MORNINGSTAR®

Reprinted by permission of Morningstar, Jan. 28, 2013 • OPP-92458

# Are U.S. Large-Cap Funds Fully Valued?

A look at how some of our favorite funds measure up using Morningstar's price/fair value ratio.

**Fund Spy** | 01-28-13 | By Laura Lallos

You wouldn't guess it from the flood of money that flowed into bond funds, but 2012 was a good year for domestic-stock fund investors. Core large-cap holdings were strong performers, with returns for large-cap blend, large-cap value, and large-cap growth categories all around 15% for the year.

With last year on the books, stocks have come a long way since the market hit bottom on March 9, 2009. The S&P 500 has gained 138% since then, through Jan. 23. Are prices getting ahead of underlying values?

Morningstar's stock analysts have developed their own measure of fair value, using a proprietary discounted cash-flow model to assess the more than 1,600 mostly large-cap names they cover. A stock with a price/fair value ratio greater than 1.0 is considered overvalued. Using that data, Morningstar calculates an overall Market Fair Value.

By that measure, larger-cap stocks overall now look fully valued. As of Jan. 24, the stocks covered by Morningstar had a median price/fair-value ratio of 1.01, up from a 52-week low of 0.85 in mid-2012. Some context: The all-time low ratio for the median stock Morningstar covered was 0.55 in November 2008.

We calculated a price/fair value ratio for large-cap domestic funds in the Morningstar500, a curated selection of funds featured in *Morningstar FundInvestor*. (We limited the results to recent portfolios for which we could calculate the figure on least 75% of assets.) In line with our Market Fair Value, we found the overall portfolio of Vanguard 500 Index (VFIAX) has a ratio of 0.96.

Not surprisingly, large-cap growth funds tend to have higher ratios than large-cap value funds', with large-blend funds' falling in between. However, the differences these days are not that dramatic. While the large-cap growth fund with the highest price/fair value ratio, Harbor Capital Appreciation (HACAX), has a ratio of 1.04, some large-cap value funds are closing in on a ratio of 1.0.

**Funds With Below-Market Price/Fair Value Ratios**

| | Category | Price/Fair Value Ratio |
|---|---|---|
| Artisan Value Fund Investor Shares ARTLX | Large Value | 0.83 |
| Sound Shore SSHFX | Large Value | 0.86 |
| Davis NY Venture NYVTX | Large Blend | 0.89 |
| Oakmark I OAKMX | Large Blend | 0.89 |
| Jensen Quality Growth JENSX | Large Growth | 0.92 |
| Vanguard PRIMECAP Core VPCCX | Large Growth | 0.94 |

*- source: Morningstar Analysts*

### Dividends Drive Up Valuations

Investors hungry for both income and security have been favoring solid dividend-payers for the past several years. As a result, some value-oriented funds that focus on high-dividend stocks now show price/fair value ratios higher than the S&P 500's. Vanguard High Dividend Yield Index (VHDYX) is almost fully valued with a ratio of 0.98 and Vanguard Equity-Income (VEIPX) is close behind, with a ratio of 0.97. Columbia Dividend Income (GSFTX) is in third, with a ratio of 0.96.

Dividends are driving up valuations in the large-cap blend category, too. One of the most expensive fund in the category is Amana Income (AMANX), with a ratio of 0.99—the fund holds only dividend-paying stocks. Vanguard Dividend Appreciation Index (VDAIX), which tracks a custom-built benchmark of companies with a long-term record of increasing dividends, is also just shy of fair value. (We cover the popular ETF version of the fund, (VIG).)

### Rooting Out Value

Because of their lofty valuations, Oakmark value iconoclast Bill Nygren contends that low-growth, high-yield stocks are among the riskiest on the market. He eschews them, and Oakmark I (OAKMX) has a price/fair value ratio of 0.89, among the lowest we calculated. Davis NY Venture (NYVTX) also has a 0.89 ratio and is also run by mavericks who focus on intrinsic value. Like Nygren, portfolio managers Chris Davis and Ken Feinberg are focusing on consumer names and financials.

Reprinted by permission of Morningstar, Jan. 28, 2013 • OPP-92458

More traditional value plays still do show up a bit better on our price/fair value measure. **Sound Shore (SSHFX)**, with a ratio of 0.86, invests in solid companies going through a slow patch. The best value on the list is Artisan Value (ARTLX), with a ratio of 0.83. Management occasionally buys debt-heavy cyclicals but prefers to place companies with solid business models and balance sheets in their compact portfolio.

**Growth, but Not at Any Price**

Most large-cap growth funds had price/fair value ratios of 0.95 or higher, with many approaching fair value, but some growth managers are more particular about price than others.

One standout is Jensen Quality Growth (JENSX), which has a ratio of 0.92. The fund's team runs a low-turnover portfolio of picks with consistently strong ROE figures that are attractively valued according to the team's long-term discounted cash-flow analysis. The managers at Vanguard PRIMECAP Core (VPCCX) look for stocks with good long-term growth potential but temporarily depressed valuations; the portfolio's price/fair value ratio is 0.94.

We are not singling out any of these funds out as ones to buy or sell on the basis of one statistic. Take Harbor Capital Appreciation (HACAX), which owns the category-high ratio of 1.04. The portfolio run by Sig Segalas and team generally has higher growth rates and higher valuations than its peers, and the aggressive strategy has produced a strong record.

All the funds cited above are Morningstar Medalists (with the exception of the unrated Vanguard Dividend Appreciation Index)—which indicates that we expect them to outperform within their categories over the long-term. That said, if you want to get in on a dividend-oriented fund now, consider dollar-cost averaging. And if you are moving strategically out of overpriced bonds, now might not be the best time to go all-in on a marketlike core fund, either.

*Laura Lallos is a senior mutual fund analyst for Morningstar, covering primarily domestic-equity offerings from JP Morgan, Dodge & Cox, Beck Mack & Oliver, Perritt, and Parnassus.*