Morningstar Guide to Investing

Who we are and what we believe

This guide is intended to serve as an introduction to Morningstar, a description of our investment philosophy, definitions of some key investing concepts and a guide on how to use our website.

log in

While we have made this guide publicly available, many of the links point to Premium content on our website. Those links can be accessed by becoming a Morningstar Premium member. If you're already a Premium member, please **log in**.

Non-Premium members can **sign-up for a free 4-week trial**.

Who we are and what we believe

The sun is but a morning star.

Walden by Henry David Thoreau

When our founder, Joe Monsueto, was trying to decide on a name for his new company he was drawn to the last line of Waldon by Henry David Thoreau. The book embodied independence, thrift and self-reliance and Joe wanted to build a company that stood for those same values. Morningstar was founded because Joe felt that it was unfair that people did not have access to the same information as financial professionals. 33 years later we still live by that founding mission and values. Our vision is to help people plan, save, and invest to reach their financial goals. This vision guides our every move and is essential to who we are. We want to see individual investors succeed in reaching their financial goals.

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What is a Morningstar Investor?

People don't always think of themselves as "investors," but most actually are through their superannuation plans and savings. That's why we're committed to supporting all investors with an independent perspective they can trust.

When we say we want to help people reach their financial goals, we mean it.

Wherever people are making decisions about investing, we are there to guide them through it. If you want to get rich quickly by trading in the stock market then you are in the wrong place. What we can do is provide you with a fundamental framework for successful long-term investing.

So what is a Morningstar investor and what do we believe in?

Knowledge is the foundation of independence
Our first investment is in ourselves. We understand that empowerment comes from understanding the foundational investment concepts necessary to make the right decisions and hold financial advisers accountable.

We are independent minded
To deliver results, we think it's necessary to invest with conviction even when it means standing apart from the crowd. Herding is commonplace in investing. We know it generally delivers average results in normal times and can drive destructive booms and busts. We understand that meeting our investment goals may often mean acting independently from the herd.

We invest for the long term
Taking a patient, long-term view helps us ride out the market's ups and downs and take advantage of opportunities when they arise. We know that investors often overemphasise the importance of recent events, rushing into hot stocks when they're overpriced and fleeing from market downturns. We fight this common error by focusing on long-term lessons and long-term performance.

We're valuation-driven investors
Anchoring decisions to an investment's fair value – or what it's really worth – can lead to greater potential for returns. We understand that our minds are hard-wired to find patterns in everything, and that much of the market's daily volatility is just meaningless noise. We know that in the long term, the underlying value of a company, relative to its price, drives performance.

We believe in fundamental research
A fundamental research approach means gaining a deep understanding of each investment. At its core, a fundamental investing approach means focusing on the future earnings of an investment and not its prospective price change. Our focus on fundamental research means we don't fall victim to convincing stories to support the merits of an investment.

Foundational investing concepts

An investment in knowledge pays the best interest.

Benjamin Franklin

A Morningstar investor understands that true independence can only come from gaining the knowledge necessary to make informed financial decisions. There are some fundamental concepts that form the foundation needed to take control of your financial life. These concepts are critical for savvy, self-directed investors evaluating and selecting their own investments, people that are new to investing, or anyone that works with financial professionals and want to assess and contribute to the advice being given.

Compounding

> Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it. Compound interest is the most powerful force in the universe.
>
> **Albert Einstein**

While it is almost universally agreed that Einstein did not in fact call compound interest the eighth wonder of the world, that does not detract from the criticality of the concept to successful investing.

