	4.22	4.03
Dividend Yield %	1.25	1.09	1.12	1.29	1.74	1.45	1.49	1.58
Earnings Growth (5 Yr)	15.87	18.80	18.15	15.22	13.19	12.76	12.55	12.23

Surveying the Sectors

Of the 12 sectors in Morningstar's database, the energy sector was the first quarter's clear leader. Its 17.26% gain for the period far surpassed that of any other sector. Within that peer group, oil- and gas-products firms, including refinery firm Valero Energy, led the way, but drillers and more-diversified exploration-and-production companies also did well.

Morningstar Sectors: 1st Quarter 2005 Return %

	3 Month	1 Year	3 Year
Information	**–6.84**	**–1.52**	**–2.40**
Software	–9.30	5.82	–2.74
Hardware	–6.86	–9.13	–2.73
Media	–4.40	4.97	–1.06
Telecommunication	–6.88	6.34	–2.55
Service	**–3.99**	**3.28**	**3.47**
Health Care	–0.75	2.24	–0.54
Consumer Services	–2.71	6.63	5.30
Business Services	–4.52	10.31	0.65
Financial Services	–6.29	1.09	6.09
Manufacturing	**4.11**	**21.59**	**8.78**
Consumer Goods	–0.34	6.59	6.02
Industrial Materials	–0.71	18.30	6.97
Energy	17.26	47.96	15.67
Utilities	4.51	22.50	7.22

Utilities, another sector sensitive to high energy prices, came in a distant second with a 4.51% increase. Within that group, the formerly distressed Texas utility TXU came up big, as did Duke Energy.

The remaining sectors finished the period in the red. Financials stocks struggled, with the average name down 6.29% for the period. Although some of the asset managers and investment banks posted respectable gains, higher interest rates dampened returns for banks. But it was regulatory and Congressional scrutiny that hurt mortgage-buyer Fannie Mae, which posted a 23.17% loss and was one of the sector's worst performers for the period.

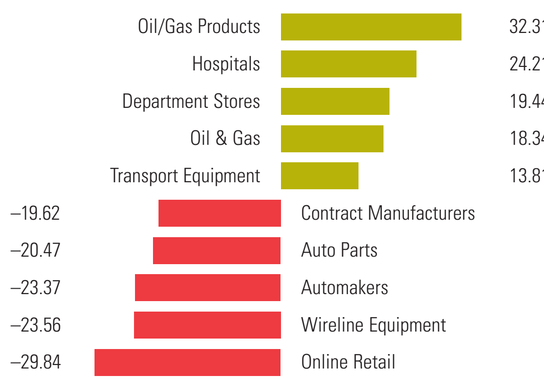
As was the case for much of 2004, technology stocks resumed their downward slide in the first quarter. The software sector brought up the rear, losing 9.30% on average, in large part due to a slump in Microsoft shares. The hardware sector also struggled as optical-equipment makers and contract manufacturers had a particularly tough time.

Industry Returns

Energy-related industries topped the performance lists for the first quarter, with some of the largest gains going to the oil- and gas-products, oil and gas, and oil- and gas-services industries. But other commodities-driven industries also performed well in response to a strengthening global economy. Coal companies, for example, gained 15.82% on average, with Peabody Energy among the top performers. The steel/iron industry was also a top performer, with firms such as Nucor posting solid results.

Among the worst-performing industries was online retail, which dropped 29.84% for the period. eBay, the online auctioneer, was to blame for much of that decline. The company's shares dropped 35.95% on concerns that the firm's growth rate is starting to slow. Automakers also had a tough quarter, losing 23.37% of their value on average. General Motors announced during the period that its earnings wouldn't meet Wall Street's expectations, due mainly to light demand for its trucks, and that news weighed heavily on the whole group.

