

Top Holdings of Four All-Weather Ultimate Stock-Pickers

While more than one third of these top fund managers are outperforming this year, four of them stand out from the rest given their ability to outperform the market over almost all time periods.

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The market has been resilient so far this year, with the S&P 500 TR Index up more than 5% year to date, even with the disruption caused by concerns over emerging and developing markets at the start of the year. Even so, only a little more than one third of our top managers have picked up enough steam to surpass the returns of the benchmark index so far in 2014. As of June 12, eight of the 22 mutual fund managers on our list of Ultimate Stock-Pickers were beating the S&P 500 on a year-to-date basis, with outperformance ranging from 13 basis points for Oakmark (OAKMX) to 245 basis points for Fairholme (FAIRX). While more than half of the Ultimate Stock-Pickers that were beating the market so far during 2014 were also outperforming on a one-year basis (with the average level of outperformance being 730 basis points), few of them have done better than the benchmark over the last three- and five-year periods. This is a little surprising to us, given that we've started to roll off of some of the poor five-year investment performance that had been out there due to the 2008-09 financial crisis. That said, nearly all of the eight managers beating the S&P 500 this year have beaten the market over the past 10 years (with the average level of outperformance being 150 basis points). Of these, two different managers— Vanguard PRIMECAP (VPMCX) and Oakmark—have actually outperformed the benchmark during all time frames. Both Sound Shore (SSHFX) and Parnassus Core Equity (PRBLX) came close, but both funds fell a little short on a five-year basis. Meanwhile, Dodge & Cox Stock (DODGX), which is not beating the index so far this year, deserves some mention as it continues to have one of the better long-term records among our top managers.

The four managers that we've highlighted—Vanguard PRIMECAP, Oakmark, Sound Shore, and Parnassus Core Equity—that are not only beating the market this year but have some of the best long-term records among our Ultimate Stock-Pickers, share relatively few similarities between them. Oakmark, for example, is considered a

Large Blend manager by Morningstar, even though fund managers Bill Nygren and Kevin Grant have a bit more of a value bent to their process. Parnassus Core Equity is also listed as a Large Blend manager, with managers Todd Ahlsten and Ben Allen capable of putting together market-beating performance, despite having to keep 75% of the fund's assets invested in dividend-paying stocks. They do this by focusing on companies with wide or increasing economic moats that sell increasingly relevant products or services, and which are guided by good management. As for Sound Shore, Morningstar considers it a Large Value manager, despite the fact that managers Harry Burn, Gibbs Kane, and John DeGulis invest in both mid- and large-cap stocks. Vanguard PRIMECAP is listed as a Large Growth manager, even though the managers of the fund show a slightly contrarian streak in their stock-picking process.

Fund Manager	Total Return YTD	1-Year	3-Year	5-Year	10-Year
FairHm FAIRX	7.9	24.9	15	14.9	11.2
TwdyBrwneVal TWEBX	7.3	18.6	13.9	14.9	7
Vngd PRIMECAP VPMCX	7.3	27.4	18.7	18.3	10.2
SoundShoreInv SSHFX	7.1	27.6	19.1	17.3	8.2
Mutual Shares TESIX	6.8	20.8	14.2	15.4	7.3
Parnss Core EqInv PRBLX	6.3	24.4	18.6	17.4	10.2
FMI LgCap FMIHX	5.9	19.6	16	16.5	9.6
Oakmark OAKMX	5.6	25.1	20.3	20.5	9
S&P 500 TR Index	5.4	22.2	17.5	17.8	7.7

Stock Price and Morningstar Rating data as of 06-12-14.

