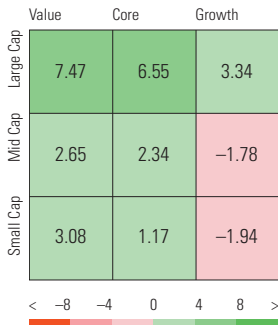


# Morningstar Market Commentary

3rd Quarter 2006

## Morningstar Market Barometer™

3rd Quarter, 2006 Return %



1 Year Return %



Markets rebounded strongly in the third quarter, following second-quarter declines. The Morningstar US Market Index added 4.6% for the quarter. The second-quarter swoon brought the averages back to roughly even, so the third-quarter surges account for nearly all the gains in the indexes for the year.

The markets surged despite macroeconomic uncertainty. Toward the end of the quarter, Federal Reserve Chairman Ben Bernanke received some assistance, in the form of lower commodity prices, in his efforts to control inflation without crashing the economy. Crude oil futures dropped from over \$77 per barrel to near \$60. Other commodity prices, including natural gas, plummeted too. Higher energy prices present a central banker with unique difficulties because they tend to cause inflation or higher prices of goods and services, prompting the bank to raise rates, while also potentially slowing the economy by hurting consumers, prompting the bank to lower rates.

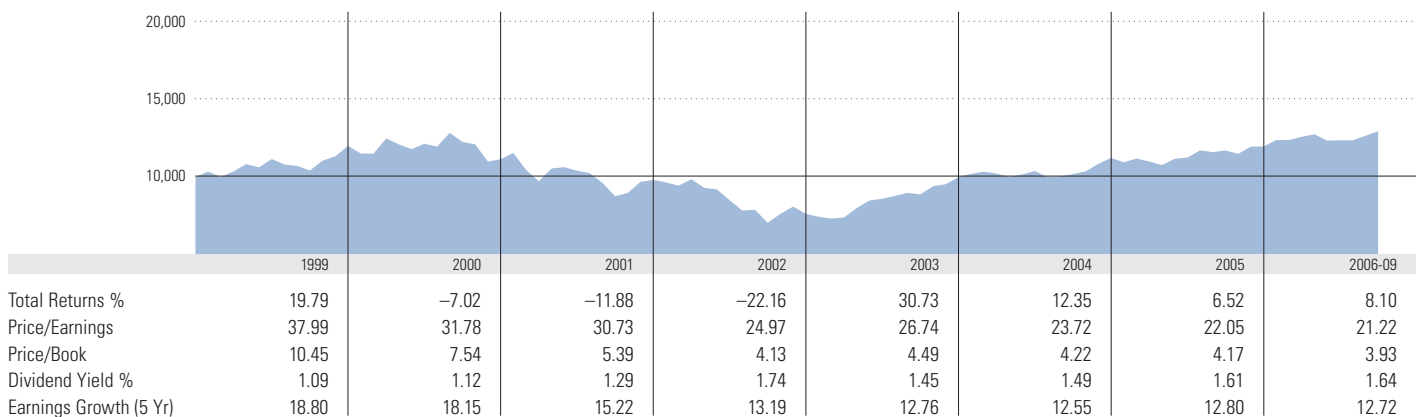
Bernanke wasn't as lucky with the bond market as he was with commodities, however. Traders continued to buy longer-term bonds, sending the yield down on the 10-year US Treasury Note to around 4.6% as of Sept. 29, defying the Fed's rate-raising efforts through

June. The yield curve (the plot of bond yields based on their maturities) is again inverted, indicating that investors are willing to be paid less to lend longer because they anticipate a weaker economy and an eventual lowering of rates.

If the commodity price drops helped the Fed, they caused troubles at hedge funds such as Amaranth Advisors, which has reportedly lost \$6 billion primarily on bad natural-gas bets, prompting observers to wonder whether heavy use of derivative instruments by hedge funds will eventually cause an economic crisis. Other prominent investors remained mostly quiet for the quarter, though Warren Buffett's company Berkshire Hathaway exercised warrants to purchase stock of sheet-rock maker USG, which emerged from bankruptcy.

Speaking of sheet rock, homebuilders continued to flounder, despite lower long-term interest rates. However, commercial real estate continued its torrid trend. Real estate investment trusts (REITs) enjoyed solid gains, spurred by private acquisitions of public companies.

