Morningstar’s Approach to Rating Stocks

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound over long periods of time is the surest way to create wealth in the stock market.

Because we focus on the intrinsic value of businesses, rather than short-term movements in stock prices, we may appear, at times, to be out of step with the stock market. When the market is high, relatively few stocks will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars.

Economic Moat

Our Economic Moat rating is our assessment of a firm’s ability to earn economic profits for a long time. A moat is defined as some competitive edge, or barrier, that allows a firm to stave off rivals to earn economic profits—profits that exceed the risk-adjusted return demanded by investors. In a competitive market, rivals tend to chip away at economic profits until the industry earns a return that corresponds only to its cost of capital. But, firms with moats have earned excess returns for extended periods and have demonstrated that they will be able to continue to do so.

We’re big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because these characteristics, among others, allow companies to protect their competitive position. These sorts of requisite attributes ensure that a firm’s excess profits aren’t a flash in the pan, caused by something like temporary windfall pricing in the industry, but rather are sustainable for many years to come.

Morningstar Research
Methodology for Valuing Companies

Our Key Investing Concepts:
- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Business Risk
- Margin of Safety
- Consider Buying/Consider Selling

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Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the intrinsic worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk involved in investing in a company. For a company with a diverse base of revenues, low financial leverage, and a high proportion of variable to fixed costs, we will use a lower cost of equity, the discount rate applied to equity capital. By contrast, a small undiversified firm with high financial leverage and high fixed costs will have a higher discount rate because there’s more risk clouding its future.

Fair Value
This is the output of our discounted cash-flow valuation model, and is our per-share estimate of a company’s intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have. For example, we deduct from a company’s fair value if it has a lot of stock options outstanding or an under-funded pension plan. Our fair value estimate differs from a “price target” in two ways. First, it is purely an estimate of the intrinsic business value, rather than what other investors might temporarily be willing to pay for a stock, which can be influenced by behavioral psychology and market-wide factors. Second, the fair value estimate represents the value today, versus a price target that typically represents what price the stock might fetch in the next 2 to 12 months, depending on market conditions.

Business Risk
We divide our coverage universe into four broad Business Risk categories: below average, average, above average, and speculative. The Business Risk rating is not based on the volatility of the firm’s shares, but rather the predictability of the underlying business and its cash flows; thus, it might more precisely be thought of as a gauge of “uncertainty” versus the sort of “risk” that is captured in the discount rate. If a business is more predictable—in other words, we have a fair degree of certainty about what future cash flows will look like—the firm would earn a below average Business Risk grade. But, if the scenarios that might be realized years down the road span a wide range, then it would earn a higher Business Risk rating.

Margin of Safety
This is the discount to fair value we would require before assigning our highest rating to a stock. The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We think it’s always prudent to buy stocks for less than they’re worth. We require larger margins of safety for less predictable stocks—those with above average or speculative Business Risk ratings—and smaller margins of safety for more predictable stocks, those with below average and average Business Risk ratings.

Consider Buying/Consider Selling
The “consider buying” price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, “consider selling” is the price at which a stock would have a 1 star rating, at which point we’d consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
We evaluate the commitment to shareholders demonstrated by each firm’s board and management team by assessing transparency, shareholder friendliness, incentives, ownership, and board independence. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives unaligned with the interests of long-term shareholders. The grades are assigned on an absolute scale—not relative to peers—and can be interpreted as follows: A means “Excellent,” B means “Good,” C means “Fair,” D means “Poor,” and F means “Very Poor.”

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