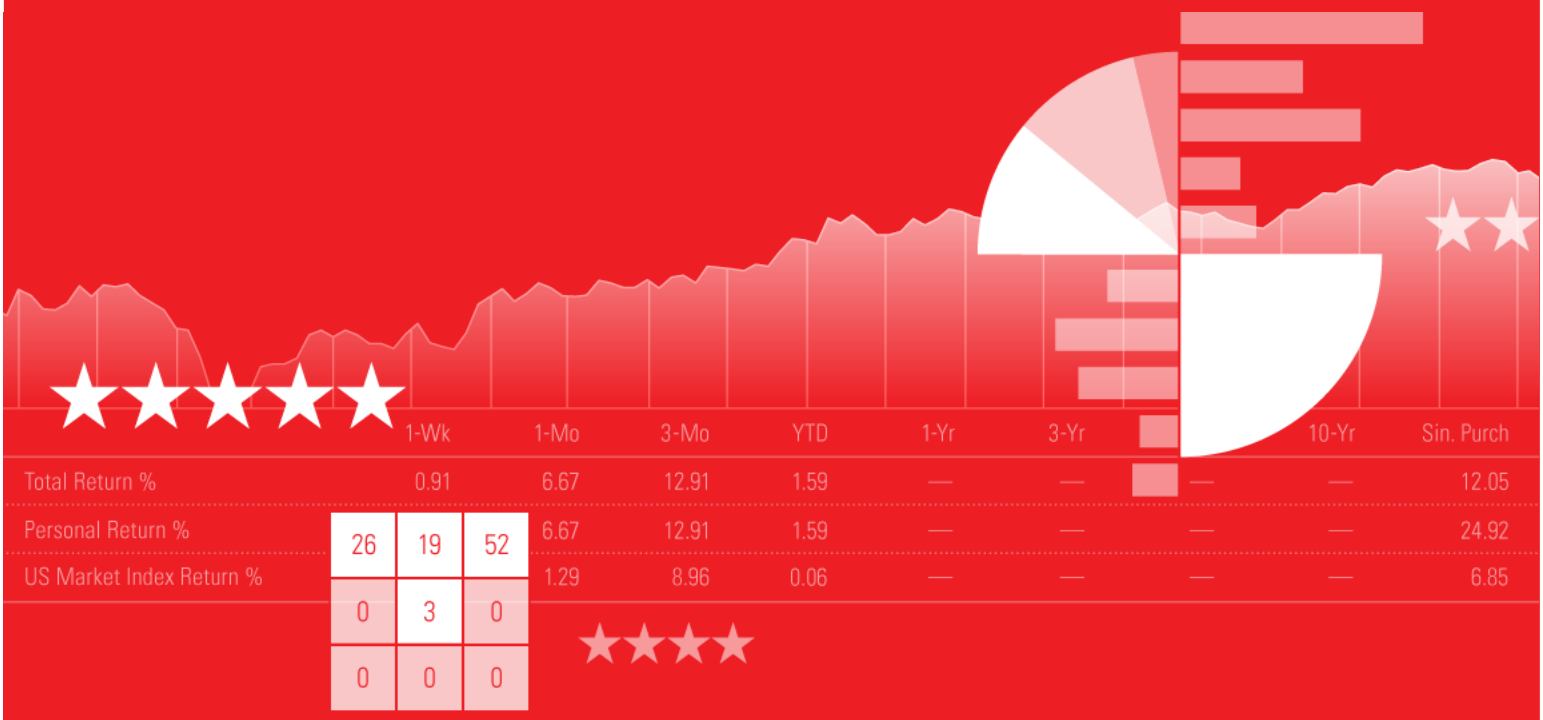
Portfolio Monitor



	1-Wk	1-Mo	3-Mo	YTD	1-Yr	3-Yr		10-Yr	Sin. Purch
Total Return %	0.91	6.67	12.91	1.59	—	—	—	—	12.05
Personal Return %	6.67	12.91	1.59	—	—	—	—	—	24.92
US Market Index Return %	1.29	8.96	0.06	—	—	—	—	—	6.85

26	19	52
0	3	0
0	0	0

Monthly Report for

April 21, 2014

Boston Holdings, LLC Portfolio

MORNINGSTAR®

Boston Holdings, LLC Portfolio

Personal Morningstar Rating	Personal Return This Period	% of Mutual Fund Outperformed	Reporting Period
—	–3.41%	—	—

Previous Balance $	103,357.23
New Net Investment $	0.00
Gain/Loss $	–3,349.26
Current Balance $	**100,007.98**

Re-Invested Dividends $	0.00
Re-Invested Interest $	0.00
Dividend $ (Top 10)	
Total	0.00
Capital Gain/Loss $ (Top 10)	
Total	0.00

Portfolio Performance

	1-Wk	1-Mo	3-Mo	YTD	1-Yr	3-Yr*	5-Yr*	10-Yr*	Sin. Purch*
Total Return %	1.31	–3.41	–0.05	–0.52	29.17	—	—	—	24.58
Personal Return %	1.31	–3.41	–0.05	–0.52	29.17	—	—	—	24.79
US Market Index Return %	1.92	–0.59	0.85	0.82	20.54	—	—	—	17.89

*Annualized

Top 5 Gainers

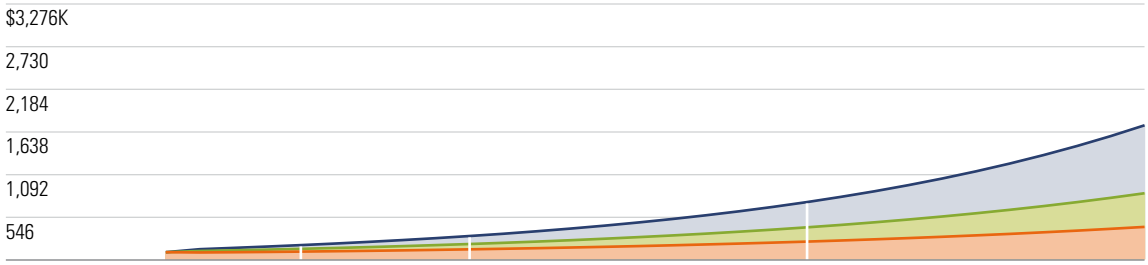
Name	Morningstar Rating	Price $	Market Value $	1-Mo Return %
LVMH Moet Hennessy Louis Vuitt ...	—	39.40	3,940.00	11.38
Market Vectors Russia ETF	—	23.99	1,199.50	7.53
iShares MSCI Frontier 100	—	38.18	1,909.00	7.37
WisdomTree Middle East Dividen ...	—	23.84	834.40	5.39
iShares MSCI Denmark Capped	—	49.84	2,492.00	2.51

Top 5 Losers

Name	Morningstar Rating	Price $	Market Value $	1-Mo Return %
Netflix Inc	↑ ★★	345.74	6,914.80	–14.84
Facebook Inc Class A	★★	58.94	7,072.80	–12.34
Coca-Cola Bottling Co Consolid ...	—	80.71	7,667.45	–8.33
Bank of America Corporation	★★	16.15	1,647.30	–8.03
Sirius XM Radio Inc	—	3.14	4,493.34	–6.27

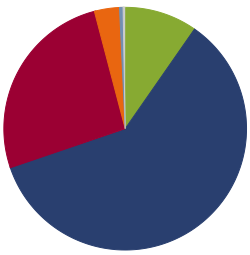
Potential Value in 5, 10, 20 and 30 Years

In this section we provide a hypothetical outlook on your portfolio's future performance highlighting the percent chance of achieving the values we project.



Years	5	10	20	30
75% Chance	107,357	136,311	235,573	423,334
50% Chance	142,982	204,422	417,852	854,117
25% Chance	190,427	306,566	741,172	1,723,264

X-Ray Overview



Asset Allocation

Cash	9.96
U.S. Stocks	60.10
Foreign Stocks	26.13
Bonds	3.34
Other	0.47
Not Classified	0.00

Equity Investment Style

Size	Value	Core	Growth
Large	1	22	2
Med	2	2	3
Small	1	9	1

Valuation

Fixed Income Style

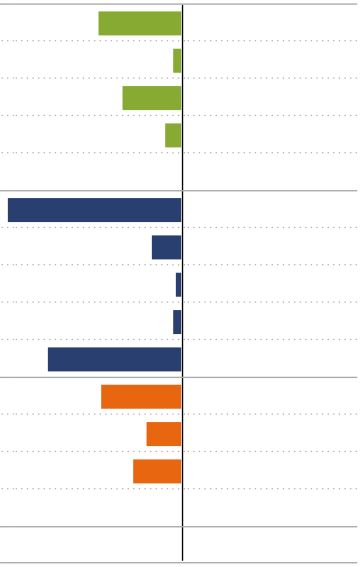
Credit Quality	Ltd	Mod	Ext
High	0	0	0
Med	0	76	0
Low	0	24	0

Interest Rate Sensitivity

Sector Weighting

		% Net Assets		1-Mo Return %	
		Portfolio	S&P 500	Portfolio	S&P 500
Cyclical		**24.62**	**31.12**	**–0.84**	**0.45**
Basic Materials		1.78	3.39	–0.06	0.29
Consumer Cyclical	♦	17.67	10.66	–0.60	0.11
Financial Services	◊	4.57	15.23	–0.16	–0.04
Real Estate		0.61	1.85	–0.02	0.09
Sensitive		**51.71**	**42.39**	**–1.76**	**0.87**
Communication Services		8.93	3.97	–0.30	0.07
Energy	◊	0.83	10.12	–0.03	0.41
Industrials	◊	2.32	11.35	–0.08	–0.07
Technology	♦	39.63	16.94	–1.35	0.46
Defensive		**23.67**	**26.49**	**–0.81**	**1.05**
Consumer Defensive		9.76	10.21	–0.33	0.76
Healthcare		13.72	13.22	–0.47	0.35
Utilities		0.19	3.07	–0.01	–0.07
Not Classified		0.00	0.00	0.00	—

Portfolio 1-Mo Return %



Stock Statistics

	Portfolio	Relative to S&P 500
Forward P/E Ratio	13.60	0.82
P/B Ratio	3.48	1.53
ROA	10.03	1.25
ROE	26.40	1.29

	Portfolio	Relative to S&P 500
5-Yr Proj EPS Growth %	16.38	1.62
Dividend Yield %	1.67	0.95
Average Market Cap $mil	52,386.35	0.78

Fees & Expenses

Average Mutual Fund Expense Ratio %	0.70
Expense Ratio of Similarly Weighted Hypothetical Portfolio %	0.71
Estimated Mutual Fund Expense $	136.33
Total Sales Charge Paid $	0.00

Regional Exposure

		% of Stocks
North America		67.89
Latin America		0.11
United Kingdom	♦	13.58
Europe Developed		13.01
Europe Emerging		1.19
Africa/Middle East		2.61
Japan	◊	1.35
Australasia		0.00
Asia Developed		0.00
Asia Emerging		0.25
Not Classified		0.00

Diagnostics

Asset Allocation

Your portfolio is aggressive. An asset mix such as yours normally generates high long-term returns but can be very volatile. Financial planners typically recommend these types of mixes for investors who have investment horizons longer than 10 years, need high returns, and are comfortable with a high level of risk.