Top and Bottom Five Industries: 1st Quarter 2005 Return %



Style and Market Cap Indexes

Morningstar US Value Index +0.12%

As was the case for much of 2004, value stocks outperformed growth in the first quarter as value-oriented energy, utilities, and industrials stocks led the market. A list of top contributors in this benchmark includes, not surprisingly, the biggest names in the energy business, including ExxonMobil, ConocoPhillips, and ChevronTexaco. In fact, among the period's top-10 contributing stocks, only one company operates outside of the energy sector: tobacco giant Altria Group, which gained 8.22%.

Morningstar US Core Index –2.10%

This index, which includes stocks that demonstrate a mix of value and growth characteristics, ended the quarter in the red, as investors took down companies with weaker growth. Concern over rising interest rates hurt big index names such as home-improvement chain Home Depot, while weaker drug pipelines and regulatory hurdles have weighed on pharmaceutical companies such as Pfizer and Wyeth. Insurer AIG, which is facing regulatory scrutiny and a management shakeup, was the index's worst contributor.

Among the best performers in this index were a smattering of energy names as well as health-care stocks such as Johnson & Johnson and hospital giant HCA. A couple of retailers also made the top-contributors list, including CVS and J.C. Penney.

Morningstar US Growth Index –4.58%

This benchmark is dominated by technology names, most of which posted significant losses for the period. Although Apple Computer, maker of the hot iPod music player, was the index's top contributor, many blue-chip technology names were down during the period, including Microsoft, Cisco Systems, and Dell. Former highflier eBay also posted a steep loss amid concerns that growth at the online auctioneer is slowing. And biotech giant Biogen IDEC also fell sharply during the period after the company pulled a drug it was developing to treat multiple sclerosis.

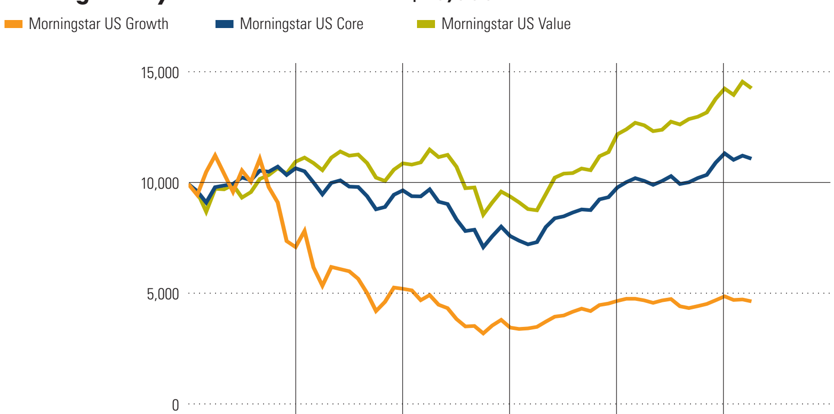
Morningstar Mid Value Index +0.44% (Best-Performing Style Index)

The Mid Value Index edged out Large Value to become the best-performing style index for the period. Both benchmarks, which represent the top two boxes in the far-left row of Morningstar's style box, were helped by their hefty stakes in market-leading energy stocks. Among the Mid Value Index's top contributors for the period were several energy stocks, along with retailers May Department Stores and Office Depot. Two companies also facing buyouts—long-distance firm MCI and distressed toy seller Toys R Us—posted big gains during the period.

Morningstar Small Growth Index –6.44% (Worst-Performing Style Index)

Small-cap stocks trailed their larger-cap counterparts during the first quarter, and of the small-cap squares in the style box, small growth came in last. Technology stocks were well represented among the index's biggest detractors during the period, as was Taser International. The stun-gun maker is facing regulatory scrutiny due to safety concerns about its products.