## Morningstar US Market Index (Growth of \$10,000)



### Surveying the Sectors

Software was the strongest sector for the quarter, advancing 16%. Electronic Arts and Activision added 30% and 33%, respectively. Sector behemoth Microsoft added 17% on news that it will increase its five-year share buyback program.

### Industry Performance

Business applications and data networking were the best-performing industries, adding 17% and 16%, respectively, for the quarter. Many of the software companies mentioned earlier helped business applications. Also, networking giant Cisco surged 18% and its smaller competitor Juniper Networks added 8% for the quarter. Analog switch maker Avocent rose 15%.

#### Morningstar Sectors: 3rd Quarter 2006 Return %

	Quarter	1 Year	3 Year
<b>Information</b>	8.44	9.32	7.99
Software	16.48	12.65	8.45
Hardware	7.19	4.35	5.72
Media	2.64	5.64	5.29
Telecommunication	10.00	26.01	18.02
<b>Service</b>	5.42	14.60	12.91
Healthcare	8.61	7.68	9.00
Consumer Services	2.52	8.85	10.51
Business Services	-3.66	13.59	16.09
Financial Services	7.28	21.77	15.68
<b>Manufacturing</b>	1.36	9.16	19.22
Consumer Goods	7.75	9.82	12.58
Industrial Materials	0.05	14.25	16.10
Energy	-3.57	3.33	31.67
Utilities	5.60	7.41	20.52

The telecommunications sector added 10% for the quarter. The largest independent operator of wireless and broadcast communications sites in the U.S., American Tower, rose 17%. Service providers continue to spend money to put equipment on towers as mobile devices become more sophisticated and are able to transmit more complex data. The service providers themselves also did well. Verizon added 12% for the quarter, despite concerns about its long-term competitive advantages versus cable companies.

Business services and energy sectors brought up the rear, falling 3.7% and 3.6% for the quarter, respectively. In business services, transportation- and employment-related companies fared poorly in anticipation of a slowing economy. Logistics company and freight broker Expeditors International dropped 20%, while parcel carrier United Parcel Service lost 12%.

If companies appear to be spending more on networking and infrastructure solutions, perhaps they felt more confident with energy prices declining. Energy and transportation industries posted among the worst showings for the quarter. Last quarter saw Coal as a top five industry, returning 10% to investors; how quickly things change as coal gave up the 10% and more, dropping a whopping 34%. James River Coal shed a breathtaking 60%.

#### Top and Bottom Five Industries: 3rd Quarter 2006 Return %

Business Applications	16.91
Data Networking	15.97
Systems & Security	15.84
Money Management	15.09
Telecommunication Services	14.87
Building Materials	-15.89
Oil/Gas Products	-16.65
Gold & Silver	-16.69
Transport Equipment	-17.45
Coal	-33.66