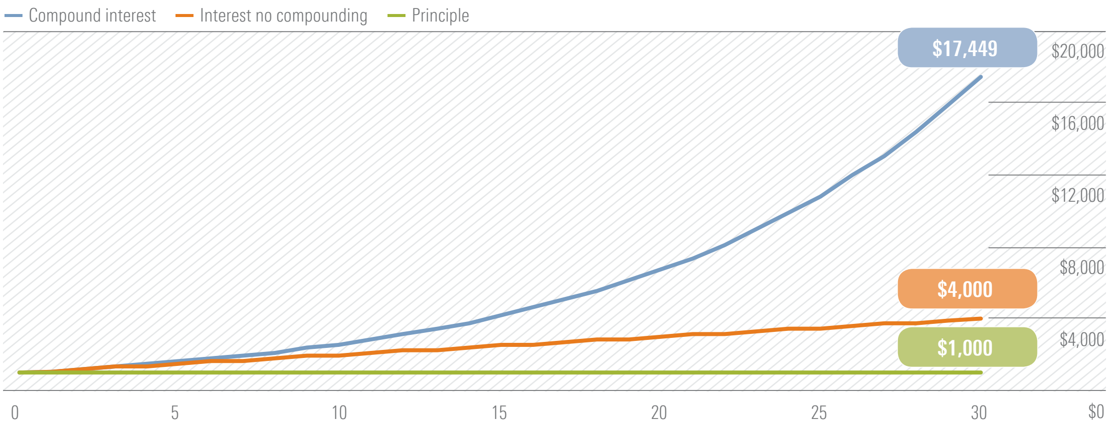
Compounding is often compared to pushing a snowball down a hill. As it travels down the hill, the snowball continually picks up more snow. The bigger it gets the more snow it gains on each rotation. The so called "snowball effect" shows that small actions continued over the long term can have large impacts.

In investing, compounding is simply the concept of earning a return on your previous returns.
A quick example is that if you invest $1000 for one year at a 10% return you will have $1100 at the end of the year. After earning this $100 you decide that you want to do the same thing for the next year and reinvest your principal ($1000) and return ($100) and earn 10% again. This year instead of earning $100 dollars you earn $110. The 10 extra dollars are due to compounding as you have earned a return on your return. This doesn't seem like very much but the secret with compounding is to amplify it by investing for long periods of time. If you invest the same $1000 dollars in your superannuation at a 10% return and leave it for 30 years your compounded total is $17,449.

It is important to note that compounding also works in the opposite direction. Seemingly small differences in the expense ratio of two equalling performing investment products can lead to large differences in long term returns.

Morningstar investors understand that the combination of time and compounding equate to long term financial security.

10% interest on $1,000 for 30 years



Source: Morningstar

The time value of money

> Money is a guarantee that we may have what we want in the future. Though we need nothing at the moment it insures the possibility of satisfying a new desire when it arises.
>
> **Aristotle**

A key concept that is central to our view on saving is the time value of money. At its core, saving money is simply an exercise in delayed gratification. Instead of spending money today a saver is making the conscious decision to save money for a future purchase. The time value of money is the mathematical concept that allows us to answer all sorts of interesting questions that are central to saving and investing. How much do I need to save every year to buy something that costs $50,000 in 10 years? If I have $100,000 in my super today, how much will that be when I retire in 15 years?

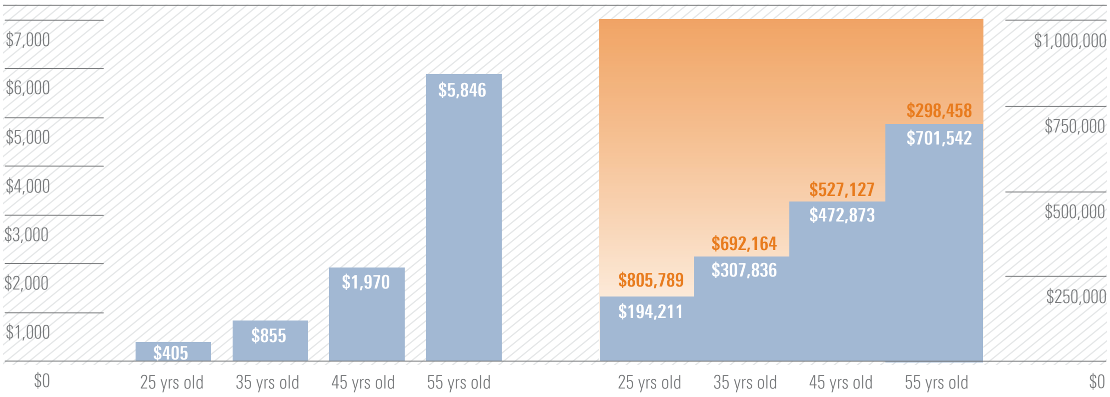
We are trying to avoid making this guide full of maths so there is no need to go through the formula given that it, and online calculators, are widely available on the internet. Conceptually, an investor needs to understand that the level of return, time horizon of the investment and the size of the initial investment are the three key variables that will impact their future level of financial security.