Morningstar Style Indexes: Growth of $10,000

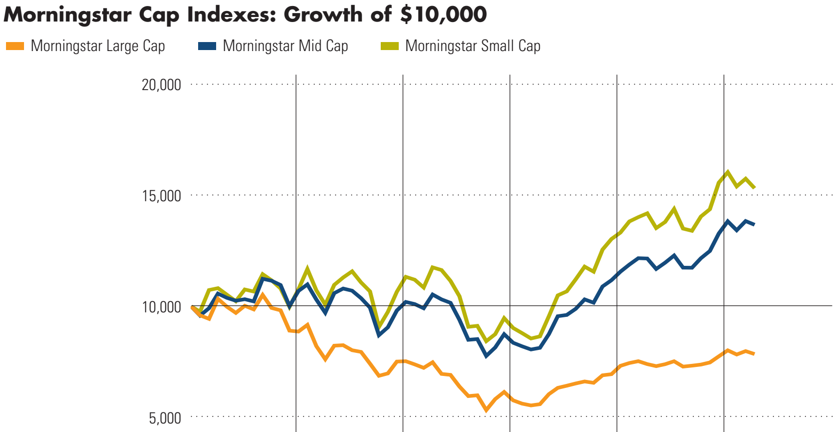


	2000	2001	2002	2003	2004	2005–03
Morningstar US Value						
Total Returns	10.06	–0.68	–13.68	29.75	16.85	0.12
Price/Earnings	20.19	21.85	20.53	18.58	16.79	16.57
Price/Book	4.15	3.00	2.17	2.83	2.57	2.50
Dividend Yield %	2.30	2.74	3.40	2.69	2.68	2.75
Earnings Growth (5yr)	11.52	10.21	9.08	8.48	8.77	8.40
Morningstar US Core						
Total Returns	7.10	–9.31	–21.18	28.63	15.62	–2.10
Price/Earnings	33.53	28.24	21.46	23.75	21.90	20.96
Price/Book	8.12	6.03	4.24	4.64	4.33	4.10
Dividend Yield %	0.86	1.04	1.59	1.27	1.30	1.40
Earnings Growth (5yr)	14.94	14.35	12.46	12.11	11.89	11.70
Morningstar US Growth						
Total Returns	–28.45	–26.32	–33.20	34.12	4.37	–4.58
Price/Earnings	44.60	47.43	32.89	38.45	33.50	31.24
Price/Book	10.56	6.92	5.61	5.93	5.96	5.71
Dividend Yield %	0.13	0.17	0.50	0.43	0.40	0.47
Earnings Growth (5yr)	28.12	21.75	17.52	17.26	17.74	17.20

Morningstar Large Cap Index –2.08%
After lagging small- and mid-cap stocks for much of the past five years, the Morningstar Large Cap Index ended the first quarter ahead of the small-cap benchmark but behind the Mid Cap Index. High oil and gas prices fueled solid earnings growth and significant share-price gains for the index's big energy stocks, including ExxonMobil and ConocoPhillips. Merger activity also helped a few notable stocks, including consumer-products company Gillette, which agreed to be bought out by Procter & Gamble during the quarter.

But the large-cap benchmark was stung by many lagging blue-chip technology and financials stocks. Among the financials, rising interest rates didn't help losers such as Citigroup and Bank of America, while troubled mortgage buyer Fannie Mae said during the period that it would restate prior earnings due to accounting concerns. Finally, J.P. Morgan Chase, a turnaround story that played well in 2004, also posted a loss.

Morningstar Cap Indexes: Growth of $10,000



	2000	2001	2002	2003	2004	2005–03
Morningstar Large Cap						
Total Returns	–11.38	–15.10	–23.47	27.04	9.54	–2.08
Price/Earnings	33.75	32.03	25.14	26.93	23.22	21.87
Price/Book	8.49	5.98	4.56	4.76	4.39	4.19
Dividend Yield %	1.02	1.29	1.80	1.54	1.62	1.73
Earnings Growth (5yr)	18.16	14.78	12.81	12.46	12.35	11.85
Morningstar Mid Cap						
Total Returns	6.94	–4.63	–18.06	38.38	19.66	–1.14
Price/Earnings	27.01	26.96	25.97	25.89	24.60	23.76
Price/Book	5.35	3.96	3.19	3.86	3.89	3.73
Dividend Yield %	1.40	1.33	1.59	1.27	1.23	1.29
Earnings Growth (5yr)	17.74	16.14	13.94	12.57	13.03	12.79
Morningstar Small Cap						
TTotal Returns	7.66	5.26	–20.36	47.70	20.44	–4.50
Price/Earnings	21.28	25.22	22.96	27.04	26.43	25.32
Price/Book	3.68	3.11	2.72	3.58	3.79	3.40
Dividend Yield %	1.35	1.18	1.56	1.09	0.97	1.04
Earnings Growth (5yr)	19.65	17.57	14.96	14.86	14.60	14.46