### Style and Market Cap Indexes

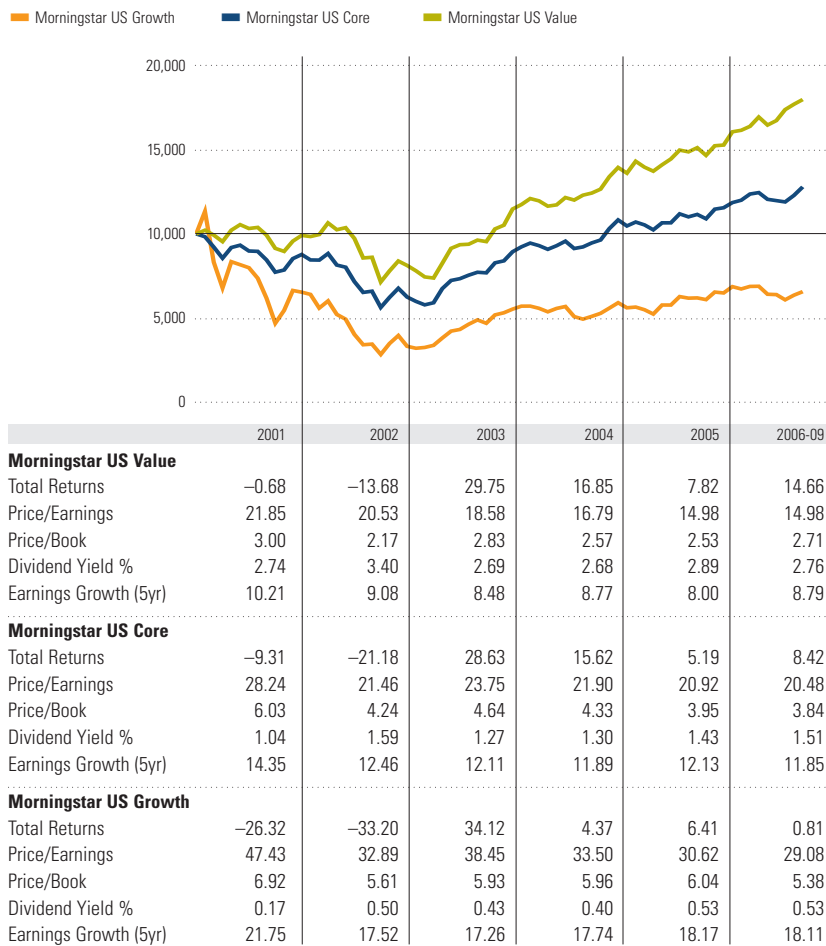
#### Morningstar US Value Index: +6.3%

Once again, value outperformed its core and growth counterparts, with the Morningstar US Value Index rising 6.3% for the quarter. Top component ExxonMobil rose 10%, though that includes a 3% drop over the past month due to declining oil prices.

#### Morningstar US Core Index: +5.4%

The Morningstar US Core Index rose 5.4% for the quarter. Top component General Electric added 8% and consumer products giant Procter & Gamble added 12%. Embattled Hewlett-Packard also rose nearly 16% for the quarter, despite recent headlines regarding members of the company's board.

#### Morningstar Style Indexes: Growth of \$10,000



Other top components that boosted the index were Microsoft and pharmaceutical behemoth Pfizer, which surged 22%. Pfizer pleased investors by shedding its consumer products unit in a deal with rival Johnson & Johnson, but it continues to struggle with restructuring its salesforce and other operations.

#### Morningstar US Growth Index: +1.9%

Again, growth lagged its peers. The Morningstar US Growth Index added 1.9% for the quarter, less than half of its core counterpart and less than one third of its value. If not for a surge in the last week of the quarter, particularly by large growth stocks, the US Growth Index would have finished the quarter in the red. Top component Cisco Systems buoyed the index, returning 18% to shareholders, while maintaining its dominant position in the networking equipment market. Apple Computer contributed as well rising nearly 34%.

Internet names didn't fare as well. Yahoo, Amazon and Google were all down for the quarter. Yahoo fell nearly 24%, followed by Amazon which dropped 17%. Top component Google was down 4% for the quarter, as investors worry about the amount of advertising spending that will occur in the event of an economic slowdown.

Investors anticipating a rebound in growth stocks will have to wait a bit longer.

**Morningstar Large Cap Index: +5.9%**

If value continued to outpace growth, previous multiyear trends abated regarding capitalization size. The Morningstar Large Cap Index outperformed its mid-cap and small-cap brethren, leading analysts to wonder whether this is the start of the much-anticipated rotation by investors to large companies. The index tacked on 5.9%.

Not only did top components ExxonMobil, General Electric, and Microsoft perform well, but financial stocks also surged. Bank of America added 13%. All of the index's top-10 holdings posted gains, and even embattled tobacco company Altria squeezed out a 5% gain, despite a federal judge certifying a class action case against major tobacco makers in the latest step of the industry's litigation saga.

**Morningstar Mid Cap Index: +1.1%**

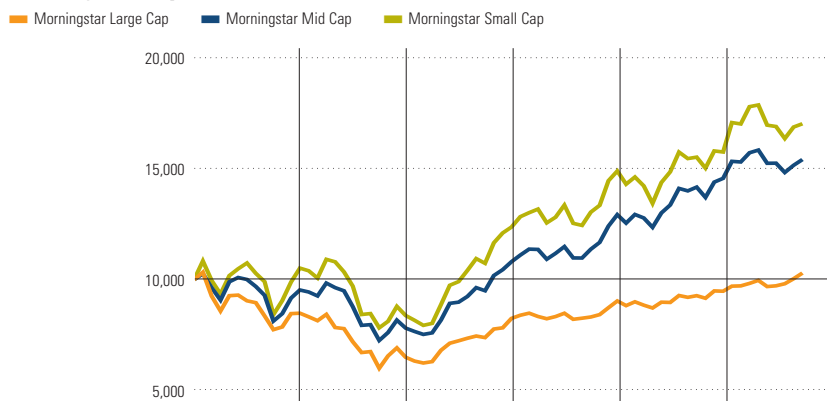
The Morningstar Mid Cap Index posted lackluster returns with a 1.1% gain for the quarter. Top holdings that did well included REITs (real estate investment trusts) Public Storage, Host Hotels & Resorts, and Boston Properties. They added 14%, 6%, and 15%, respectively. REITs continued their torrid multiyear run as yield-hungry buyers bid up their prices, and institutional and retail investors alike have become more confident in owning real estate businesses through publicly traded equities. Private equity firms continue to purchase public companies in the industry.