Each fund also has a unique approach to portfolio management. Vanguard PRIMECAP, for example, divides its portfolio into sleeves that are managed independently by each of the four listed managers— Theo Kolokotronis, Joel Fried, Al Mordecai, and M. Mohsin Ansari—with some senior analysts also getting smaller sleeves to run. While this approach should keep the overall portfolio fairly diversified, because the different managers interact frequently and tend to look

at the market in similar ways, the portfolio is often significantly tilted toward similar sectors and industries. The two managers at Parnassus Core Equity also run the portfolio in separate sleeves, with each manager responsible for half of the fund's 40 or so holdings. While Ahlsten (who took over as manager of the fund in 2002) maintains a senior role and has the final say on all stock picks, he and Allen (who joined Parnassus as a senior research analyst in 2005 and became co-manager in 2012) are generally of a like mind. Both managers are hands on and regularly adjust their position sizes as valuations and risk profiles change.

Oakmark runs its fund in a similar fashion, with Nygren making the final decisions for both this fund and its sibling Oakmark Select (OAKLX), a much more concentrated Large Blend fund that he runs with Win Murray and Tony Coniaris (who were just named co-managers in 2013). Nygren ranks among Oakmark's most seasoned managers, and played a central role in the development of the processes that are used by each of the shop's seven funds. Managers are encouraged to invest wherever they see bargains, which typically involves looking for situations where a company's shares are trading well below their own estimates of a firm's intrinsic value. While this can lead to holdings that may strike value traditionalists as unusual—like Oracle (ORCL) and Directv (DTV)—the process has led to unusual success for the fund.

With one of the longest tenures among our Ultimate Stock-Pickers, the managers at Sound Shore have been using the same value strategy to guide their portfolio for more than three decades. Burn and Kane founded Sound Shore Management in 1978, and have managed the Sound Shore fund since its inception in 1985. They elevated DeGulis

(who had worked with them as an analyst since 1995) to the role of co-manager in 2003. The three managers, and a support staff of four in-house analysts, look for stocks that have solid fundamentals and encouraging prospects, but which are out of favor for one reason or another.

With regards to portfolio construction, it is a tossup between Vanguard PRIMECAP and Parnassus Core Equity as to who runs the most concentrated portfolio of the four managers we've highlighted. Vanguard PRIMECAP's top 10 holdings accounted for 44% (and its top 25 holdings made up 69%) of its total stock portfolio at the end of March 2014. Parnassus Core Equity's top 10 holdings accounted for 36% (and its top 25 holdings made up 73%) of its total stock portfolio at the end of April 2014. Sound Shore and Oakmark both run slightly more diverse portfolios, with their top 10 holdings accounting for 27% and 24%, respectively, of each fund at the end of March, and their top 25 holdings making up 63% and 54%, respectively. That said, Sound Shore also has the highest annual turnover rate among the four managers at 44% during the past year. While this is below the category average of 55% for Large Value funds, it is well above the rates posted by Oakmark (19%) and Parnassus Core Equity (17%). Vanguard PRIMECAP has the lowest annual turnover rate of the four, though, at 5%, which isn't too surprising given that the managers are willing to keep their favorite stocks in the portfolio for years.

Morningstar fund analyst David Kathman recently noted that after four years of lackluster performance relative to its peers, Vanguard PRIMECAP finally broke away from the pack last year and demonstrated why it continues to be one of the best Large Growth funds in our coverage. Vanguard PRIMECAP gained nearly 40% during

Top 10 Stock Holdings at Vanguard PRIMECAP (as of March 31, 2014)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
Biogen BIIB	2	Wide	309.78	1.26	Medium	73,257	7.8	(-)
Amgen AMGN	4	Wide	116.2	0.89	Medium	87,966	5	(-)
Roche Hldg	2	Wide	37.37	1.07	Low	255,874	4.4	+
Eli Lilly LLY	3	Wide	58.88	1	Medium	65,259	4.3	+
TX Instrmnts	2	Narrow	48.14	1.2	Medium	51,960	4.1	+
Microsoft MSFT	3	Wide	40.58	0.97	Medium	332,910	4	+
FedEx FDX	3	Narrow	139.21	0.95	Medium	40,119	4	NC
Google GOOGL	3	Wide	559.5	1.08	High	377,379	4	(-)
Adobe ADBE	2	Wide	66.56	1.19	Medium	33,129	3.9	NC
Novartis NVS	2	Wide	89.29	1.08	Low	218,479	3	(-)

Stock Price and Morningstar Rating data as of 06-12-14.