While these three factors may seem obvious, the key is their interplay. If you are looking to build long-term financial security it is obviously best to optimise all three variables--start young, save as much as possible, and earn a strong return. If this is not possible, start thinking about trying to get two out of three right. If you are like most people who would rather spend money than save money, there is a simple solution--start saving earlier in life and get your non-emergency fund money out of nominal assets like bank accounts and into investments with higher potential returns. This will allow you to save less when you are older. There is an opportunity cost to delaying savings and that is the years of returns that you are missing. Time truly is the one thing you can never get back and making up for those years of lost returns will require more future savings or more risky investments to try and gain higher returns.

Morningstar investors understand that the ability to earn and compound returns makes a dollar today worth far more than a dollar in the future.

The earlier you start investing, the easier it is to reach your goals

Monthly savings needed to accumulate $1 million by age 65



Source: Morningstar

Inflation

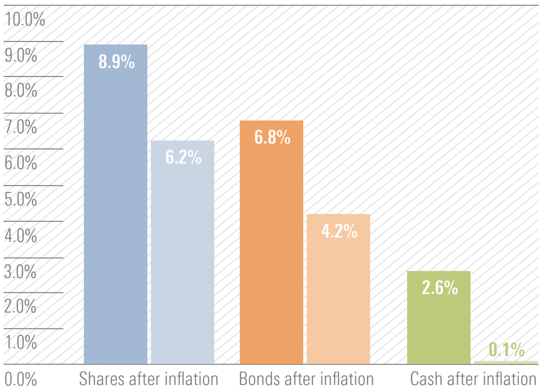
> Inflation is taxation without representation.
>
> **Milton Friedman**

Inflation is a critical concept when it comes to investing. We have talked about returns and the time value of money but an important consideration is how inflation will impact these concepts. We have all heard the proverbial inter-generational interaction of a grandparent telling their grandchild that they could get a can of Coke for 10 cents when they were younger. We all intuitively understand the concept of inflation when we are looking at past prices but few people take it into account when considering the future. Inflation is defined as the general increase in prices and the converse fall in the purchasing value of money. First, we will take a look at how inflation plays a role when looking at investment returns:

- In the investment world, we measure success by the returns that are achieved. In other words, in an absolute sense, how much our money has grown. If at the start of the year we have $10,000 and at the end of the year we have $11,000, then we have achieved an absolute return of 10% in year.

The impact of inflation on investment returns

1996–2016



Source: Morningstar

- In the real world, we need to look beyond how much our money has grown in an absolute sense and consider how much it has grown in a relative sense to the increase in the costs of the goods and services that we are saving to purchase. Individual investors should be focused on the real rate of return or inflation-adjusted returns. We will use the same example but this time add inflation. If at the start of the year we have $10,000 and at the end of the year we have $11,000 but inflation increases 5%, what is our real rate of return or inflation-adjusted return? Our absolute return remains 10% but given the 5% increase in the cost of goods and services, our real rate of return or inflation-adjusted return is only 5%.

Now that we have described the basics of inflation we can start to consider why it is so critical for investors. Applying inflation to investment returns will give you a more complete picture of the growth of your investment in terms of purchasing power. This is especially true with so-called “safe” vehicles such as bank savings accounts, as a guaranteed 2% is not very safe in a 3% inflation environment.

Finally, one important thing that should be considered is your personal inflation rate and how that may differ from official inflation rates. Governments measure inflation by comparing the price of baskets of goods over time. That is a great way to measure how overall price levels change across the economy but the applicability to individuals varies. If you are older and own your home outright, you may not care about changes in housing affordability but might be very focussed on medical cost inflation. The opposite may be true if you are younger and looking to buy your own home as prices rise. As with any part of crafting a financial plan, it is critical to understand the drivers of your own costs and how these may correlate with the returns of different investments.