Despite the powerful performance of REITS, the Mid Cap Index is home to many industrial and energy companies, which did not enjoy good quarters. Fastenal, a supplier of fasteners and repair products, slid over 4%. Many consumer services businesses also stumbled on fears of an economic slowdown and on concerns that housing price declines would deprive consumers, who are accustomed to borrowing money against the value of their homes, of a source of spending power. Restaurant chain Cheesecake Factory declined hard, though it rebounded before the end of the quarter. In total, it shed 1%, though it is down over 20% for the year.

**Morningstar Small Cap Index +0.7%**

Small caps posted the poorest returns compared with their mid-cap and large-cap peers. The Morningstar Small Cap Index rose 0.7%. Telecommunications service provider Windstream, formed from a merger of Alltel's fixed-line businesses and Valor Communications in July 2006, returned 18% for the quarter. However, manufacturer of advanced semiconductor wafer probe cards FormFactor dropped 6%.

Industrial and energy names also hurt the index. Oil and natural-gas explorer Houston Exploration dropped 10% as commodity prices declined. Additionally, small biotechnology stocks suffered for the quarter. Adolor plummeted 45%. The company's lead drug Entereg is a candidate for post-operative ileus, but it isn't approved yet.

**Morningstar Cap Indexes: Growth of \$10,000**

	2001	2002	2003	2004	2005	2006-09
<b>Morningstar Large Cap</b>						
Total Returns	-15.10	-23.47	27.04	9.54	4.87	8.67
Price/Earnings	32.03	25.14	26.93	23.22	21.37	20.41
Price/Book	5.98	4.56	4.76	4.39	4.28	3.97
Dividend Yield %	1.29	1.80	1.54	1.62	1.77	1.78
Earnings Growth (5yr)	14.78	12.81	12.46	12.35	12.36	12.33
<b>Morningstar Mid Cap</b>						
Total Returns	-4.63	-18.06	38.38	19.66	12.70	5.83
Price/Earnings	26.96	25.97	25.89	24.60	23.90	23.39
Price/Book	3.96	3.19	3.86	3.89	4.00	3.92
Dividend Yield %	1.33	1.59	1.27	1.23	1.23	1.25
Earnings Growth (5yr)	16.14	13.94	12.57	13.03	13.62	13.33
<b>Morningstar Small Cap</b>						
Total Returns	5.26	-20.36	47.70	20.44	5.76	8.10
Price/Earnings	25.22	22.96	27.04	26.43	24.44	24.83
Price/Book	3.11	2.72	3.58	3.79	3.54	3.55
Dividend Yield %	1.18	1.56	1.09	0.97	1.15	1.21
Earnings Growth (5yr)	17.57	14.96	14.86	14.60	15.22	15.45

**Active vs. Passive, 3rd Qtr 2006**

	Value	Core	Growth
Large Cap	0.51	2.00	15.98
	7.47	6.55	3.34
Mid Cap	32.20	25.77	58.45
	2.65	2.34	-1.78
Small Cap	9.76	13.23	41.20
	3.08	1.17	-1.94

○ Percent of actively managed mutual funds outperforming their respective benchmark. Includes the oldest share class for all US diversified mutual funds with at least a one-year history. As of September 30, 2006 there were 2,577 eligible funds. Morningstar classifies funds into style categories based on the average style score (using the same 10-factor methodology as underlying benchmarks) of all available portfolio holdings over a three-year period.

● Index Returns (%), 3rd Quarter, 2006

**Fund Categories vs. the Benchmarks**

Active management made a poor showing, as the mid-growth category was the only one where a majority of actively managed funds beat their benchmark. The Morningstar Mid-Cap Growth and Small-Cap Growth Indexes had the worst performances of the quarter, making it easy for active funds in those categories to gain victories if they drifted even slightly out of their benchmarks. So if mid-cap funds owned some large-cap stocks, they tended to do well. By contrast, the large-value funds had the worst showing versus their benchmark, the Morningstar Large Value Index, because that index performed so well. Going outside the index didn't help.