Equity Investment Style

Your portfolio contains large positions in unusual securities, has little stock exposure, or Morningstar is unable to assign style boxes to much of it. As a result, we are unable to provide a written assessment of this aspect of your portfolio. You can still examine the investment styles of those holdings for which data are available.

Sector Weighting

♦ Over Exposure
◊ Under Exposure

Fees & Expenses

The mutual funds in your portfolio tend to have average expense ratios.

Regional Exposure

♦ Over Exposure
◊ Under Exposure

Name	Ticker	Morningstar Rating	Change in Rating	% of Assets	Holding Value $	Personal Return % 1-Mo	3-Mo	1-Yr*	3-Yr*	5-Yr*
Apple Inc	AAPL	★★★	0	15.75	15,748.20	–1.49	–4.39	34.42	—	—
GlaxoSmithKline PLC ADR	GSK	★★★	0	10.50	10,502.00	–1.06	–4.44	4.10	—	—
Microsoft Corp	MSFT	★★★	0	8.00	8,002.00	–0.37	10.62	34.42	—	—
Coca-Cola Bottling Co Consolid ...	COKE	—	—	7.67	7,667.45	–8.33	11.94	32.44	—	—
Facebook Inc Class A	FB	★★	0	7.07	7,072.80	–12.34	0.73	129.07	—	—
Netflix Inc	NFLX ↑	★★	+1	6.91	6,914.80	–14.84	5.18	111.63	—	—
Cash	CASH$	—	—	5.00	5,000.00	—	—	—	—	—
Nike Inc Class B	NKE	★★	0	4.81	4,806.58	–1.68	0.27	21.38	—	—
Sirius XM Radio Inc	SIRI	—	—	4.49	4,493.34	–6.27	–15.36	4.49	—	—
LVMH Moet Hennessy Louis Vuitt ...	LVMUY	—	—	3.94	3,940.00	11.38	12.31	24.29	—	—
Yahoo! Inc	YHOO	★★	0	3.64	3,638.00	–4.11	–7.95	55.01	—	—
Loomis Sayles Investment Grade ...	LIGRX	★★★★★	—	3.05	3,055.00	1.08	2.00	–3.93	—	—
iShares MSCI Denmark Capped	EDEN	—	—	2.49	2,492.00	2.51	6.41	44.00	—	—
ProShares Short Oil & Gas	DDG	—	—	2.30	2,300.00	–4.68	–7.07	–24.13	—	—
iShares MSCI Germany Small-Cap	EWGS	—	—	2.08	2,083.11	–0.40	–1.04	31.93	—	—
iShares MSCI Frontier 100	FM	—	—	1.91	1,909.00	7.37	10.44	28.99	—	—
iShares MSCI Ireland Capped	EIRL	—	—	1.73	1,726.65	0.00	2.65	37.04	—	—
Bank of America Corporation	BAC	★★	0	1.65	1,647.30	–8.03	–5.06	38.51	—	—
iShares MSCI United Kingdom Sm ...	EWUS	—	—	1.48	1,482.25	–0.09	–0.38	32.39	—	—
First Trust Germany AlphaDEX	FGM	—	—	1.25	1,249.05	0.47	–0.42	29.46	—	—
Market Vectors Russia ETF	RSX	—	—	1.20	1,199.50	7.53	–12.13	–6.94	—	—
Honda Motor Co Ltd ADR	HMC	★★★★	0	1.20	1,195.95	–2.40	–14.21	–13.84	—	—
Metropolitan West Total Return ...	MWTRX	★★★★★	—	1.05	1,048.60	0.28	0.66	–2.46	—	—
WisdomTree Middle East Dividen ...	GULF	—	—	0.83	834.40	5.39	11.77	42.33	—	—

*Annualized

Apple Inc AAPL | ★★★

$524.94 ↓$7.93 | –1.49%

Fair Value Estimate	**$570**
Consider Buying Price	**$342**
Consider Selling Price	**$883.5**
Fair Value Uncertainty	**High**
Economic Moat	**Narrow**
Stewardship Grade	**Standard**

03-10-2014 | by Brian Colello, CPA

The Thesis 03-10-2014

We believe Apple's strength lies in its experience and expertise in integrating hardware, software, services, and third-party applications into differentiated devices that allow Apple to capture a premium on hardware sales. Although Apple has a sterling brand, robust product pipeline, and ample opportunity to gain share in its various end markets, short product life cycles and intense competition will prevent the firm from resting on its laurels or carving out a wide economic moat, in our opinion.We believe Apple has developed a narrow economic moat, thanks to switching costs related to a variety of attributes around the iOS platform that may make current iOS users more reluctant to stray outside the Apple ecosystem for future purchases. However, much of Apple's exponential growth in recent years has stemmed not from the firm's moat, but from the achievement of building the first truly revolutionary smartphone, the iPhone, that integrated hardware and software, as well as a robust apps store and ecosystem that attracted new users to platform. Apple's first-mover advantage may be diminishing, and "easy growth" coming from early smartphone adopters may be winding down as the smartphone market moves up the adoption curve and competition ramps up from Samsung and others. Yet we still foresee iPhone growth, coming from both attracting new customers to iOS (mostly in emerging markets, although we still see U.S. growth as well) and retaining Apple's existing premium iPhone customers, where we think the company's moat will play an increasingly important role. A partnership with China Mobile, the world's largest wireless carrier, should also give iPhone growth a shot in the arm.Ultimately, we think future smartphone and tablet competition will stem from software and services, as hardware is already approaching commoditization. We view Apple as well positioned to develop and expand enough services to enhance the user experience, in order to build switching costs that will help the firm retain customers and generate significant repeat purchases will be critical for future iPhone growth in the years ahead.

Valuation

Our fair value estimate for Apple is $570 per share, which implies fiscal 2014 (ending September 2014) price/earnings of 13.5 times, and only 10 times after excluding $157 per share of net cash on hand as of December 2013. We project revenue growth of 6% in fiscal 2014, down from our prior projection of 13%. Apple profited from successful launches of new devices such as the iPhone 5s, but follow up sales in the March 2014 quarter were below our expectations, which points to even lower revenue growth through the rest of fiscal 2014 as these products age. Longer term, Apple should still attract late smartphone adopters in developed markets and new customers in emerging markets, especially as Apple's partnership with China Mobile, the world's largest wireless carrier, begins to pay dividends. As more and more consumers are previous smartphone owners, rather than first-time buyers, we think Apple has a good chance to retain a sizable portion of its iOS user base today, and perhaps gain further share at the high end of the market. However, although Apple has taken on the strategy of maintaining premium pricing, which may support gross margins in the years ahead, such pricing may weigh on future revenue growth. In turn, we model low single-digit iPhone revenue growth in fiscal 2015 and beyond.We project solid iPad revenue growth in fiscal 2014 and 2015, as this device both displaces PCs and is purchased as a third device alongside PCs and phones, but minimal growth thereafter as Apple maintains premium pricing on these devices but fails to recognize exponential unit growth as in years past. We assume Apple's line of Mac PCs will see modest revenue growth, as Macs gain share in the declining PC industry. We also do not make any profitability assumptions for an Apple TV or iWatch but recognize that future innovations may provide upside to our valuation.We project 37.5% gross margins in fiscal 2014 and mid-30% gross margins in the long term, as Apple maintains its focus on premium pricing that helps to stave off meaningful gross margin compression, albeit with relatively slower unit sales growth. In turn, operating margins should fall to the mid-20% range five years out. Our fair value uncertainty rating for Apple is high.

Risk

We believe a large, well-diversified company like Apple faces several risks. Smartphone and tablet competition is rising, as Samsung, in particular, has developed compelling iPhone alternatives in the premium smartphone space. Meanwhile, we anticipate that a greater portion of smartphone sales come from low-end devices in emerging markets where Apple does not participate. If these devices turn out to offer only a slightly worse user experience than iOS products, Apple may be unable to capture an adequate premium on future hardware sales. Apple also has to square off against several competitors with much different strategies than traditional hardware makers. Apple's devices compete against firms like Amazon (with its Kindle Fire tablet) and Xiaomi, which appear willing to sell hardware at cost, in order to drive other revenue streams.Despite its intentions to control as much of the user experience as possible for its products, Apple still relies on a robust app developer base and strong partnerships with third parties. Its decision to use an in-house mapping solution (and subsequent apology) may have diminished Apple's reputation and its customers' user experience, and other similar missteps may cause customers to leave the iOS ecosystem altogether. If Apple were to falter and its exceptional brand be diminished as customers departed iOS in droves, we're not even sure that Apple's mighty cash cushion could help the firm buy its way out of any problem.As a premium phone supplier, Apple also runs the risk that wireless carriers could reduce or eliminate the subsidies that they provide their customers on the iPhone, in turn raising customers' up-front costs and perhaps making other smartphones appear to be better alternatives. Finally, Apple lost cofounder and visionary Steve Jobs in October 2011, and while we believe CEO Tim Cook is a more-than-capable leader, Apple runs the risk that its unique culture and sense of innovation may diminish over time.

Management & Stewardship

We view Apple as a good steward of shareholder capital. Arthur Levinson, former chairman and CEO of Genentech, is chairman of Apple's board of directors. Tim Cook became CEO in August 2011 after cofounder, longtime CEO, and visionary Steve Jobs stepped down from the CEO role before passing away in October 2011. Cook was considered to be Jobs' right-hand man and served in various operations roles with Apple before becoming COO in 2005. We believe Jobs' passing was a blow to the firm, as he was a one-of-a-kind leader and creative mind. Although Apple maintains sterling brand recognition and has hundreds of millions of loyal followers, the company has made a couple of missteps under Cook that, some would argue, would have never happened under Steve Jobs. Apple executed poorly when it decided to part ways with Google Maps in iOS 6 and launch Apple Maps with a variety of bugs and errors, leading to a formal apology and the ouster of VP Scott Forstall. Also, Apple hinted that it believes that a 4" screen is an adequate screen size for a smartphone, yet Samsung has done quite well in the near term with its much larger Galaxy smartphones and Galaxy Note phablets (phone/tablets). We fear that Apple may miss out on part of the premium smartphone market if it fails to build a larger-screen iPhone in the near-future, although rumors continue to swirl that an iPhone 6 launch in 2014 may include a larger screen version.On the other hand, while many

may have questioned Apple's management team about its decision to price the iPhone 5c at $549, rather than at lower prices that more directly addresses emerging market demand, we tend to approve of Apple's decisions to maintain its premium pricing position. We also applaud Cook's decision to initiate a dividend and stock buyback plan in early 2012, as well as take on debt in order to fund a $60 billion stock buyback program in 2013. We recognize that many high-profile investors have called for an even larger buyback program, but we think that Apple's current plan is satisfactory as long as buybacks (and the debt issuances needed to fund these buybacks) are made in a prudent manner. In retrospect, the misstep may have come from not front loading the buyback program in 2013 when both Apple's share price and interest rates were lower than today.Perhaps more importantly, we think Apple's frugality is quite admirable in terms of acquisitions. Apple's strategy of focusing on smaller tuck-in deals and developing products in-house, rather than splashy but questionable deals like Microsoft's purchase of Skype or Google's foray into hardware by acquiring Motorola Mobility and Nest, appears to have served investors quite well in recent years. Apple has also done a good job of attracting top-notch talent to the company in recent months, such as former Burberry CEO Angela Ahrendts to run Apple's retail and online stores, and Paul Deneve, the former CEO of Yves Saint Laurent. We are comfortable that these hires have strengthened Apple's bench in the unlikely event that Cook were to depart the company. Both hires not only have experience managing luxury brands that sell aspirational goods, but also fuel speculation that an iWatch is on the horizon. All the while, Apple's ongoing operations continue to generate operating margins and cash flow well above its peers in various hardware industries, which bodes well for future free cash flow for investors.