A Morningstar Investor believes it makes sense to define an investment objective that starts with keeping up with inflation, then adding an additional amount of return that is based on an individual investment goal and risk tolerance.

> If you have trouble imagining a 20% loss in the stock market, you shouldn't be in stocks.
>
> **John C. Bogle**

Diversification is a straightforward concept that is commonly misapplied and misunderstood. The goal of building a diversified portfolio is to lower risk without impacting the level of returns. The key question is: What is the risk that you are trying to diversify away from? We think about risk differently than most of the financial industry, who use terms such as "price volatility" and "standard deviation". Traditional views of diversification are based on the correlation between different assets classes and are focused on creating a portfolio that contains asset classes that show little correlation. In other words, the portfolio contains some asset classes that are supposed to go up when other asset classes go down. That way there is less short-term volatility in the overall account value.

Morningstar uses a simpler and more practical definition. We define risk as losing money that can't be made back. For investors, that's the risk of not having enough money in time to retire or having to change your lifestyle so that your savings last throughout retirement. Take some time to think about your own view of risk and how fluctuations in your portfolio would impact your life. If you are investing for the long term and can adequately cover any short-term cash outlays with an emergency fund, then perhaps your definition of risk is the same as ours. The less value that an investor puts on the correlation of returns of different asset classes, the more attention can be paid to building a portfolio of global investments that are trading at attractive prices compared to intrinsic value.

Remember that the underlying fundamentals drive most long-term investment returns, that price matters, and that your own goals and time horizons should inform your strategy. That's the way a Morningstar investor approaches investing.

> The key to investing is… determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver to investors.
>
> Warren Buffett

If you want to be a successful long-term investor it doesn't get much easier than simply buying great businesses and holding the shares for a long time. So, what is a great business? At Morningstar we believe a great business is one that has a long-term competitive advantage which allows it to fend off competitors while investing capital at a high rate of return. The long-term competitive advantage of a business is called an economic moat. Just as moats were dug around medieval castles to keep enemies at bay, economic moats protect the high returns on capital enjoyed by the world's best companies. A company with an economic moat is quite rare because any time a profitable product or service is developed other firms respond by trying to produce a similar version, or even improving on the original version. Some companies are able to withstand the relentless competition of the marketplace and these are the wealth-compounding machines that an investor wants to find and own.

We believe there are five major sources of competitive advantage, or economic moat:

1. Intangible assets: These can include brands, patents, or government licenses that explicitly keep competitors at bay. This can be seen in pharmaceutical companies with patent protection or with consumer brands that have long-standing and well-regarded brands.
2. Cost advantage: Firms that can provide goods and services at lower costs have significant advantages over rivals as they can either undercut their rivals on price or sell at the same price and earn a higher profit margin. Generally, moats based on cost advantage are due to economies of scale.
3. Switching costs: Switching costs refer the inconveniences or expenses associated with a customer switching from one product to another. Banks can be good examples as it is time-consuming to switch bank accounts once you have set up direct deposits and payments.
4. Network effect: The network effect occurs when the value of a particular good or service increases as more people use the good or service. Social media sites are perhaps the best example as a low number of members provides less of a benefit to a user than a high number of members.
5. Efficient scale: Efficient scale applies to companies that serve limited markets where there are a small number of competitors. Potential competitors are discouraged from entering the market based on the small opportunity. An example can be a pharmaceutical company that produces drugs for diseases that only impact small patient populations.

Morningstar investors understand the foundation of any great investment is a great company

> The stock market is filled with individuals who know the price of everything, but the value of nothing.
>
> Phillip Fisher

It is easy to figure out the price of almost anything. A central tenet of the modern economy is price discoverability. In simple terms that means that in order to encourage commerce the price of goods and services must be widely known. This tenant also applies to liquid financial assets such as stocks or bonds. A quick trip to the internet (perhaps www.morningstar.com.au) is all it takes to find out the price of any liquid security. That is the magic of market liquidity. We are always able to find the price of liquid assets because they are constantly changing hands and thus always fluctuating. This fluctuation causes many investors a good deal of angst and causes many people to forget that an equity is not simply a piece of paper being traded but ownership of the underlying business.