Morningstar indexes are "style pure," meaning they exhibit clearly the characteristics associated with a specific style box. This makes them difficult to beat when they are the darlings and relatively easy to beat when they are the dogs. Because no indexes were markedly poor for the quarter, it makes sense that the actively managed funds had difficulty beating them. Similarly, the sound drubbing of large-growth and large-core funds by their indexes may be cause for hope that large caps are returning to favor.

**Conclusion**

The rise in the equity markets has our market valuation graph indicating that the aggregate of stocks covered by Morningstar analysts is roughly fairly valued. At the end of the difficult second quarter, stocks appeared

undervalued for the first time since a brief dip into undervaluation in October 2005.

Despite the aggregate of stocks covered by Morningstar analysts appearing fairly valued, the condition of undervalued higher-quality businesses persists. Market valuation metrics indicate that "wide moat" companies (those with sustainable competitive advantages) are undervalued.

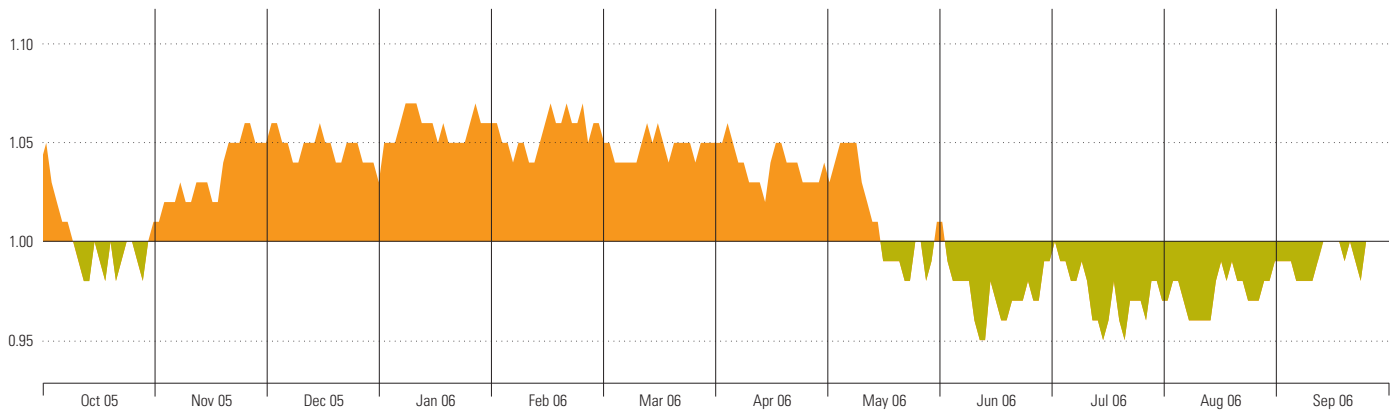
Many of these wide-moat businesses continue to trade at prices below analysts' fair value estimates—in other words, in 5-star territory. Large, steady companies on the list include 3M, Anheuser-Busch, Berkshire Hathaway, Coca-Cola, Dell, Expeditors International, ExxonMobil, Fastenal, Home Depot, Johnson & Johnson, Medtronic, Microsoft, UPS, Washington Post, and Wm. Wrigley Jr.

Morningstar analysts think that we've traversed a multi-year period when investors have forgotten about high-quality businesses and have been willing to speculate on lower-quality operations with less-certain prospects. It is difficult to say what will produce a so-called rotation back to wide-moat stocks, and the market could take these stocks lower in the meantime. Nevertheless, Morningstar analysts think they represent good long-term value.

**John Coumarianos**  
Mutual Fund Analyst

**Market Valuation**

■ Overvalued ■ Undervalued



<b>52-Week High</b> 1.07 (02-27-06)	<b>52-Week Low</b> 0.95 (07-21-06)	<b>All-Time High</b> 1.14 (12-01-04)	<b>All-Time Low</b> 0.78 (10-09-02)	<b>3rd Quarter Close</b> 1.00 (09-29-06)
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**Market Valuation Chart**

The graph shows the ratio of price to fair value for the median stock in the universe of stocks covered by Morningstar over time. A ratio above 1.00 indicates that the stock's price is higher than Morningstar's estimate of its fair value; a ratio below 1.00 indicates that the stock's price is lower than our estimate of its fair value. The further the price/fair value ratio rises above 1.00, the more the median stock is overvalued. The further it moves below 1.00, the more the median stock is undervalued.

