Morningstar® Managed Portfolios™
Select Stock Baskets—U.S. Wide Moat Focus

The U.S. Wide Moat Focus Select Stock Basket is the newest addition to the Strategist Series of Select Stock Baskets from Morningstar Investment Services. This low-cost, low investment minimum strategy is designed to track the Morningstar® Wide Moat Focus™ Index, which boasts an outstanding long-term track record. The portfolio invests equally in the 20 cheapest “wide moat” stocks in the Morningstar, Inc. coverage universe.

What’s a Wide Moat?
The concept of an economic moat is a cornerstone of Morningstar, Inc.’s investment philosophy. Just as a moat around a medieval castle kept the opposition at bay, an economic moat is a structural competitive advantage that allows a firm to earn above-average returns on capital over a long period of time.

There are four sources of economic moats. The first two include intangible assets (such as brands, patents, licenses, and government approvals) and switching costs. The second two sources of moats are the network effect, which helps to keep market share captive, and the cost advantages that some companies enjoy. The longer a company can sustain a competitive advantage, the wider its economic moat. Morningstar, Inc. assigns one of three Economic Moat Ratings—Wide, Narrow, or None—to each of the companies it covers.

Wide Moats Are Rare
Great management, the right size, dominant market share, easily-replicable technology, and hot products all represent advantages to any business. However, none of them is a structural advantage—that is, an advantage inherent to the business—guaranteed to sustain high returns over a long period of time. That’s because high returns attract competitors like bees to honey. So, rivals will try to poach managers, knock off products, and do just about anything to get in on the action, which will often cause a company’s once-high returns to dwindle.

Carving out a wide moat able to withstand the relentless onslaught of competition is difficult. In fact, according to the nearly 100 equity analysts at Morningstar, Inc., roughly 10% of the 1,600 companies in their coverage universe warrant a Wide Moat rating. These analysts conduct extensive research on industry dynamics, a firm’s competitive position, and the durability of any advantages that the firm might boast.

Economic Moats
The Five Sources of Sustainable Competitive Advantage

Source: Morningstar, Inc. For illustrative purposes only.
Why Do Wide Moats Matter?
A wide moat company that can generate high returns on invested capital for many years will compound wealth at a very brisk clip. Yet the benefits conferred by a wide moat are often not fully factored into stock prices. After all, market participants tend to own securities for relatively short time periods, and moats matter much more in the long run. The performance of the Wide Moat Focus Index suggests that purchasing wide moat stocks when they’re cheap can be a compelling strategy.

A Professionally Managed, Focused Solution
This portfolio is designed to track the Morningstar Wide Moat Focus Index, which consists of equal sums of the twenty wide moat domestic stocks trading at the largest discounts to Morningstar, Inc.’s fair value estimates. The strategy follows a “best ideas” approach, investing in the most compelling opportunities among wide moat stocks, wherever they happen to reside. Thus, the sector weights in the U.S. Wide Moat Focus Select Stock Basket portfolio can bear scant resemblance to those of the broader market. The strategy’s approach also means that it is unbiased to size (i.e., large-cap vs. small-cap) and to style (i.e., growth vs. value). Each client portfolio is assembled by Morningstar Investment Services, and monitored daily, as well as rebalanced quarterly to replicate the Index.

Tailored to Investor Needs
As with all of our stock portfolios, the U.S. Wide Moat Focus Select Stock Basket offers the flexibility to exclude certain sectors, industries, or individual stocks for a customized solution. It also allows investors to combine a portfolio of stocks with fixed income mutual funds or ETFs in a single account, provided that the equity portion of the portfolio meets the account minimum of $100,000.

S&P 500 Index — The S&P 500 Index tracks the performance of the 500 largest stocks that are considered to be widely held. Its performance is thought to be representative of the stock market as a whole.

Morningstar Wide Moat Focus Index — An index comprised of the 20 stocks given an Economic Moat™ rating of Wide that are trading at the largest discounts to the Morningstar, Inc. fair value estimate. The Index is reviewed and rebalanced on a quarterly basis.

The Select Stock Baskets portfolios invest in common stocks of U.S. companies and American Depositary Receipts (ADRs), which are a type of equity security that represents an ownership interest in a company. Common stocks are subject to greater fluctuations in market value than other asset classes as a result of such factors as a company’s business performance, investor perceptions, stock market trends, and general economic conditions. During some periods, the securities of small- and mid-cap companies, as a class, have performed better than the securities of large companies, and in some periods they have performed worse. Stocks of small- and mid-cap companies tend to be more volatile and less liquid than stocks of large companies. Small- and mid-cap companies, as compared to larger companies, may have a shorter history of operations, may not have as great an ability to raise additional capital, may have a less diversified product line making them susceptible to market pressure, and may have a smaller public market for their shares.

Performance Record of the Morningstar® Wide Moat Focus™ Index

<table>
<thead>
<tr>
<th>Index Performance as of 06-30-2014</th>
<th>Trailing 1-Year</th>
<th>Trailing 3-Year</th>
<th>Trailing 5-Year</th>
<th>Since 09-30-2002*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morningstar Wide Moat Focus Index</td>
<td>26.9</td>
<td>19.6</td>
<td>20.6</td>
<td>12.7</td>
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<tr>
<td>S&amp;P 500 Index (Cap-Weighted)</td>
<td>24.6</td>
<td>16.6</td>
<td>18.8</td>
<td>7.8</td>
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</tbody>
</table>

* Morningstar Wide Moat Focus Index Inception
* Return is annualized

For illustrative purposes only; the indices’ returns do not represent actual client experience. Morningstar Investment Services manages a Select Stock Basket Strategist Series that is based on the Morningstar Wide Moat Focus Index and the research of Morningstar, Inc. The indices displayed are unmanaged and cannot be directly invested in. Past performance is not a guarantee of future results.