Morningstar Mid Cap Index –1.14%
This index performed the best of the three size-oriented indexes for the first quarter. For the most part, the mid-cap energy names that did the most to boost this benchmark benefited more from higher oil and gas prices than the mega-cap integrated firms that are prominent in the Large Cap Index. For example, Kerr-McGee, a top Mid Cap Index contributor, streamlined its business in the late 1990s so it only focuses on oil and gas exploration and production, making its profits more sensitive to commodity prices than a fully integrated company. Thus, Kerr-McGee's share price jumped 36.32% for the quarter while ExxonMobil, a mega-cap integrated company, was up a more modest 16.80%.

Those energy stocks' gains weren't enough, however, to pull this bogy into the black. Steep losses among technology stocks such as Network Appliance and Advanced Micro Devices dragged on the benchmark. Former highflier Sirius Satellite Radio, which gained 141% in 2004, was also one of the biggest detractors for the period.

Morningstar Small Cap Index –4.50%
The sun may have set on the "small-cap effect." Nimble small-cap companies had dominated market returns since 2000, due mainly to their ability to grow their earnings during the early 2000s economic slowdown. More recently, however, some larger-cap firms have demonstrated that they're not dead yet, and some are benefiting nicely from higher commodity prices and a weak U.S. dollar.

Stocks that dragged down the Small Cap Index include Ciena, the telecom-equipment firm, and Avocent, a data-networking company. Another big loser during the quarter was Calpine, the power-producer that was hurt by ultra-expensive natural gas, which it uses to fire its power plants.

Active vs. Passive, 1st Qtr 2005

	Value	Core	Growth
Large Cap	18.85 / 0.43	46.45 / –1.93	73.49 / –5.44
Mid Cap	35.45 / 0.44	69.13 / –2.38	30.85 / –1.51
Small Cap	88.33 / –4.18	57.40 / –3.13	72.83 / –6.44

○ Percent of actively managed mutual funds outperforming their respective benchmark. Includes the oldest share class for all US diversified mutual funds with at least a one-year history. As of March 31, 2005, there were 2,442 eligible funds. Morningstar classifies funds into style categories based on the average style score (using the same 10-factor methodology as underlying benchmarks) of all available portfolio holdings over a three-year period.

● Index Returns (%) for 1st Quarter, 2005

Fund Categories vs. the Benchmarks

Bucking the long-term trends, active mutual fund managers did pretty well against Morningstar's market indexes for the period. Of the nine areas of Morningstar's style box, the average fund in five of the squares beat its indexed style-box equivalent. Interestingly, the average active small-cap manager—regardless of style—outperformed the similar market index, with small-value managers adding the most value. The average small-value mutual fund lost 1.97% for the period, while the Small Value Index declined 4.18%.

Although small-cap active managers did better on average than their Morningstar benchmarks, the same was true for the average large-growth and mid-blend skippers. The average large-growth fund lost 4.34%, while the Large Growth Index declined 5.44%. And the typical mid-blend fund was down 1.28%, beating the Mid Core Index's 2.38% loss.

Among the fund managers subtracting the most value were those in the large-value and the mid-value categories. The Large Value Index gained 0.43%, for example, while the typical fund in the same category lost 0.82%. Meanwhile, the Mid Value Index gained 0.44% while the average fund in the mid-value category declined 0.21%. In both cases, the discrepancy in returns can be at least partially explained by the indexes' larger energy stakes, as energy stocks led the market. The energy weighting in each index was twice that of the typical fund in the corresponding category.