**Trailing Returns %**

Index	Quarter	6-Month	1-Year	3-Year	5-Year	10-Year
Morningstar US Market	4.63	2.73	10.52	13.30	8.05	8.53
Large Cap	5.94	4.74	11.02	11.73	5.86	7.76
Mid Cap	1.08	-1.95	8.79	17.53	13.64	10.14
Small Cap	0.74	-4.34	9.71	16.64	15.12	9.87
US Value	6.29	8.15	15.66	18.52	11.44	NA
US Core	5.39	2.73	11.43	13.74	7.94	NA
US Growth	1.85	-3.10	3.99	7.43	4.37	NA
Large Value	7.47	10.38	17.33	17.92	9.81	NA
Large Core	6.55	4.51	11.98	12.39	5.59	NA
Large Growth	3.34	-1.37	2.98	4.53	1.83	NA
Mid Value	2.65	2.51	10.66	20.05	15.24	NA
Mid Core	2.34	-1.68	8.44	16.80	14.33	NA
Mid Growth	-1.78	-6.35	7.20	15.46	10.62	NA
Small Value	3.08	-0.63	10.78	18.88	17.77	NA
Small Core	1.17	-2.38	13.59	19.19	16.93	NA
Small Growth	-1.94	-9.78	4.79	11.80	10.36	NA

**Morningstar Market Barometer 3rd Quarter Return %****Morningstar Market Barometer Trailing 4 Quarters Return %****4th Quarter 2005**

0.75	2.97	2.87
1.43	2.35	4.52
0.56	1.87	2.08

**1st Quarter 2006**

5.50	4.06	1.49
6.43	7.77	9.52
10.86	14.22	13.78

**2nd Quarter 2006**

2.71	-1.91	-4.56
-0.14	3.93	-4.65
-3.60	-3.51	-7.99

**3rd Quarter 2006**

7.47	6.55	3.34
2.65	2.34	-1.78
3.08	1.17	-1.94

**Biggest Positive Influence on Morningstar US Market Index**

	Style	Contribution %	QTR	1-Year	3-Year
Pfizer Inc.	■	0.27	21.86	17.22	0.32
Microsoft Corp.	■	0.27	17.77	7.66	3.99
Exxon Mobil Corp.	■	0.26	9.89	7.57	24.43
Bank of America Corp.	■	0.20	12.54	32.14	14.86
General Electric Co.	■	0.19	7.86	7.81	8.41
Procter & Gamble Co.	■	0.16	12.03	6.22	11.98
Cisco Systems Inc.	■	0.15	17.67	28.24	5.46
AT&T Inc.	■	0.14	17.94	41.34	17.92
JPMorgan Chase & Co.	■	0.13	12.62	42.41	14.13
American Inter. Group Inc.	■	0.12	12.49	7.93	5.43

**Biggest Negative Influence on Morningstar US Market Index**

	Style	Contribution %	QTR	1-Year	3-Year
Cendant Corp.	■	-0.10	-88.77	-90.07	-47.80
Yahoo! Inc.	■	-0.07	-23.39	-25.30	12.63
Valero Energy Corp.	■	-0.07	-22.51	-8.47	75.88
Halliburton Co.	■	-0.06	-23.12	-16.12	34.10
ConocoPhillips	■	-0.06	-8.61	-12.86	31.96
Sprint Nextel Corp.	■	-0.06	-14.08	-27.46	6.32
United Parcel Service Inc.	■	-0.05	-12.16	6.19	5.90
Qualcomm Inc.	■	-0.04	-8.98	-17.83	21.40
Caterpillar Inc.	■	-0.04	-11.25	13.79	25.77
Peabody Energy Corp.	■	-0.04	-33.92	-12.25	68.16

Biggest Influence on Quarter performance is calculated by multiplying the stock returns for the quarter by their respective weight in the Index as of the start of the quarter.

**News Briefs: Morningstar Dividend Indexes Serve Income Seeking Investors**

In March 2006 Morningstar introduced two new indexes designed to help investors understand and access the income potential of equities—Morningstar Dividend Composite and Morningstar Dividend Leaders. For more information on portfolio composition and investing applications, visit <http://indexes.morningstar.com>. Also, First Trust Advisors launched an Exchange Traded Fund based on the Dividend Leaders Index (ticker: FDL).