Profile

Apple designs consumer electronic devices, including PCs (Mac), tablets (iPad), phones (iPhone), and portable music players (iPod). Apple's products run internally developed software, and this integration of hardware and software often allows the firm to maintain premium pricing for its devices. Apple's products are distributed online as well as through company-owned stores and third-party retailers.

GlaxoSmithKline PLC GSK | ★★★

$52.51 ↓$0.56 | –1.06%

Fair Value Estimate	**$56**
Consider Buying Price	**$39.2**
Consider Selling Price	**$75.6**
Fair Value Uncertainty	**Medium**
Economic Moat	**Wide**
Stewardship Grade	**Standard**

04-11-2014 | by Damien Conover

The Thesis 04-11-2014

As one of the largest pharmaceutical companies, GlaxoSmithKline has used its vast resources to create the next generation of medicines. The company's innovative new product lineup and expansive list of patent-protected drugs create a wide economic moat, in our opinion. The magnitude of the company's reach is evidenced by a product portfolio that spans most major therapeutic classes, as well as vaccines and consumer goods. The diverse platform insulates the company from problems with any single product. Additionally, the highest revenue generator, Advair, represents close to 20% of total revenue. However, the complexity in approving a generic version of an inhaled drug like Advair will likely hold off significant generic competition well past the drug's 2010 patent expiration, especially in the U.S., where approvals for generic inhaled drugs are particularly difficult. Further, the company's advancement of its next generation respiratory drugs should help the company's maintain its entrenchment in both asthma and chronic obstructive pulmonary disease. On the pipeline front, Glaxo has shifted from its historical strategies of targeting slight enhancements toward true innovation. The benefits of this strategies are showing up in Glaxo's strong pipeline of oncology and rare disease drugs. We expect this focus will improve both approval rates and pricing power. From a geographic standpoint, Glaxo is strategically branching out from the developed markets into emerging markets. Glaxo's consumer and vaccine segments well positions the firm in these price sensitive markets. While this strategy will likely create some challenges like the potential legal violations that arose in early 2013 in China, we believe the fast-growing emerging markets will help support long-term growth and diversify cash flows beyond developed markets.Turning to the bottom line, Glaxo continues to implement cost savings initiatives. Since 2012, the company has identified over GBP 3 billion in potential annual cost savings, which should be achieved by 2014-16. The improved productivity should help mitigate pricing pressure in Europe.

Valuation

We are maintaining our fair value estimate of $56 per share. We forecast average annual sales growth of 2% during the next 10 years, with new products offsetting patent losses. Further, growth in emerging markets should mitigate the patent losses in developed markets, as brand names are more important in emerging markets and give products a much longer life cycle. Also, steady growth from vaccines and consumer health-care products should reduce the volatility from patent losses in the prescription drug business. We expect steady operating margins over that period as cost-cutting efforts help to offset expansion into lower-margin geographies and lost sales from the high-margin drug Advair. For the discount rate, we estimate Glaxo's weighted average cost of capital at 8%, in line with the company's peer group.The fair value estimate for this share class is derived using a model in the firm's reporting currency, and applying the applicable exchange rate for the share. Any differences between the fair value estimate shown in the valuation section and the fair value displayed elsewhere in this report is a function of a more recent exchange rate.

Risk

Like all pharmaceutical companies, Glaxo faces risks of drug delays or nonapprovals from regulatory agencies, an increasingly aggressive generic industry, and competition in the pharmaceutical industry. However, specific to Glaxo, generic competition could come at any time for the company's leading drug Advair, which could be detrimental to the company as the drug represents over 20% of the top line and a higher portion of the bottom line because of the drug's high margins.

Management & Stewardship

Glaxo selected the president of its European pharmaceutical business, Andrew Witty, to succeed Jean-Pierre Garnier as CEO in May 2008. Witty's leadership in increasing sales in a cost-conscious European environment should be an asset in the U.S., where cost-containment pressures are rising. Further, Witty's experience overseeing operations in Asia signals the firm's interests in expanding its presence in developing countries. Witty has shaken up senior management, bringing in top talent from competing firms and the Food and Drug Administration. We are pleased to see the split of the CEO and chairman roles. Chairman Christopher Gent brings an independent voice to the board, but not much pharmaceutical experience. We rate Glaxo's stewardship as standard. Over the past few years and under the current CEO, the company has not made many significant external investments, excluding the recent $2.6 billion acquisition of Human Genome Sciences, which appears to be a fair value for the firm. Also, many of the legal claims that the company has settled over the past years have cost the firms billions of dollars, but the related activities stem from management that is no longer at the firm and current management have instilled much better operating practices. Nevertheless, the legal fees have hurt Glaxo's resources to effectively reinvest in the company. On the other hand, even with lower resources, the company's internal pipeline has been growing, suggesting an efficient research and development operation.

Profile

In the pharmaceutical industry, GlaxoSmithKline ranks as one of the largest companies by market capitalization. The company wields its might across multiple therapeutic classes, including cardiovascular, metabolic, respiratory, neurological, and antiviral, as well as vaccines and consumer products. Prescription drug and vaccine sales account for close to 80% of total sales.

Microsoft Corp MSFT | ★★★

$40.01 ↓$0.15 | –0.37%

Fair Value Estimate	**$39**
Consider Buying Price	**$27.3**
Consider Selling Price	**$52.65**
Fair Value Uncertainty	**Medium**
Economic Moat	**Wide**
Stewardship Grade	**Standard**

01-24-2014 | by Norman Young

Analyst Note 03-27-2014

Fifty-two days into his reign as CEO, Satya Nadella has already made several important decisions that signify a strategic shift for Microsoft. Nadella expects to make additional strategic updates on the company's core businesses over the coming weeks, after which we will update our thesis accordingly. We view the Office for the iPad announcement as incrementally positive as it should help nudge users to Office 365, but the device-agnostic Enterprise Mobility Suite (mobile device management tool) was the real news, in our opinion. We are modeling slightly better growth in the licensing business segments due to faster Office 365 adoption, but expect perpetual license growth to decay faster, which leaves our fair value estimate unchanged at $39, for now. We remain comfortable with our wide moat rating.Long overdue, Microsoft finally released Office for the iPad. Touch-enabled, the product was designed specifically for the iPad, but users only gain full functionality with a subscription to Office 365. We believe this will help drive a modest uptick in Office 365 subscription in the consumer business, but the real growth will come in the commercial business, where we think Microsoft had been concerned as enterprises had begun adopting and supporting iOS devices. This move should help keep enterprises in the Microsoft services fold.Nadella also announced its Enterprise Mobility Suite, a service that allows enterprises to manage mobile devices, apps, services, and access and identity control. With the ability to manage Android, iOS, and Windows devices, this is a shot across the bow of competitors such as Citrix, BlackBerry, and VMWare and a continuing shift from the firm's earlier "Windows first" strategy. We believe this is an important shift, and should help the firm offer Microsoft services (Outlook, Office 365, Skype, Azure, OneDrive, among others) through any device. We look forward to the coming weeks as Nadella fleshes out this new strategy.

The Thesis 01-24-2014

As the computing world changes, Microsoft is a story of two companies: a lagging consumer and devices firm, and a firm whose dominance in the enterprise world is growing.In the consumer world, Microsoft faces myriad threats. From tablets to smartphones and everything in between, consumers are moving away from the world of PCs and laptops. For the most part, these devices that don't run on Microsoft's Windows OS and also may not include other Microsoft products such as Office or Internet Explorer, further loosening Microsoft's once-tight grip on the casual consumer. Changing preferences and strategic missteps have left Microsoft playing catch-up as competitors have started eroding its wide economic moat. In the enterprise world, Microsoft continues to strengthen, even as computing moves from the PC server to the cloud-device model. Whether it is providing software to run computers, servers, datacenters, or or providing a cloud platform, Microsoft's size and scale are advantages, allowing it to undercut competitors' prices while offering complete end-to-end solutions that appeal to customers who are looking for a one-stop enterprise software provider. The company's recent reorganization strives to move Microsoft to a more cohesive structure, uniting disparate product lines and their product teams into a devices and services company. Part of this strategy entails developing and building devices that run Windows software, such as tablets and smartphones, to better challenge Apple and Google. The company hopes to shorten its formerly glacial release cycle while creating more compelling devices and services that strengthen the links between users and the Windows OS, productivity software, and ecosystem that are the key drivers behind its wide economic moat. The recent acquisition of Nokia's handset and devices business and in-house production of Surface tablets are the early steps Meanwhile, Microsoft remains a cash flow juggernaut. Generating more than $24 billion in free cash flow in the last fiscal year and with over $80 billion in cash on its balance sheet, the company has the financial flexibility and resources to remake this technology powerhouse.

Valuation

We are increasing our fair value estimate to $39 per share from $38, which implies a 2014 price/earnings multiple of 14. We forecast slowly declining revenue growth from the Windows division over the next 10 years because of a short-term slow erosion of market share of Windows-based PCs. We expect Windows 8.1, RT, cloud strategies, and Microsoft's entrance into tablet computing to slow the erosion in market share over the next three years. We forecast long-term revenue growth in commercial business , but we expect the hardware business (which includes Xbox consoles, Surface tablets, and Windows Phones) to weigh on operating margins over the long term. Given the less advantageous pricing and poor economics associated with having a lower market share in the search business, we forecast that the online services business remains unprofitable for the foreseeable future.