2013, placing it in the top decile for its category (in a year when growth funds in general posted strong gains). Kathman goes on to note that the rebound at Vanguard PRIMECAP started in earnest in the second half of 2012 and continued through the first quarter of 2014, with the fund landing in the top 2% of Large Growth funds. A more than 7% gain on a year-to-date basis through the end of last week kept Vanguard PRIMECAP near the top of the heap.

Overweight positions in Health Care, which accounted for 32% of the fund's total stock holdings at the end of March (compared with a 13% weighting in the S&P 500), and Technology, which also accounted for 32% of the fund's total stock holdings at the end of last quarter (compared to a 17% weighting for the benchmark), have paid off handsomely. Vanguard PRIMECAP's allocations in each sector continue to beat the returns generated by the collection of stocks in the S&P 500. With nine of its top 10 holdings dedicated to Health Care and Technology stocks, and seven of those nine holdings up by double digits on a year-to-date basis, the fund is likely to continue its outperformance this year.

With the Vanguard PRIMECAP portfolio divided into independently managed sleeves, it is unsurprising to see a few holdings outside of Health Care and Technology—like Southwest Airlines (LUV) and DirecTV—also making meaningful contributions to performance. It is interesting as well to see the managers taking some money off the table in some of its best-performing stocks over the past year. When Vanguard PRIMECAP trims or sells a holding it is generally for valuation reasons, although the fund has been known to eliminate a stock from the portfolio when something about the company or the economic environment has changed significantly.

Morningstar fund analyst Shannon Zimmerman believes that the key to Oakmark's success over the past 15 years has been the managers' commitment to a straightforward strategy. From a universe of the 250 largest U.S. companies as defined by revenue, book value, and net income, Nygren and Grant look for stocks of these firms that trading at a 40% or more discount to their estimate of the business' actual worth. Zimmerman goes on to note that while many managers at rival funds use broadly similar approaches, Oakmark's execution of the strategy has generated uncommon success, with trailing returns over all periods ranking among the elite in the Large Blend category.

The fund increased more than 37% during 2013, placing it in the top decile for its category. While year-to-date results have been less stellar, with the fund now being bested by about one fourth of Large Blend funds, Oakmark is still beating the market overall. The fund's best-performing stock during the first quarter of 2014 was Forest Laboratories (FRX), which was up 54% during the period following a \$25 billion takeover bid from Actavis (ACT). The stock was Oakmark's third-largest holding coming into the year, so it was not too surprising to see the managers take some money off the table after the deal was announced. However, Morningstar stock analyst David Krempa does not anticipate that, should the Actavis deal fall through for any reason, he would reinstate his previous \$60 per share fair value estimate for Forest based on its fundamentals as a stand-alone entity.

Oakmark continues to bet big on Financial Services, which accounted for 28% of its total stock holdings at the end of the first quarter (compared with 15% for the S&P 500). Bank of America (BAC) continued to be its largest holding, and Capital One Financial COF and American International Group (AIG) both were top 10 holdings for the

Top 10 Stock Holdings at Oakmark (as of March 31, 2014)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
BankAmer BAC	3	Narrow	15.42	1.03	High	162,151	3.3	NC
Oracle ORCL	3	Wide	42	1.02	Medium	187,273	2.4	+
CapOne COF	3	Narrow	80.93	0.9	Medium	46,315	2.3	NC
Apache APA	4	Narrow	96.31	0.9	Medium	37,147	2.3	+
Directv DTV	2	Narrow	82.92	1.18	Medium	41,777	2.3	NC
UndHlth UNH	3	Narrow	79.44	1.01	Medium	77,840	2.3	NC
Medtronic MDT	3	Wide	60.79	1.01	Medium	60,840	2.3	+
TE Conn TEL	2	None	61.75	1.19	Medium	25,239	2.3	NC
FedEx FDX	3	Narrow	139.21	0.95	Medium	40,119	2.2	NC
AIG AIG	3	None	54.42	1.05	Medium	78,727	2.2	+

