20 Great Companies with Cheap Stocks

A great, durable business model isn't enough to get into this 20-member club.

Mike Taggart, CFA
+1 312 384-5413
mike.ford-taggart@morningstar.com

As investors, there are few things we like more than companies with durable competitive advantages selling at steep discounts to their value. At Morningstar, we have an index called the Morningstar Wide Moat Focus. This index is comprised of the cheapest wide-moat firms in our 2,000-plus stock coverage universe. These are the firms with the strongest competitive advantages in their industries and the ones where we believe the advantages will persist for years to come. Less than 10% of the companies that we follow have built a competitive advantage that is durable enough to qualify for our wide-moat rating, limiting our wide-moat universe to 174 firms. Still, that's not good enough to be included in our index, because we don't want to simply buy great firms--we want to buy them at bargain basement prices. So we limit the index to the 20 cheapest (based on price/fair value) wide-moat firms. And every three months, we reconstitute the list so that, once again, only the 20 cheapest wide-moat firms get in and we readjust the holdings to equal-weight the index. It's a pretty exclusive club, and its performance shows that it pays to wait.

The most recent index, before its reconstitution, ran from March 23 until June 19 and racked up a 40.6% return over that period. Through July 6, the index has increased 14% year-to-date and has a 0.5% annualized return over a three-year period. These returns far outpace the market's return in the same periods.

As long-term investors know, it often takes several quarters if not years for an investment idea to play out, for the market to reflect a stock's intrinsic worth. American Express AXP and Legg Mason LM are examples of this: each stock has been included in the index for several quarters, typically logging a negative return; however, in the prior three months both firms saw their stock prices increase considerably, and the two stocks had the highest contribution to the index's 40.6% return. American Express logged a 104% return but is still the cheapest wide moat in the current portfolio. Sometimes--too rarely it seems--a cheap firm appears on the radar screen and then Mr. Market quickly rationalizes its valuation. Such was the case with Advisory Board ABCO, which appeared for the first time in the prior portfolio, returned 70% over three months, and no longer qualified for the current portfolio.

While past performance cannot predict future returns, we believe that our "buy great firms with significantly undervalued stocks" strategy will continue to work over the long term. Despite the current economic environment--as confusing as it is with its rising unemployment rates, mounting budget deficits, and yet sprouting "green shoots" here and there--strong firms should continue to outperform weaker ones (and the broader market) over the long term.

Current Constituents of Morningstar Wide Moat Focus Index*

Company	Fair Value Estimate	Price/Fair Value	Fair Value Uncertainty	Portfolio Weighting	New to Portfolio?
American Express Company AXP	$54.00	42%	High	4.6%	
IMS Health, Inc. RX	$26.00	47%	Medium	4.7%	Yes
St. Joe Corporation JOE	$50.00	47%	High	5.1%	
Time Warner Cable, Inc. A TWC	$60.00	50%	Medium	5.1%	Yes
Applied Materials AMAT	$22.00	50%	Medium	4.9%	Yes
International Speedway Corporation A ISCA	$51.00	50%	Medium	4.8%	
Zimmer Holdings, Inc. ZMH	$78.00	51%	Medium	5.1%	
Lowe's Companies, Inc. LOW	$36.00	52%	Medium	5.0%	
Comcast Corporation CMCSK	$25.00	52%	Medium	5.3%	Yes
Paychex, Inc. PAYX	$46.00	53%	Medium	4.6%	
Stryker Corporation SYK	$72.00	53%	Low	5.0%	
Harley-Davidson, Inc. HOG	$28.00	54%	High	5.0%	
The Western Union Company WU	$28.00	55%	Medium	4.9%	
US Bancorp USB	$31.00	55%	High	4.9%	
Pfizer Inc. PFE	$26.00	56%	Medium	5.2%	Yes
KLA-Tencor Corporation KLAC	$45.00	57%	Medium	5.0%	
Linear Technology LLTC	$38.00	60%	Medium	5.1%	Yes
Merck & Co., Inc. MRK	$46.00	60%	Medium	5.6%	Yes
RenaissanceRe Holdings, Ltd. RNR	$77.00	61%	High	4.9%	yes
Eli Lilly & Company LLY	$54.00	62%	Medium	5.1%	Yes

* Data as of July 7, 2009

The current portfolio contains nine newcomers--firms that weren't cheap enough to include in the prior portfolio. Three of them (Merck MRK, Pfizer PFE, and Eli Lilly LLY) are global pharmaceutical firms. Senior Analyst Damien Conover explains why all three are being undervalued in the marketplace and why he believes they offer compelling investment opportunities: "The market's short-term focus on patent losses and fear of U.S. health-care reform have weighed heavily on pharmaceutical companies' valuations. However, over the long term, we believe pharmaceutical companies' pipelines will create the next generation of blockbusters mitigating the near-term generic competition.

Further, we expect a relatively neutral impact from U.S. health-care reform as we believe new reform will increase drug usage, offsetting modest price concessions." Once again, time arbitrage and a long-term investment horizon look set to trump short-term concerns.

There are also two cable firms that are new to the index: Time Warner Cable TWC and Comcast CMCSK. Associate Director Michael Hodel recently wrote an article explaining how we believe the market is misvaluing the long-term competitive strengths of cable operators' networks. Once again, our index is anticipating that over the long term the market will get the valuation right, generating solid returns for investors with the patience to wait.