Risk

Microsoft's flagship Windows operating system and Office productivity software suite are under assault from tablet computers, cloud alternatives, and OS X offerings from Google, Apple, and open-source providers like Linux. Windows-based PC shipments have slowly eroded from approximately 95% market share a decade ago to 90% today owing to shifting consumer preferences and the rise of OS X and Android-based tablet computers and smartphones. With the release of Windows 8, the Surface tablet, and the pending release of the Nokia Windows phone, Microsoft hopes to reverse market share declines while establishing beachheads in the smartphone and tablet markets. We believe the Surface and upcoming OEM Windows-based tablets are good first efforts and the inclusion of Office should help broaden the appeal of Windows tablets to traditional laptop users in addition to tablet users.

Management & Stewardship

Given their combined equity stake of 9.4%, we believe CEO Steve Ballmer's and chairman Bill Gates' interests are probably aligned with shareholders. Ballmer, who has been with the company since 1980, has served as CEO since January 2000 but has announced his retirement, to be effective when a successor is named. He has done a satisfactory job building and protecting the core businesses, but the company has consistently had to play catch-up in key growth areas (Internet, online commerce, social networking) over the past decade. Large acquisitions in an attempt to regain lost ground (aQuantive and Skype, for example) have had a mixed record at best. The Board of Directors has been searching for a replacement for Ballmer since August 2013 and we believe the process has taken longer than anticipated. While it is important to find the best possible candidate, we believe a prolonged search may result in some uncertainty in strategy and direction within the organization, despite last year's announced restructuring.

Profile

Microsoft develops and sells software, hardware, and services. The company is organized into two main segments: Devices and Consumer (which includes Licensing, Hardware, and Other divisions) and Commercial (which includes Licensing and Other divisions). Commercial is the largest component of revenue at 58% in fiscal 2013, with Commercial Licensing the largest contributor at 51% of total revenue. Devices

and Consumer Licensing contributed 24% of total revenue.

Facebook Inc FB | ★★

$58.94 ↓$8.30 | –12.34%

Fair Value Estimate	**$45**
Consider Buying Price	**$27**
Consider Selling Price	**$69.75**
Fair Value Uncertainty	**High**
Economic Moat	**Wide**
Stewardship Grade	**Standard**

01-29-2014 | by Rick Summer

Analyst Note 02-20-2014

In a bold and aggressive move, Facebook has agreed to purchase WhatsApp, a global messaging company, for approximately $19 billion, including $4 billion in cash, 184 million shares of Facebook stock, and 46 million restricted stock units for employees of WhatsApp. Based on our $45 fair value estimate, the size of the deal is roughly 13% of Facebook's enterprise value. The deal is expected to close in late 2014. We are sticking with our fair value estimate for Facebook, and we maintain our wide economic moat rating. We still consider Facebook's shares to be overvalued, and we recommend investors to wait for a meaningful pullback in the stock price before allocating new capital to this name. The deal's financial merits may eventually materialize. However, in our view, the potential synergies of this acquisition are at best opaque and potentially nonexistent. Facebook management has highlighted its intent to maintain WhatsApp as an independent product, with a nod to its Instagram acquisition. Furthermore, we think Facebook is unlikely to introduce advertising into WhatsApp messages, implying no potential increase in its ad revenue or monetization capabilities. By acquiring WhatsApp, Facebook will now be managing three separate social networks: its eponymous Facebook platform, Instagram, and WhatsApp. While we think Instagram introduces additional scale for advertisers--which is a key component of Facebook's economic moat, in our assessment--WhatsApp does not deliver similar benefits.

The Thesis 01-29-2014

Facebook is building the foundation to revolutionize online advertising. However, the company will need to leverage its proprietary consumer data beyond Facebook as an intermediary to place advertising across the Internet at large.Facebook's massive base and engagement arguably create advertising opportunities that capture reach and target based on specific criteria. Growth in Facebook's user base across geographies has been impressive. Monthly active users exceed 1.2 billion, and the company operates the largest social network on the web. These users are logging into Facebook at least once a month, communicating with friends, posting pictures, and using applications. We believe hundreds of millions of users face switching costs that keep them from leaving Facebook. People are unlikely to leave unless they can take their network of friends, content, and applications with them.The company's growth in mobile usage has been equally impressive, particularly considering that Facebook was very slow to market with a downloadable application. The company's mobile usage is skyrocketing, and there are almost 1 billion mobile users. In fact, there are now more mobile users than desktop users, and revenue from mobile ad products exceed revenue from desktop. After its long delay in building mobile advertising products, we believe the company is a preeminent mobile advertiser.In spite of our bullishness about the company's prospects, the company will need to aggressively grow advertising revenue per user to justify a premium market valuation, in our view. As the company is already the most visited desktop and mobile site in the world, Facebook will have to find new and innovative ways to continue increasing advertising units and pricing. Ultimately, this growth is not limitless, and we believe any meaningful slowdown will have negative impact on what the stock is worth.

Valuation

We are increasing our fair value estimate to $45 per share from $38 to account for a more optimistic forecast for operating margins. Our valuation represents a multiple of 37 and 21 times our 2014 adjusted earnings per share and adjusted EBITDA estimates, respectively.In modeling the company, we forecast 10 years of financial statements. Admittedly, there is a great deal of uncertainty about Facebook's ultimate growth trajectory and profit profile, but the exercise is important to us for several reasons. First, we believe the company will reach its structural maturity within 10 years, whereby it has normalized operating margins and cash flow yields. Second, understanding the size of the revenue opportunity at the end of our explicit forecast period helps quantify our level of optimism about the firm's revenue potential. While we would not feel comfortable about our level of precision in forecasting the absolute level of revenue in three years, we do think our 10-year forecast results in a fair representation within a range of possible outcomes. The key value drivers in our model include revenue of $40 billion in 2021, operating margins normalizing at approximately 39%, and forward returns on invested capital of more than 30%. Facebook's revenue would still be meaningfully lower than Google's, according to our forecasts, but profitability metrics would be similar. We expect Facebook to have to continue investing in sales and marketing, which would drive additional operating expenses. Additionally, the company will have to increase its revenue sharing with third parties for an advertising network, and we would also expect local and payment businesses to have higher-cost structures that the existing business.

Risk

Although the revenue opportunity for Facebook is large, the company faces several risks that could ultimately prove our investment thesis to be overly optimistic. First, regulators may prevent the company from tracking its users. Significant regulatory action could detract from the value of its advertising platform. Second, excessive advertising or privacy fears could lead to a mass exodus of users. Other social networks (for example, MySpace, owned by News Corporation NWS) have experienced declines. Lastly, if agencies and advertisers experience a permanent lack of visibility into advertiser return on investment, Facebook's advertising opportunity may be significantly constrained.

Management & Stewardship

Mark Zuckerberg founded Facebook and has held the role of CEO since 2004. He also serves as chairman of the board. Chief operating officer Sheryl Sandberg has worked at Facebook since 2008 after spending more than seven years in an executive-level role at Google GOOG. We have a positive view of the skill set and performance of the management team to date and believe its patience and capital allocation have enabled it to drive profits and competitive advantages. While we expect Facebook to continue to be patient as a young public company, we acknowledge management may feel pressure to pursue revenue growth in areas that may actually weaken the firm's economic moat. The concern about capital allocation becomes even more paramount because Zuckerberg controls about 57% of the voting shares of the company. In 2012, the company acquired Instagram, a social networking site for sharing photos. Although the purchase only represented approximately 1% of the value of Facebook, it has been reported that the deal happened with very little involvement from the board of directors. If Zuckerberg loses discipline in allocating the company's capital, there can be no guarantee that any such mechanism would prevent the company from destroying shareholder value.

Profile

Facebook's 1.2 billion monthly active users create the world's largest online social network. More than 750 million people use Facebook daily, spending more time there than any other website, according to most third-party reports. Users go to Facebook

to communicate with friends, share news, and play games, providing the company with a treasure trove of information to target online advertising. Currently, the U.S. represents less than 20% of traffic but nearly 50% of overall revenue.

Netflix Inc NFLX | ★★

$345.74 ↓$60.25 | –14.84%

Fair Value Estimate	**$230**
Consider Buying Price	**$115**
Consider Selling Price	**$402.5**
Fair Value Uncertainty	**Very High**
Economic Moat	**None**
Stewardship Grade	**Standard**

01-27-2014 | by Peter Wahlstrom

The Thesis 01-27-2014

Netflix's stock has more than tripled since October 2012, rising from $60 to more than $380 per share following fourth-quarter earnings in January 2014. We view the stock price as overvalued while recognizing our intrinsic value has been far too conservative for the past 12 months. In short, we think that the lack of a nationwide rollout of authentication among traditional pay TV distributors has allowed Netflix to become the best source for on-demand children's programming and past seasons of popular shows still running on cable networks. However, we believe the market is too optimistic about Netflix's future sales growth and profitability potential. We remain extremely skeptical about Netflix's aggressive international push; we recognize the addressable market is large but sustainable, and material profitability will be much harder than management currently anticipates and may drag on cash flow for the foreseeable future. We appreciate the inherent operating leverage in the model (when subscribers are growing); however, we question the ultimate growth potential and sustainable level of long-term profitability for Netflix given the increasing competition and potential for content owners to retain most of the economic profits. We think owners of valuable and sought-after content hold the upper hand as they have the ability to sign shorter licensing deals, which allows them to consistently reprice their content (which may cap Netflix's margins). We view Netflix's subscriber base as a head start rather than a sustainable competitive advantage. To obtain each incremental subscriber, Netflix needs to offer a great value proposition, which means it must consistently improve its content menu or stay competitive on price. Admittedly, video distribution firms have suffered from inertia in building out a more attractive video-on-demand product for pay TV subscribers. However, we believe this will change as they work closer with content owners to offer a better experience, including a deeper library of TV shows.

Valuation

We are attempting to balance the growth potential of the business and realistic assumptions for profitability for Netflix. Our fair value estimate moves to $230 per share, from $180 previously, and implies a 2014 price/earnings ratio of 45 times. Our valuation model assumes that Netflix's domestic streaming subscriber count reaches roughly 51 million subscribers in 2018, and we forecast 6 million new domestic streaming subscribers in 2014, which implies 39.5 million at the year-end. We also assume that the domestic DVD business (the most profitable segment) will lose about 600,000 subscribers per year through 2018, which implies a decline from 5.4 million at the start of 2014 to 3 million in 2018. We continue to believe the international segment will struggle to reach a positive 15% contribution margin by 2018, as the company's success in Canada will be hard to replicate in other regions, especially in Latin America, which has the largest addressable market. We would not be surprised to see Netflix exit some regions once it realizes that profitability is impossible. Although performance has been improving, we view the international business acting as a drag on overall earnings and cash flow over much of our explicit forecast period. These subscriber forecasts generate 15% average annual revenue growth between 2013 and 2018, and we assume Netflix starts charging $8.99 as its base price in the U.S. (currently $7.99) and expect overall operating profit margins to reach 18% in 2018. We expect domestic streaming contribution margins to reach 35% by 2018. We believe the overall margin will be weighed down from by the international business. The sales decline of the high-contribution margin DVD business (48% in the fourth quarter of 2013) over our explicit forecast period will also drag on profitability. The ultimate market for streaming dated content, the future of digital content delivery, and Netflix's ultimate position in the market are all very difficult to forecast with precision. For these reasons, we assign Netflix's shares a very high uncertainty rating.