Stock Price and Morningstar Rating data as of 06-12-14.

fund. While Oakmark was also overweight in Technology, the spread between the fund and the market was nowhere near as wide as it was with Financial Services, with only two names from the Technology sector—Oracle and TE Connectivity (TEL)—represented in the fund’s top 10 stock holdings. That said, both stocks were up by double digits on a year-to-date basis at the end of last week, besting the results from all three Financial Services names.

week, have kept the fund near the top of the heap. This is surprising, given that just one of its top 10 holdings—Hess (HES)—and eight of its top 25 holdings are up by double digits this year. That said, there are a few names in its top 10 holdings that are up by high single digits this year—namely, Qualcomm (QCOM), BP PLC ADR (BP), and CVS Caremark (CVS)—which has helped lift overall performance. Sound Shore’s managers continue to believe that the market will go on rewarding

Top 10 Stock Holdings at Sound Shore Investor (as of March 31, 2014)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
Qualcm QCOM	3	Wide	79.34	0.99	Medium	133,916	3	NC
BP BP	3	Narrow	51.3	0.9	High	176,296	2.9	+
GE GE	3	Wide	26.96	0.93	Medium	270,349	2.9	+
BankAmer BAC	3	Narrow	15.42	1.03	High	162,151	2.8	NC
Sanofi SNY	4	Wide	53.69	0.84	Medium	142,206	2.8	+
Hess HES	3	Narrow	95.48	1.15	High	30,001	2.6	+
AES AES	3	None	14.17	1.09	High	10,278	2.6	+
P&G PG	4	Wide	79.76	0.9	Low	215,827	2.6	+
CVS Caremk	2	Wide	75.98	1.12	Medium	88,838	2.6	NC
Teradata TDC	4	Narrow	42.75	0.84	High	6,742	2.6	+

Stock Price and Morningstar Rating data as of 06-12-14.

Morningstar fund analyst Gregg Wolper notes that Sound Shore’s managers try to hold down risk but are willing to step in when trouble creates a buying opportunity. The fund’s contrarian value investment process, which has been unchanged since 1978, typically produces a focused portfolio of about 40 holdings that the managers think are not only attractively priced versus their historic norms, but poised for internally driven financial improvement. Wolper notes that even with such a compact portfolio the fund is not overly concentrated in individual companies, as no single stock typically accounts for more than 3.5% of the fund. While the managers tend to have a long-term perspective, they sell a stock when it appreciates to their target price or the story changes for the worse.

Sound Shore gained more than 40% during 2013, placing it in the top decile for its category. A nearly 4% gain during the first quarter, and a more than 7% gain on a year-to-date basis through the end of last

company-specific results as opposed to grand themes, and have positioned its portfolio accordingly.

Looking at Sound Shore’s sector weightings, the fund looks like a bit of a mixture between Vanguard PRIMECAP and Oakmark. Much like Vanguard PRIMECAP, it is overweight in Health Care, dedicating 18% of the fund to the sector, and has nearly matched the weighting that Technology stocks have in the S&P 500. Also like Oakmark, the fund maintains an overweight position in Financial Services stocks, which accounted for 21% of the portfolio at the end of the first quarter. Sound Shore has also built up a larger stake in the Energy sector, which accounted for 12% of its portfolio (compared with 10% for the S&P 500 at the end of March). The fund was also the only one of the four managers we’ve mentioned here that was a net buyer of stocks during the most recent period.