While much is made of the short-term noise that drives day-to-day price fluctuations, in the long term it is the performance and value of the underlying business that will influence the stock price. In one of the most famous quotes in investing, Ben Graham said: "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." Simply put, Graham is saying the price and the value of an equity may deviate significantly over the short term but eventually they will intersect. That is why we are so focused on intrinsic value at Morningstar and why we include our valuation estimate within each of our research reports.

A Morningstar investor is always focused on valuation and sees price declines below the intrinsic value as a long-term opportunity and not a reason to panic.

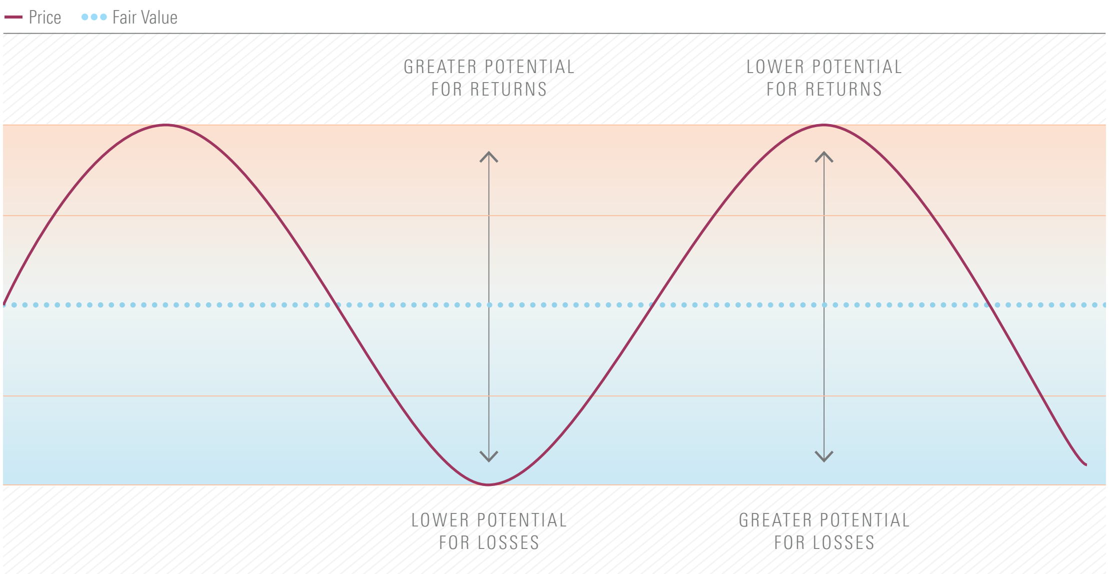
> Confronted with a challenge to distil the secret of sound investment into three words, we venture the motto, Margin of Safety
>
> **Ben Graham**

We have just discussed the differences between the price of a security and the underlying value. If the size of the difference between the price of a security and the underlying value is significant, we call that gap the margin of safety. The simplicity of the concept does not diminish its importance.

At Morningstar, our analysts spend their time following companies and gain a deep understanding of their operations and the influences on their earnings and cash flow. One of the outputs from this analysis is an estimate of the intrinsic value of the company. There are many factors that go into the model used to calculate the intrinsic value, and since it is based on the future, there are a number of estimates that need to be made. Our analysts are experienced and thorough in their work but the future is of course unknowable, and it is exceedingly difficult to calculate the intrinsic value of a security. This inherent lack of precision in the intrinsic value calculation is what makes the margin of safety so important. Even when buying stocks at a significant discount to the intrinsic value, there is no guarantee they will go up in the future. It is the margin of safety that protects investors from loses.

A Morningstar investor is focused on valuation but always remembers to leave an adequate margin of safety to increase the opportunity for future gains and limit the downside.

Price of a security over time



Source: Morningstar

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