Risk

As technology improves, more consumers will be able to download content quickly via the Web and play it on their televisions or alternative devices. The advantage Netflix developed in the DVD rental market does not translate to digital delivery. The cost of licensing content will rise as competitors emerge and bid for content that Netflix desires. Netflix's expansion outside the United States and Canada could be unprofitable and drag on cash flow as foreign markets have different tastes and watch less video content than the average U.S. consumer. Netflix has signed several long-term fixed-price licensing deals that would look horrible if subscriber growth flattened out or declined.

Management & Stewardship

We believe Netflix's stewardship of shareholder capital is Standard. Reed Hastings has done an outstanding job of building Netflix from scratch and moving the company from a DVD rental service to streaming. Hastings founded Netflix in 1998, owns about 6% of the company, and currently serves as CEO and chairman. CFO David Wells has a long history with Netflix. Hastings has transitioned the company from DVDs to streaming, which has allowed Netflix to emerge as a major player in content distribution. We respect Hastings' long-term savvy, but a few decisions in 2011 were questionable, including the decision and subsequent reversal of Qwikster, a short-lived idea to rebrand and spin off the DVD business from streaming. While we view the current stock price as overvalued, even at our revised intrinsic value estimate Netflix has created enormous value for shareholders.

Profile

Netflix operates a video streaming service available in the U.S., Canada, and certain countries in Europe and Central and South America. Netflix delivers digital content to PCs, Internet-connected TVs, and consumer electronic devices, including but not limited to the Xbox 360, PlayStation, and Wii. In 2011, Netflix introduced DVD-only plans and separated the combined streaming and DVD plans, making it necessary for subscribers who want both to have separate plans. This resulted in price increases across the board.

Nike Inc NKE | ★★

$73.95 ↓$1.26 | –1.68%

Fair Value Estimate	**$64**
Consider Buying Price	**$44.8**
Consider Selling Price	**$86.4**
Fair Value Uncertainty	**Medium**
Economic Moat	**Wide**
Stewardship Grade	**Exemplary**

01-02-2014 | by Paul Swinand

Analyst Note 03-21-2014

We believe Nike's powerful brand, global sourcing and cost advantages helped drive strong performance in its fiscal third quarter, and supports our wide moat rating. Performance was broad-based, spanning categories and geographies, and came despite modest foreign exchange headwinds. Although we continue to be impressed with Nike's growth and persistent high returns on capital, shares continue to trade at a premium to our $64 fair value estimate, which will not change materially after this quarter. We caution that despite our affinity for the company and its powerful global brand, our model already incorporates the continuation of fairly high growth rates (including revenue growth in mid-to-low teen percentages in 2015-16). Some of the current investor enthusiasm has built as a result of the coming FIFA World Cup, in our view, and although we view guidance as conservative, investors should be cautious not to put new money to work during periods of peak optimism. Longer term, the continued success of the Nike Flyknit (which is now being produced in a football boot and several running styles) platform is significant for the brand. Although adidas has announced a competing product, we think momentum will continue to grow for the Nike platform as Nike was first to market, and in our view is making a bigger bet on knit technologies this year with its launch into football and basketball. For the long run, the knit platform holds promise to lower production costs; but equally important, it also increases the amount of customization possible and shortens lead times, both of which put Nike closer to its consumers. Brand loyalty is Nike's major source of competitive advantage, so we view such strategies as very important.

The Thesis 01-02-2014

Nike is the largest, dominant player in athletic footwear and apparel, which it has helped revolutionize over the last four or more decades. Although footwear and apparel are competitive businesses, with many producers of athletic-oriented products, few companies dominate like Nike. Because of its size, brand image, and related competitive advantages, we expect Nike to maintain its market leadership and wide moat.Cohesive product innovation, marketing, and distribution strategies remain the cornerstone of Nike's success. New innovations in shoe production technologies, if accepted by consumers, could drive higher long-term margins; equally important, this will support Nike's image of being a market leader. Although the firm develops products across a wide range of skill levels and price points, its competency in higher-end performance footwear and apparel is unmatched in the industry. The firm's tremendous marketing resources, coupled with endorsements from widely recognized athletes, add instant credibility to Nike's new product innovations. We believe this is a key reason, despite cyclical economic pressures, new product launches in running shoes, marquee basketball products, and performance apparel continue to outperform competing footwear and apparel lines on a relative basis. In addition, we see long-term growth opportunities in global soccer, where Nike has been steadily gaining share and where developing markets will continue to increase average price and performance-product penetration. Nike's emphasis on technical products increases profitability and minimizes product overlap with other footwear and apparel manufacturers, resulting in industry-leading margins.International expansion will be the firm's primary growth engine, but North America continues to post surprising revenue gains. We see considerable opportunities for long-run expansion in China, specifically, where the brand is already a leader with revenue of more than $2.4 billion in 2013. Inventory control, new product, and investments with wholesale and retail partners appear to have stabilized China (despite slowing market concerns), which bodes well for the long term.

Valuation

We have raised our fair value estimate to $64 per share from $60. Our new estimate is based on a slightly more favorable current-year revenue growth forecast of 9.5% (from 8.6%), improving gross margins to 44.4% (from 44.1%), and the time value of money. Offsetting these positives in our valuation are slightly higher capital expenditure assumptions throughout our 10-year explicit forecast, as its direct-to-consumer business (which is more capital intensive) continues to grow. Our valuation implies forward May 2015 fiscal-year price/earnings of 21 times, enterprise/EBITDA of 13 times, and a free cash flow yield of around 4%. Input cost headwinds are showing signs of easing, and selective price increases coupled with markdown controls suggest gross margins can go higher. Over a longer time horizon, we remain confident in the firm's ability to sustain high-single-digit revenue growth thanks to increased penetration of developing markets and continued athletic trends at home and in Europe. We believe operating margins will continue to grow, topping out at 15.5% in 2018, owing to increased product development, supply chain and distribution efficiencies, and increased scale advantages at home and in emerging markets. Fly-knit product gross margin improvement potential is partially contemplated in this forecast, but the platform is still too young and the full impact on sales and margins is not well understood. Increased direct-to-consumer efforts and a modest mix shift to apparel products should also benefit gross margins. Through fiscal 2015, we expect returns on invested capital to grow to the low to mid-20s. Returns are already running over 20%, exceeding our prior estimates. Compared with our 9.8% cost of capital assumption, Nike is creating a high level of shareholder value (and cash flow), providing support for our opinion that the firm has an economic moat. Our mid-20s average ROIC projection (high 20s adjusting for rents and excluding cash) is consistent with company internal targets.

Risk

We assign Nike a medium uncertainty rating. Nike's intrinsic value can be influenced by global economic trends, including discretionary spending patterns. Industry competition, particularly from adidas, Puma, and Under Armour, is always present and could also come from new entrants in developing-market economies such as China. Changes in consumer tastes and preferences are always a risk in athletic footwear and apparel categories. With more than half of its sales coming from outside the U.S. and a heavy concentration of Asia-based suppliers, the firm does face the risk of increased import costs and currency volatility, which cannot be hedged indefinitely.Nike has experienced strong growth in its home market as the brand's popularity has been ever increasing since the North American financial crisis. We note that some athletic segments, such as basketball where Nike is dominant, tend to be somewhat cyclical with fashion trends and investors should be wary of extrapolating trends too far into the future.Although the company has always succeeded with a wholesale-dominated strategy, recent gains and increasing management emphasis on direct-to-consumer channels pose risks. Retail channels require greater investment and higher overhead; profits also tend to be more cyclical with the economy. In the near term, direct-to-consumer sales could increase growth and profitability, but investors run the risk that such investments could dilute returns in the longer term.

Management & Stewardship

Mark Parker was named CEO in 2006 following the resignation of William Perez, who clashed with founder and chairman Phil Knight. We think Nike is in good hands with Parker at the helm. A Nike employee for nearly 30 years, most recently serving as

copresident with Charlie Denson, Parker brings plenty of industry experience as well as an understanding of the firm's unique corporate culture. We are confident that Parker and Knight are capable of leading Nike while maintaining its market dominance. Knight has sold some of his Nike stock since stepping down as CEO, yet still owns about 19% of the company with his Class A and B shares. Even though Knight is entitled to elect the majority of the directors, we believe that the board is sufficiently independent; 10 of the 13 directors are outsiders. Overall, executive compensation, although high, does not appear grossly out of line with peers for a market leader like Nike. Given Nike's high returns on capital, focus on the brand, and executive focus on increasing returns on invested capital, our Morningstar Stewardship Rating is Exemplary.

Profile

Nike is the world's largest designer and wholesaler of athletic footwear and apparel. The firm sells to more than 50,000 retail accounts through a network of more than 750 company-owned stores and through independent distributors and licensees in more than 170 countries. North American Nike brand sales are projected to account for 41% of revenue in fiscal 2014, followed by Western Europe (16%), emerging markets (15%), and China (10%). Other businesses, including Converse and Hurley, should represent 10% of revenue.

Yahoo! Inc YHOO | ★★

$36.38 ↓$1.56 | –4.11%

Fair Value Estimate	**$30**
Consider Buying Price	**$18**
Consider Selling Price	**$46.5**
Fair Value Uncertainty	**High**
Economic Moat	**Narrow**
Stewardship Grade	**Standard**

01-02-2014 | by Rick Summer

Analyst Note 04-16-2014

Yahoo issued yet another anemic report for its core business in the first quarter, with continued growth in revenue and cash flows of Alibaba Group (of which Yahoo owns 24%) overshadowing continued share loss in the digital advertising market. Although we anticipate a modest increase to our fair value estimate based on the potential initial public offering of Alibaba later this year, we still do not recommend the shares. Our narrow moat and negative moat trend ratings remain. The possibility of an IPO of Chinese Internet company Alibaba provides most of the potential upside for Yahoo shareholders. Still, we believe recent volatility experienced by technology stocks trading at high valuation multiples illuminates the downward risk for investors. If growth stocks experience a meaningful sell-off and Alibaba delays its IPO, Yahoo's stock price is likely to experience a material decline as well. This uncertainty combined with the lack of control for this asset results in our cautionary approach to the name. Yahoo's core advertising business continues to lose share to giants such as Facebook and Google, but first-quarter results show the bleeding has stopped. Display revenue excluding traffic acquisition costs grew 2%, while search revenue ex-TAC grew 9%. Total advertising revenue was $853 million ex-TAC and grew only 5%. By comparison, the digital advertising market is growing in the double digits. Our skepticism about the turnaround remains, although Yahoo's formidable audience of approximately 800 million monthly users will always have some level of relevance to advertisers, in our view. However, we believe several competitors have broader reach, more unique audience insights, or both.