Top 10 Stock Holdings at Parnassus Core Equity Investor (as of April 30, 2014)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
Apple AAPL	3	Narrow	92.29	1.06	High	556,478	4.9	NC
AppMats AMAT	2	Wide	21.75	1.21	Medium	26,478	4	NC
CHRobnsn	3	Wide	61.82	0.94	Medium	9,162	3.7	NC
P&G PG	4	Wide	79.76	0.9	Low	215,827	3.6	+

Top 10 Stock Holdings at Parnassus Core Equity Investor (as of April 30, 2014) (continued)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
Motorola MSI	2	Narrow	66.46	1.25	Medium	16,776	3.5	NC
Mndlez MDLZ	2	Wide	37.31	1.17	Medium	63,109	3.5	+
Allergan AGN	3	Wide	162.04	1.01	Medium	48,216	3.4	(-)
Xylem XYL	2	Narrow	37.77	1.26	Medium	6,941	3.3	NC
Pentair PNR	3	Narrow	75.35	1.02	Medium	3	3.1	+
Qualcm QCOM	3	Wide	79.34	0.99	Medium	133,916	3	NC

Stock Price and Morningstar Rating data as of 06-12-14.

Morningstar fund analyst Laura Lалlos continues to be impressed by Parnassus Core Equity's ability to outperform, given the restrictions that the fund faces. The fund must keep 75% of assets in dividend-paying stocks, and has placed more emphasis on environmental, social, and governance criteria in its stock selection process. That said, there is no particular emphasis on high-dividend payers or dividend growth, and the managers believe that companies that score well on corporate governance, employee benefits, stakeholder relations, products, environmental impact, and customer and supply chain relationships are more likely to outperform industry peers.

Lалlos goes on to note that managers Ahlsten and Allen invest in companies with wide or increasing economic moats that sell increasingly relevant products or services and that are guided by good management. While they do not make top-down sector calls, there can be sector biases in their portfolio (especially in periods when the market underappreciates a particular industry or sector). At the end of the first quarter, Parnassus Core Equity was overweight in Financial Services (21% of the portfolio compared with a 15% weighting for the

market) and Health Care (18% of the portfolio compared with a 13% weighting for the S&P 500).

While the fund's weighting in Technology approximates the market's weight of 17%, outperformance from top 10 holdings Apple (AAPL), Applied Materials (AMAT), and Qualcomm all have contributed to Parnassus Core Equity's above-average performance this year. The fund also has received a big boost from Allergan (AGN), which is up close to 50% on a year-to-date basis following Valeant Pharmaceuticals' (VRX) ongoing attempt to buy the firm. Given that a deal is unlikely to be finalized anytime soon, we think it was prescient on the part of the Parnassus Core Equity managers to trim their stake in Allergan by 30% in April (when Valeant Pharmaceuticals made its first bid for the firm).

In the past, readers have been interested in the Morningstar Ultimate Stock-Pickers TR Index data points, as well as details on the construction and maintenance of the index. As of the end of last month, the index had 46 total stock holdings, with its top 10 positions

Top 10 Stock Holdings of the Morningstar Ultimate Stock-Pickers TR Index (as of May 31, 2014)

Company Name	Star Rating	Moat Rating	Current Price (\$)	Price/FVE	Fair Value Uncertainty	Market Cap (\$ Mil.)	% Stock Holdings	Buying/Selling
Williams WMB	2	Wide	46.85	1.12	Medium	32,117	5	+
Accntr ACN	3	Wide	82.42	1.02	Medium	54,574	4.9	+
Eli Lilly LLY	3	Wide	58.88	1	Medium	65,259	4.9	+
Praxair PX	3	Wide	130.99	1.01	Medium	38,372	4.9	+
ExxnMbl XOM	4	Wide	101.66	0.93	Low	436,566	4.6	(-)
Emerson EMR	3	Wide	66.44	0.96	Medium	46,624	4.5	(-)
NatOilVrco NOV	3	Wide	77.06	0.96	Medium	33,357	3.6	(-)
Kohl's KSS	4	Narrow	52.25	0.86	Medium	10,807	3.5	+
Qualcm QCOM	3	Wide	79.34	0.99	Medium	133,916	3.3	(-)
McKsson MCK	2	Wide	183.27	1.15	Medium	42,258	3.1	(-)

Stock Price and Morningstar Rating data as of 06-12-14.

accounting for 42% (and its top 25 holdings making up 74%) of the total invested portfolio. This concentration puts the index in the middle of the pack relative to the eight managers that we highlighted above as beating the market so far this year, but we would note that the size and concentration of the portfolio will change over time, as this is an actively managed index that tries to tap into the movements of our top managers over time.