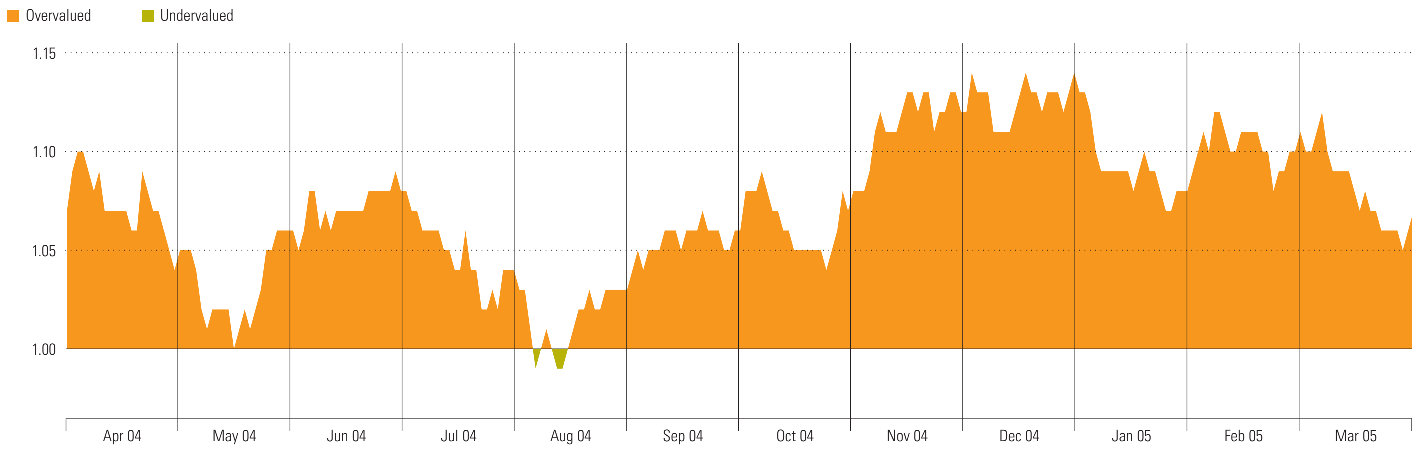
Conclusion

Many of the trends that proved difficult for stocks in the first quarter will likely continue through much of 2005. The Federal Reserve has signaled that it will continue to raise interest rates, and oil and gas prices have remained high due to robust worldwide demand. We've also seen few signs of a significant uptick in corporate technology spending, which would give a shot in the arm to many lagging technology stocks.

Beyond those larger macro trends, it's also worth noting that Morningstar's stock analysts think the market remains largely overvalued. Just 65 stocks of the 1,531 on our coverage list are rated 5 stars, indicating we think they're significantly undervalued. What's more, 430 stocks receive just 1 star, indicating they're trading far above our analysts' estimates of the stocks' fair values. In the energy sector, which has run up considerably in recent months, just two stocks receive a 5-star rating. Thus, those looking for compelling buys have relatively few options, in our view. M

Laura Pavlenko Lutton
Mutual Fund Analyst

Market Valuation



52-Week High	52-Week Low	All-Time High	All-Time Low	1st Quarter Close
1.14 (12-28-04)	0.99 (08-13-04)	1.14 (12-28-04)	0.78 (10-09-02)	1.07 (03-31-05)

Market Valuation Chart

The graph shows the ratio of price to fair value for the median stock in the universe of stocks covered by Morningstar over time. A ratio above 1.00 indicates that the stock's price is higher than Morningstar's estimate of its fair value; a ratio below 1.00 indicates that the stock's price is lower than our estimate of its fair value. The further the price/fair value ratio rises above 1.00, the more the median stock is overvalued. The further it moves below 1.00, the more the median stock is undervalued.