The Thesis 01-02-2014

We believe that today's stock price is predicated on a robust valuation and successful exit of Yahoo's investment in Alibaba Group. Investors should be aware that a significant amount of Yahoo's enterprise value is tied up in its 35% interest of Yahoo Japan and its 24% interest in Alibaba Group. Alibaba Group has ownership interests in privately held Taobao and Alipay, as well as publicly traded Alibaba.com. Because of the opacity of this holding, we do not believe its value can support a sound investment thesis. Yahoo may be able to turn around its core business, but the divide between possible and probable is wide. Marissa Mayer has been at the helm for more than a year, but declaring a successful turnaround is premature, in our view. We believe the company can improve its near-term fortunes, but Yahoo's longer-term positioning and durability of its advantages are unclear. Yahoo's large base of more than 650 million users is an important asset, but management must appropriately navigate several hurdles in order to effectively turn around its core business. First, although Yahoo's focus on display has been its strength, users and advertisers are spending more time and money on other websites like Facebook, a social networking giant. Second, while Yahoo's media properties including its homepage, Yahoo Sports, and Yahoo Finance are well suited to a desktop world, the company has done very little to connect mobile applications to its more traditional web experience. Yahoo has continued to lose market share in online advertising to other destination sites such as Facebook and Twitter. In our discussions with ad agencies, many suggested that advertisers are prioritizing a Facebook strategy higher than a Yahoo strategy. We aren't surprised. Currently, Facebook is the most heavily trafficked website in the world. Furthermore, Facebook has been able to gather superior information about its users, which helps advertisers target their campaigns. Although this industry is still relatively nascent, we believe these efforts will shift offline dollars to social networking companies more rapidly than to more traditional firms dependent on display like Yahoo and AOL.

Valuation

We are raising our fair value estimate to $30 per share from $23 per share to account for an updated "mark-to-market" valuation for Alibaba Group and Yahoo Japan. Our fair value estimate considers approximately $9 per share for Yahoo's core business, with the balance represented by cash and its ownership interest in Yahoo Japan and Alibaba Group. It is important to note that we still believe we are at a distinct information disadvantage in valuing the interest in Alibaba Group, and we would be hard-pressed to encourage aggressive investment exposure to what is essentially a venture capital investment. Furthermore, corporate governance is a serious issue at Alibaba Group, and it's not apparent that Yahoo shareholders will ever receive a value that is close to Alibaba Group's current fair value. We expect revenue to decline in 2013 before resuming mid-single-digit growth in 2014. We also believe search revenue will grow at a rather pedestrian rate as well because we remain concerned about Yahoo's ability to drive search query volume. We expect overall revenue growth to average 5% over the next five years. We are encouraged that the new management team will instill greater discipline in managing operating expenses, although we expect a reasonably heavy investment period over the next couple of years in mobile applications.

Risk

If the search partnership with Microsoft continues to underperform, advertisers may abandon placing ads in Yahoo's search property, leading to declines in revenues. Furthermore, if the relationship with Microsoft sours, it's not clear that Yahoo has any better options to support its search technology. Social networking sites like Facebook also represent a risk to Yahoo. If these sites are able to continue growing users and building tools for advertisers to selectively target large and specific demographic groups, Yahoo may quickly become an inferior place for advertisements. Additionally, Yahoo's mobile strategy is less than clear, and the company risks investing in several low-return projects. Lastly, financial interests in Yahoo Japan and Alibaba Group ultimately may be worth much less on an after-tax basis than the firm currently believes. As a private company, Alibaba Group is challenging to value. We have no information advantage relative to management of Yahoo or Alibaba Group in in pricing this holding. Although we recognize the ultimate value of Alibaba Group could prove quite lucrative, there is a wide range of values that this interest may hold for Yahoo shareholders. With respect to Yahoo Japan, it will be challenging to unload this large of an interest without taking a discount or encountering a potential tax liability.

Management & Stewardship

After several years of management turmoil and a decade of questionable board oversight, we think the company made several moves in 2012 that are more aligned with shareholders' interests. First of all, the majority of Yahoo's board of directors was replaced, including longstanding chairman Roy Bostock. Additionally, the company pursued a high-profile CEO, naming Marissa Mayer to the post. While we aren't convinced that her background will provide a long-term halo effect to the company's shares, we do believe she is quite capable as a manager, a motivator, and a recruiter for new talent. Mayer, a former Google executive, has served as CEO since July 2012. In her short tenure, she has appointed several hand-picked executives in an effort to improve company morale, enhance product development, and turn around its core business. It is too early to evaluate Mayer's performance, but several datapoints are positive, in our view. First of all, Mayer has stated that she believes the company will pursue small technology and product-based acquisitions rather than large transformative deals. We agree with this strategy and

embrace her long-term view. However, even if Mayer's strategy is successful, we do not anticipate more positive financial results until 2014. The board also appointed Ken Goldman as CFO in 2012. Goldman was CFO of Fortinet prior to joining Yahoo. With respect to Yahoo's ownership in Alibaba Group, the company's liquidity plan has successfully begun. Alibaba Group bought back half of Yahoo's interest, freeing up sufficient capital for Yahoo to return $1.5 billion to shareholders through a stock repurchase program. The company plans to repurchase an additional $1.5 billion in 2013 as well. Furthermore, we are encouraged that there are additional measures in place to monetize the remaining ownership interest in Alibaba Group over the next several years. There continues to be turmoil in the engineering, sales, and executive talent, and these changes product delays and sales challenges. Unlike the past turnover, we believe these changes are part of building cohesive team whereby everyone is pursuing the same strategy. As with many technology companies, employees have a significant amount of compensation in the form of stock options and restricted stock. A portion of these performance-based awards vest depending on certain financial goals and stock performance goals. We do not find these variable compensation practices overly concerning.

Profile

Yahoo is one of the most heavily visited collection of websites on the Internet. Some of its more trafficked websites include Yahoo Search, Yahoo Mail, and Yahoo News. The company has undertaken significant effort to offload nonstrategic businesses and outsource the underlying search algorithm and operations to Microsoft. In 2012, display advertising represented 43% of total revenues, and search advertising represented 36%. Yahoo also owns 35% of Yahoo Japan and 24% of Alibaba Group.

Loomis Sayles Investment Grade Bond

A LIGRX | ★★★★★

$12.22 ↑$0.13 | 1.08%

Morningstar Analyst Rating

Gold

Morningstar Pillars

Process	Positive
Performance	Positive
People	Positive
Parent	Positive
Price	Neutral

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

Gold Silver Bronze Neutral Negative

Pillars Spectrum

Positive Negative Neutral

02-11-2014 | by Sarah Bush

A strong choice for those with a long time horizon and a stomach for volatility.

Loomis Sayles Investment Grade Bond may be tame by its family's standards, but it's still got plenty of zing.

This fund is more constrained than its famous sibling Loomis Sayles Bond LSBRX. It is limited to 10% of assets in below-investment-grade bonds, 20% in non-U.S.-issuers (with no limitation on Canadian exposure), and up to 10% of assets in equities, with a 5% cap on common stock. Still, that leaves the team here plenty of room to maneuver. Midquality BBB rated names typically dominate the portfolio (38% recently, close to double the category norm) and, unlike many dollar-dominated intermediate-term bond funds, the fund makes active use of nondollar currencies (30%, including 14% in the Canadian dollar). Its 3% equity stake also stands out in a category where most funds don't hold any stocks.

The experienced team of Matt Eagan, Dan Fuss, Elaine Stokes, and Brian Kennedy has put this flexibility to good use and has demonstrated an eye for value. In 2012, the fund benefited from a stake in European corporates built in the rocky market of late 2011 and a position in Irish sovereign debt, added in 2010 near the height of that country's troubles. The fund's credit-intensive portfolio also held up relatively well in 2013 as yields spiked in the year's so-called taper tantrum, thanks in part to strong performance in its convertibles stake (5%). Indeed, the fund's 7.2% annualized gain over the past decade comes out near the top of the intermediate-term bond category; it also looks good relative to Morningstar's corporate-bond category (the fund doesn't quite make the 65% corporate threshold required for inclusion in this group).

Of course, with such flexibility comes risk. The fund lost 11.4% in 2008, lagging 80% of peers in that year's tumultuous markets; it also fell behind in 2011's rocky third quarter. This limits its appeal for those in search of a high-quality bond fund that can provide diversification away from the equity markets. However, for those with a long time horizon and the stomach for volatility, this remains a strong choice.

Process Pillar

This strategy should look familiar to fans of Loomis Sayles Bond. The fund's management team employs a value-driven, credit-intensive approach and is always on the lookout for securities and currencies that it believes are undervalued. The fund is more constrained by prospectus than its famous sibling: It is limited to 10% of assets in below-investment-grade bonds, 20% in non-U.S. issuers (with no limitation on Canadian names), and up to 10% of assets in equities, with a 5% cap on common stock. That said, a number of themes run across this team's portfolios, including an emphasis on midquality corporates and nondollar bonds.

Not surprisingly, there's a strong contrarian bent at work here. For example, the fund loaded up on Ford F debt in 2009 when others predicted bankruptcy, a move that paid off nicely. In late 2011, it added to stakes in battered European corporates amid fears over the long-term survival of the euro; this position rallied nicely in 2012. Such levelheadedness when credit markets swoon helps explain the fund's stellar long-term returns, although a penchant for credit and currency risk makes it vulnerable in flights to quality.

Under the leadership of chief investment officer Jae Park, the team has significantly built out its tools and staff dedicated to risk management, and these are integrated into the day-to-day management of the fund.The team's macroeconomic outlook calls for continued slow growth and an ongoing upward bias to interest rates. That's led to large stakes in midquality corporates--a long-term theme here--and a preference overall for securities with limited correlation to interest rates. (The fund's corporate stake falls just short of the 65% level required for inclusion in the corporate bond category.) As of December 2013, BBB rated bonds stood at 38% of assets, well above the intermediate-term bond category norm. And, after coming into 2013 with some concerns about high-yield valuations, the team has increased this stake from 7% in September 2012 to near the high end of the fund's historic range (12%); it argues that corporate metrics remain strong. A firmwide preference for equities shows in the fund's 8.6% allocation to a mix of equities, convertibles, and preferreds. The team likes convertibles, in particular, for their attractive upside potential and competitive yield; they also allow the fund to invest in sectors the team likes that aren't big issuers in the bond markets.

At the other end of the fund's credit barbell is a relatively modest 4% stake in U.S. Treasuries and a total 22% in AAA rated securities, including Canadian, Norwegian, and Australian government debt. Canada is a particular favorite across the Loomis Sayles portfolios; the team argues that the name offers both liquidity and strong fundamentals.