For some background, the Morningstar Ultimate Stock-Pickers TR Index was set up to reflect the highest conviction holdings that our top managers are investing in on an ongoing basis. It is constructed by taking all of the stock holdings of our Ultimate Stock-Pickers that are not only covered by Morningstar stock analysts but have either a Low or Medium Uncertainty Rating and then ranking them by their Morningstar Conviction Score, which measures the level of manager conviction in any given holding in their portfolio. The Morningstar Conviction Score is made up of three factors that represent 1) the overall conviction (number and weighting of a holdings), 2) the relative current optimism (holdings being purchased), and 3) the relative current pessimism (holdings being sold) of each stock being assessed.

The index itself is comprised of three sub-portfolios—each containing 20 securities—which are reconstituted quarterly on a staggered schedule. As such, one third of the index is reset every month, with the top 20 securities with the highest conviction scores making up each sub-portfolio when they are reconstituted. This means that the index overall can hold anywhere between 20 and 60 stocks at any given time. In reality, though, the index has tended to be comprised of 35 to 45 securities. In our view, these stocks represent the best investment opportunities that have been identified by our Ultimate Stock-Pickers in any given period, with the performance of the index highlighting the merit of the methodology put together by our index team.

Performance of Morningstar Ultimate Stock-Pickers TR Index relative to S&P 500 TR Index

	Total Return YTD	1-Year	3-Year	5-Year	Standard Deviation	Sharpe Ratio
Morningstar Ult Stock-Pickers TR	6.79	20.18	13.93	17.73	12.9	1.4
S&P 500 TR Index	4.97	20.45	15.15	18.4	13.4	1.4

Source: Morningstar Direct. Performance Data as of 05/31/14.

As of the end of May, the Morningstar Ultimate Stock-Pickers TR Index was outperforming the S&P 500 TR Index by just over 180 basis points on a year-to-date basis. That said, it is underperforming the benchmark

by about 30 basis points on a year-over-year basis, by 120 basis points on a three-year basis (almost entirely due to heavier best on energy stocks during the first part of 2012), and lagging the index by about 70 basis points over the five-year time frame. The performance record of the Morningstar Ultimate Stock-Pickers TR Index began at the end of December 2005, so we have no 10-year numbers to compare against the S&P 500.

The performance was slightly better through June 12 (the cutoff period for the performance of our Ultimate Stock-Pickers relative to the market), with the index generating a 7.3% total return (relative to a 5.4% gain for the S&P 500) on a year-to-date basis. This level of performance leaves the index outperforming all but three of our top managers since the start of 2014. Our Ultimate Stock-Pickers were, however, doing slightly better than the Morningstar Ultimate Stock-Pickers TR Index on a year-over-year basis, with 10 of our 22 fund managers beating the portfolio managed by our index team. The S&P 500 was also beating the index, with a 22.2% gain year over year compared with a 20.3% increase for the Morningstar Ultimate Stock-Pickers TR Index.

Disclosure: Gregory Warren has ownership interests in the shares of the following securities mentioned above: Mondelez International and Procter & Gamble. Carr Lanphier has no ownership interests in the shares of any of the securities mentioned above. It should also be noted that Morningstar's Institutional Equity Research Service offers research and analyst access to institutional asset managers. Through this service, Morningstar may have a business relationship with fund companies discussed in this report. Our business relationships in no way influence the funds or stocks discussed here.