Trailing Returns %

Index	Quarter	6-Month	1-Year	3-Year	5-Year	10-Year
Morningstar U.S. Market	–2.06	7.88	7.57	3.69	–2.49	10.61
Large Cap	–2.08	6.44	6.12	1.62	–5.37	10.09
Mid Cap	–1.14	12.38	12.51	9.07	5.28	11.48
Small Cap	–4.50	9.09	7.97	9.21	7.22	11.55
US Value	0.12	9.87	13.24	7.41	7.91	NA
US Core	–2.10	8.50	9.89	4.51	2.49	NA
US Growth	–4.58	4.78	–0.95	–1.92	–16.05	NA
Large Value	0.43	9.26	12.10	5.56	4.91	NA
Large Core	–1.93	7.62	9.75	2.48	–0.70	NA
Large Growth	–5.44	1.52	–4.44	–4.33	–18.81	NA
Mid Value	0.44	12.23	17.54	11.99	16.08	NA
Mid Core	–2.38	11.18	10.04	9.95	12.00	NA
Mid Growth	–1.51	13.80	9.80	4.13	–9.09	NA
Small Value	–4.18	8.58	11.89	12.87	18.27	NA
Small Core	–3.13	10.26	11.71	11.29	13.90	NA
Small Growth	–6.44	8.27	–0.01	2.91	–8.09	NA

Morningstar Market Barometer 1st Quarter Return %

		Value	Core	Growth
	US Market –2.06	0.12	–2.10	–4.58
Large Cap	–2.08	0.43	–1.93	–5.44
Mid Cap	–1.14	0.44	–2.38	–1.51
Small Cap	–4.50	–4.18	–3.13	–6.44

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Morningstar Market Barometer Trailing 4 Quarters Return %

2nd Quarter 2004

0.96	2.60	1.63
2.51	0.77	–0.01
1.30	1.69	1.09

3rd Quarter 2004

1.62	–0.61	–7.37
2.17	–1.77	–3.51
1.73	–0.36	–8.65

4th Quarter 2004

8.79	9.74	7.36
11.74	13.89	15.54
13.32	13.82	15.73

1st Quarter 2005

0.43	–1.93	–5.44
0.44	–2.38	–1.51
–4.18	–3.13	–6.44

Biggest Positive Influence on Morningstar US Market Index

	Style	Contribution %	3 Month	1 Year	3 Year
Exxon Mobil Corp.		0.50	16.80	45.90	12.60
ConocoPhillips		0.13	24.77	57.14	21.56
ChevronTexaco Corp.		0.11	11.81	36.42	11.58
Johnson & Johnson		0.10	6.35	34.66	2.56
Valero Energy Corp.		0.09	61.56	145.43	44.00
Altria Group Inc.		0.09	8.22	25.36	11.71
Apple Computer Inc.		0.08	29.41	208.21	52.07
HCA Inc.		0.06	34.38	33.16	7.16
Walgreen Co.		0.06	15.90	35.42	4.66
Unocal Corp.		0.06	43.13	67.62	18.04

Biggest Negative Influence on Morningstar US Market Index

	Style	Contribution %	3 Month	1 Year	3 Year
Microsoft Corp.		–0.17	–9.24	9.95	–2.85
American Interntl. Group Inc.		–0.15	–15.43	–21.86	–7.99
Citigroup Inc.		–0.11	–5.81	–9.90	–0.61
eBay Inc.		–0.10	–35.95	7.56	38.02
JPMorgan Chase & Co.		–0.10	–10.43	–14.28	2.75
Fannie Mae		–0.10	–23.17	–24.32	–9.36
Verizon Communications Inc.		–0.09	–11.42	1.37	–4.52
IBM Corp.		–0.08	–7.12	0.28	–3.54
Bank of America Corp.		–0.07	–5.19	13.24	12.63
Cisco Systems Inc.		–0.07	–7.40	–24.10	1.85

Biggest Influence on 1 year performance is calculated by multiplying stock returns for the year with their respective weight in the Index as of the start of the year.

News Briefs: Morningstar Releases Indexes Yearbook 2004

Morningstar released the inaugural issue of the Morningstar Indexes Yearbook. This annual year-in-review highlights Morningstar Index performance from the previous year, reports Index data, and includes commentary from Morningstar staff. To receive a copy of the Indexes Yearbook, please e-mail your complete mailing information to indexes@morningstar.com.