Performance Pillar

This portfolio's bargain-hunting, corporate-heavy strategy shines in strong credit markets. That was true in 2009, when stakes in battered cyclicals (including then-top holding International Paper IP) and blue chips like AT&T T contributed to a near-category-topping 27% gain. And more recently in 2012, a stake in European corporates and a 2% position in Irish sovereign debt were particularly strong performers. The portfolio also held up relatively well as Treasury yields spiked in 2013, thanks to large slugs of midquality corporates, junk bonds, and meaningful stakes in a mix of convertibles and equities. The team's longer-term record is topnotch: Its 7.2% annualized gain over the past decade through January 2014 lands near the top of the intermediate-term bond category.

Those heady returns haven't come without risk. The fund typically piles on far more exposure to midquality corporates--and even the occasional troubled sovereign--than does its typical peer. That gives it one of the highest correlations to the S&P 500 in its category and leaves it vulnerable to losses when the economy slows or in broad-market flights to quality. The fund's 11.7% loss in 2008 landed it behind 80% of its peers; its 3.3% loss in August and September of 2011 was also one of the worst in the category. That's not to detract from the team's exceptional record, but this fund is probably best paired with a high-quality portfolio.

People Pillar

Kathleen Gaffney's departure in the fall of 2012 came as a surprise to many external observers who viewed her as manager Dan Fuss' eventual successor. However, the success of this fund and the Loomis Sayles fixed-income lineup has depended on more than one or two individuals for some time, and Gaffney left behind a strong team. Fuss, who pioneered Loomis Sayles Bond's unique benchmark-agnostic approach, remains actively involved and has no immediate plans to retire. He works closely with Matthew Eagan and Elaine Stokes, both Loomis Sayles veterans who have comanaged this fund since 2006. Brian Kennedy, a two-decade veteran of the firm, was named as a fourth comanager in February 2013. A 40-person credit team along with dedicated sovereign and macro researchers support the portfolio managers.

Under CIO Jae Park, Loomis Sayles has also invested significantly in the resources backing this group, including the expansion of the firm's risk-management, securitized-asset research, and macroeconomic research capabilities. Park has also established a committee structure to help fuel its fixed-income teams' macroeconomic views, asset allocation, and yield-curve positioning.

Fuss won Morningstar Fixed-Income Manager of the Year honors in 1995, and the whole team won in 2009 for its work on Loomis Sayles Bond.

Parent Pillar

Paris-based Natixis Global Asset Management is the parent to Boston-based Loomis Sayles and a handful of other asset managers, including the Gateway and ASG funds, with Loomis representing the majority of the firm's $90 billion in U.S. fund assets.

Loomis Sayles' reputation has largely been forged by the firm's well-regarded fixed-income operation and its vice-chairman, Dan Fuss, who has capably led Loomis Sayles Bond the past 20 years. The firm also offers a small array of equity funds. The stock funds don't get the same attention as their bond cousins, but the teams behind funds like Loomis Sayles Value LSVRX have quietly built decent records.

The firm is preparing for a post-Fuss era. Jae Park, the firm's fixed-income CIO, now oversees all of Loomis' investment teams. Park had already built out resources to support the firm's fixed-income managers. The departure of Fuss' comanager Kathleen Gaffney for Eaton Vance in late 2012 was a setback, but the people and systems Park had put in place have helped the team weather that loss.

Across Natixis' U.S. funds, manager investment in fund shares is fair, and few of the funds' expense ratios are high relative to similarly distributed peers. One fund board oversees all of the funds, and the directors have done a reasonable job representing fundholders' best interests.

Price Pillar

Expenses on this fund's institutional Y shares (about 60% of assets) stand at 58 basis points, landing them a shade above the median for similarly structured share classes. The 83-basis-point levy on the fund's A shares (24% of assets) receive a Morningstar Fee Level of Below Average, while the 1.58% fee on the C shares (16% of assets) rank as Average.

Bank of America Corporation BAC |

$16.15 ↓$1.41 | –8.03%

Fair Value Estimate	**$14**
Consider Buying Price	**$8.4**
Consider Selling Price	**$21.7**
Fair Value Uncertainty	**High**
Economic Moat	**Narrow**
Stewardship Grade	**Standard**

12-30-2013 | by Jim Sinegal

Analyst Note 04-16-2014

Bank of America reported a net loss of $276 million, or $0.05 per diluted share, for the first quarter of 2014, as litigation expenses of $6 billion took a toll on results. In our view, the results support our thesis that legal and compliance expenses at some level will continue to be a fact of life for most large, complex banks for the foreseeable future. We think there is increasing evidence that the costs of size are beginning to offset--if not exceed--any advantages related to economies of scale and scope at financial institutions. Aside from adjustments for the time value of money since our last update, we do not intend to significantly alter our $14 fair value estimate, which now represents a slight premium to Bank of America's current tangible book value per share.Bank of America's exposure to the U.S. consumer will continue to be a growth headwind for the next several years, in our view. Average domestic consumer loan balances fell across the board in the first quarter, and we believe the relatively high level of household debt to GDP within the United States will lead to a continuation of this trend over our forecast period. Though commercial loan balances grew 6% during the past year, we're still concerned by increasing domestic pricing pressure over the last several years, as U.S. loan officers have been reporting loosening standards and more aggressive pricing for quite some time.A bright spot for B of A has been the performance of equity markets and with them, the bank's Global Wealth and Investment Management segment. The bank achieved record client balances of $2.4 trillion, and benefited from a continued client shifts from liquidity products to long-term investments. Advisor productivity also grew from $970,000 to $1.06 million over the past year.Finally, though Bank of America's capital levels are now strong, we think its inability to demonstrate earnings power will result in subpar dividend yields for years to come.

The Thesis 12-30-2013

Bank of America's collection of businesses, ranging from its massive deposit franchise to the "thundering herd" of Merrill Lynch's brokers and wealth managers, is impressive on a qualitative basis, garnering the company a narrow economic moat. In our view, however, the struggles associated with integrating all of these businesses are not yet complete. Furthermore, while Bank of America is slowly putting its crisis-era problems behind it, the business of consumer lending in the United States is not getting any easier. Low interest rates, relatively high consumer leverage, and increased oversight through the Consumer Financial Protection Bureau and other regulators will ensure a slow road back to full earnings potential, in our opinion. In this type of environment, expense reductions are likely to be a key focus for Bank of America. The bank has already shed about 40,000 employees since 2010. We do think that the assemblage of Bank of America from its predecessor institutions resulted in a bloated organization. However, given the company's past problems with customer service and an increasing compliance burden, we think the pace of cost-cutting will slow in the near future. Bank of America's biggest opportunity may be in cross-selling investment products to its deposit, card, and mortgage customers. The bank now maintains only a small share of customers' wallets in investments, with the opportunity to capture trillions in additional, highly profitable balances. We think Bank of America's trust and wealth management businesses are most likely to move the needle over the next five years, though competition is sure to be fierce. That said, we think Bank of America has an interesting approach to segmenting the market, from its Merrill Edge platform for the mass affluent to its Merrill Lynch Wealth Management and U.S. Trust services for high-net worth clients. The bank certainly has the capability to succeed in this area, but execution has not been Bank of America's strong point in recent years.

Valuation

In our base-case valuation, we think Bank of America is worth $14 per share, up from $13 based on the time value of money since our last update. This equates to approximately 1.0 times reported tangible book value per share, 0.7 times book value per share as of Sept. 30, and 14 times our 2014 earnings per share estimate. We do not expect much asset growth in the near term. We believe the bank will make significant progress on its expense-control initiatives, resulting in a 61% efficiency ratio by the end of our five-year forecast period. We expect the net interest margin to average 2.9% in the long run, as nonperforming assets decline and the yield curve eventually steepens. In the long run, we forecast net charge-offs averaging 1.3% of loans. We expect Bank of America to maintain a tangible common equity ratio of 8% according to our calculation, as the bank currently meets anticipated Basel III requirements. We use a 12% cost of equity, reflecting the uncertainty around various drivers of the bank's long-run earnings power.

Risk

The biggest company-specific risk facing Bank of America still stems from the more than $2 trillion in mortgages originated by the company and its predecessors between 2004 and 2008. Though the company has reserved for and settled many claims, litigation outcomes are difficult to predict. Bank of America also faces the same macroeconomic risks as the rest of the sector--namely, continued deleveraging, low interest rates, and a lack of loan demand.

Management & Stewardship

Bank of America's management has done little to cover itself in glory during the past five years. The acquisitions of Merrill Lynch and Countrywide in 2008 resulted in a bailout of the bank, and legal liabilities resulting from past deals are still eating away at Bank of America's capital ratio. New CEO Brian Moynihan inherited these problems, and initial underestimates of mortgage-related liabilities under his watch failed to inspire much confidence. That said, we believe it is too early to form a conclusion regarding Bank of America's new leadership, and we regard its stewardship of shareholder capital thus far as standard. The current strategic plan--reducing risk-weighted assets, cutting costs under the "New BAC" program, settling mortgage claims, and investing in wealth management--makes sense, though the company's ability to execute is uncertain. If successful, the plan could result in a smaller Bank of America, but one with a wider economic moat. We think the jury is out on Bank of America's planned board changes. While it makes some sense to learn from other heavily regulated industries, lack of financial services expertise at large banks was a significant contributor to the financial crisis, in our opinion.

Profile

Bank of America is one of the largest financial institutions in the United States and the world, with lending operations in the consumer, small-business, and corporate markets in addition to asset management and investment banking divisions. The company has operations in all 50 states.

Honda Motor Co Ltd HMC | ★★★★

$34.17 ↓$0.84 | –2.40%

Fair Value Estimate	**$46**
Consider Buying Price	**$27.6**
Consider Selling Price	**$71.3**
Fair Value Uncertainty	**High**
Economic Moat	**None**
Stewardship Grade	**Standard**

01-31-2014 | by David Whiston, CFA, CPA, CFE

The Thesis 01-31-2014

A weaker yen against the dollar and recovering U.S. demand for light vehicles make the future bright for Honda. The company's products and strong financial position should keep it on solid ground. Honda's brand and reputation for quality drive demand for its vehicles, but the company's longtime niche in fuel-efficient cars has well positioned Honda to take advantage of consumers seeking more fuel-efficient vehicles. Unlike the Detroit Three, which just recently began focusing more on fuel-efficient cars, Honda's product line is not reactionary and instead comes from management anticipating consumer demand for more such cars over SUVs and pickups. Since 2003, the U.S. light-truck/car mix has made the transition to 50%/50% from 54%/46% and we expect it to keep moving toward cars as gas prices likely will keep rising. In 2013, cars made up about 56% of Honda's U.S. sales mix compared with 38% for General Motors and 34% for Ford. This mix gives Honda an advantage as the critical U.S. market is undergoing a structural shift away from gas-guzzling pickups and SUVs and toward Honda's vehicle-making expertise. The Detroit Three, however, have dramatically improved their compact, subcompact, and midsize models. Despite a strong product lineup, Honda still operates in an industry with formidable threats. If steel prices increase again, it will hurt profits for Honda and all other automakers. Honda can mitigate this problem by using more common-size vehicle platforms to reduce costs, but even that will probably only partially offset raw-material price increases. The weak dollar relative to the yen also hurts profits, but this trend abated in 2013 as the dollar strengthened considerably against the yen. Still, expanding business outside the triad of Japan, North America, and Europe is critical for Honda and all other automakers as OEMs should produce where they sell to mitigate exchange risk. With emerging markets still growing and Honda's gas-friendly U.S. lineup expanding, the company's prospects look bright in this improving U.S. sales environment.

Valuation

We are raising our fair value estimate to $46 per share from $42 per share. The change is primarily due to the yen weakening against the dollar since our last update as well as due to an increase in the book value of Honda's captive finance arm. We have increased our assumed operating margin because of the yen weakening since our last report. We assume a global foreign exchange impact to operating income of JPY 18 billion (about 0.2% of nonfinancial services revenue) for every one-yen change against the dollar and other major currencies. We project Honda's financials in yen.Competition continues to expand for Honda, which may make margin expansion more difficult than in the past. To translate our yen fair value estimate to U.S. dollars, we use an exchange rate of JPY 102.33 per $1 versus our prior assumption of JPY 97.28 per $1. We model a compound annual growth rate for revenue, excluding the captive finance arm, of 8%, and we now project the firm's operating margin will average slightly less than 7% instead of below 6% previously. We expect capital expenditures will average about 6% of sales. Although we have provided a single-point estimate for Honda's intrinsic value, we stress that the firm's high degree of operating leverage makes our fair value estimate very sensitive to our assumptions. For example, changing our year five operating margin of about 8% by 1 percentage point, while holding all other assumptions constant, would increase or decrease our fair value estimate by as much as 9%. We have valued Honda's financial services business at book value because we see no significant threats to the captive's financial health.

Risk

Honda faces many risks. The company operates in a very cyclical industry. New U.S. fuel-efficiency laws will raise vehicle prices for consumers. Honda is the number-two player in California (a state with ever-increasing environmental regulation), so higher car prices in the largest U.S. market would not necessarily be good for business, despite its fuel-efficient product focus. Large fixed costs create a high degree of operating leverage that can cause profits to swing widely in response to relatively small changes in demand or from lost production due to supply shocks. Profits could again be hurt by the strong yen if Japanese monetary policy is unsuccessful. To reflect the significant degree of operating leverage inherent in a large manufacturer and the possibility that commodity costs could rise beyond our forecast, our fair value uncertainty rating is high.

Management & Stewardship

Honda consistently generated healthy economic profit until the recession, but we expect return on invested capital below the company's WACC throughout our explicit five-year forecast period. Management's capital allocation policy is to maintain a shareholders ratio of about 30%. This ratio is computed as dividends plus share repurchases divided by consolidated net income of Honda Motor Co. Ltd; we calculate the fiscal 2013 ratio to be about 37%. Meaningful share buybacks are highly unlikely because the company does not issue stock options and does not have a history of buying back its shares. Honda has a management structure that differs from most public U.S. corporations. A board of up to 15 directors (currently 13) runs the company. Takanobu Ito, who became president and CEO in June 2009, has been with Honda since 1978 and used to head research and development. Like many foreign companies, Honda is exempt from certain rules required of U.S. firms, such as the need for independent directors. Although Honda files regular U.S. GAAP financial statements, we are not pleased that it fails to provide a complete income statement that separates the financial services business. Doing so would allow a more accurate gross margin of the industrial company to be seen and then compared with other automakers'. In the United States, Honda trades as an American depositary receipt, with one ADR equal to one common share of the Japanese stock.

Profile

Incorporated in 1948, Honda Motor was originally a motorcycle manufacturer. Today, the firm makes automobiles, motorcycles, and power products such as boat engines, generators, and lawnmowers. Honda sold 19.5 million cars and motorcycles in fiscal 2013, and consolidated sales were JPY 9.9 trillion. Automobiles constitute over 75% of revenue, motorcycles 14%, and the rest is split between power products and financial services. Honda also makes robots and private jets.

Metropolitan West Total Return Bond

M MWTRX | ★★★★★

$10.70 ↑$0.03 | 0.28%

Morningstar Analyst Rating

Gold

Morningstar Pillars

Process	Positive
Performance	Positive
People	Positive
Parent	Neutral
Price	Positive

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

Gold Silver Bronze Neutral Negative

Pillars Spectrum

Positive Negative Neutral

05-13-2013 | by Miriam Sjoblom, CFA

Mastering the details.

Changes beneath the surface at Metropolitan West Total Return Bond highlight what it does well.

After a ho-hum 2011, this fund has benefited hugely from a rebound among credit-sensitive bonds in 2012. The fund's value-oriented managers have aimed to reduce credit risk here as a result, but at a high level changes appear modest. They've trimmed the fund's exposure to corporates by a few percentage points to 20% (as of March 31, 2013). Meanwhile, the size of its nonagency residential mortgage stake has stayed roughly constant at 16%, and its commercial mortgage exposure at 9%.

Upon closer examination, the managers have made some significant changes to the composition of their holdings within these sectors. In the nonagency RMBS stake, for instance, they've swapped out of low-dollar-priced bonds that have rallied the hardest this year into marginally better-quality bonds with less downside risk. In late 2012, mortgage specialist Bryan Whalen noted that the average price of the fund's nonagency RMBS stake had risen to 70 cents on the dollar from 50 cents as a result of these efforts. Similarly, they improved the quality of the CMBS stake by shifting half of it into agency-backed bonds and by selling those issued at the the real estate market's peak.

These underlying shifts demonstrate the team's value discipline, but they also suggest a willingness to take considerable risk when the price is right. During the volatile months of late 2011, for instance, the portfolio was moving boldly in the opposite direction. Even after these latest moves, the fund could still suffer relative to its typical peer during bouts of risk aversion. Its relatively short duration (4.3 years versus the index's 5.3) means it may not keep up when yields fall, either. But the Federal Reserve's plan to purchase agency mortgages indefinitely has done nothing to assuage the team's longer-term concerns about mounting inflationary pressures, so they're standing pat. The fund's exceptional long-term record suggests investors have been well compensated for its risks. Expect that to continue.

Process Pillar

This fund is run by value investors looking to buy bonds when they're fundamentally cheap and sell them when they get expensive. It's benchmarked against the Barclays U.S. Aggregate Bond Index, but its managers will actively adjust the fund's duration relative to that bogy and have the flexibility to invest outside the index; high-yield corporates and nonagency residential mortgages have figured prominently here. That can result in a more aggressive credit profile than the category norm. The team also employs credit default swaps to gain or reduce exposure to sectors or companies.

That value orientation works partly because it's rooted in fundamental research, particularly in areas where others aren't looking. For instance, the team has invested heavily in the data and tools necessary to evaluate nonagency RMBS, even as others have steered clear of the sector's junk credit ratings.

The managers dial risk up and down in predictable fashion here. When yield spreads offered by corporate bonds over U.S. Treasuries reached historic lows in 2007, for example, they reduced the fund's corporate stake to an all-time low of 7% by early 2008, then reversed course as spreads widened in 2008. Similarly, their pessimism about the economy caused them to lengthen the fund's duration before the financial crisis; since the 10-year Treasury dropped below 2% in 2011, they've kept it shorter than the index's.Following the financial crisis, this fund's portfolio has emphasized credit--including financial corporates and nonagency mortgages--and downplayed U.S. Treasuries, where the team thinks real yields are too low to compensate for looming inflationary pressures. Arguing that prepayment risk is lower than it has been historically--given depressed home prices and tighter lending standards--while demand from the Federal Reserve and other buyers is strong, they've also emphasized agency mortgages, although they reduced that bet significantly in 2012.

Such views held the fund back in 2011, as eurozone crisis fears weighed on credit-sensitive bond sectors and fueled a Treasury rally. But true to form, this team viewed that volatility as an opportunity to increase risk in areas it viewed as fundamentally sound, swapping from senior into subordinated debt of some U.S. money-center banks, for instance, and moving into lower-quality nonagency RMBS that got hit the hardest.

Those steps paid off in 2012, prompting the managers to cut back on risk. The size of the fund's nonagency RMBS stake has stayed roughly the same at 16%, but they changed its composition by selling more volatile low-dollar-priced bonds and buying better-quality bonds. They've also trimmed the fund's corporate stake to 20% as of March 2013 (less than the index's 26%) while taking more senior positions in companies' capital structures.

Performance Pillar

This fund's long-term record is enviable. Its total returns over the trailing 10-and 15-year periods through Oct. 31, 2012, are the fifth and seventh best in the intermediate-bond category and beat the Barclays U.S. Aggregate Bond Index by 244 and 126 basis points, respectively. Its volatility has been higher than the group norm, but its risk-adjusted metrics such as the Sharpe ratio rank near the category's top.

The managers' value discipline has produced bouts of short-term pain. They bought battered nonagency mortgages early in 2008, for instance, although exposure to long U.S. Treasuries and credit default swap protection purchased against commercial mortgages contained the damage. More notoriously, the fund got burned a decade ago by its exposure to troubled telecom and energy names, including Worldcom. Although it eventually bounced back, the fund finished 2002 with a 0.95% loss, more than 11 percentage points behind the rallying Barclays U.S. Aggregate Bond Index.

While 2002 was an extreme example, it demonstrated the managers' determination to stand by their analysis through trying times. That was the case in 2011, when the fund's short duration and more credit-sensitive holdings weighed on it relative to its peers and benchmark. The team didn't capitulate on those bets and even increased risk in areas such as nonagency mortgages, which helped the fund rocket back in

2012.

People Pillar

The fund's three generalist portfolio managers' working partnership goes way back. Steve Kane, Laird Landmann, and Tad Rivelle managed portfolios together at Hotchkis & Wiley in the early 1990s (Landmann and Rivelle co-directed the fixed-income department there) before leaving to found MetWest in 1996. Before that, the trio worked together at West Coast rival PIMCO. The specialist ranks have also seen a good amount of stability. Mitch Flack and Bryan Whalen, who co-head the mortgage team, have been with MetWest since 2001 and 2004, respectively. Credit research director Jamie Farnham joined in 2002, while government and rates specialist Bret Barker joined back in 1997.

Rivelle serves as TCW's fixed-income CIO, but the process has long revolved around teamwork rather than one or two stars. The generalist managers formulate the team's investment outlook, including deciding how much and what types of risk they want to take in any given environment, and the sector specialist teams, made up of analysts, traders, and portfolio managers, handle the day-to-day management of securities in the fund. No group is an island, though. For example, the nonagency mortgage team's detailed work on the sector's fundamentals has informed the generalists' macroeconomic thinking as well as the corporate team's view of mortgage risk on banks' balance sheets.

Parent Pillar

In a transaction that closed in February 2013, TCW was bought by private equity funds managed by the Carlyle Group, in combination with TCW management, from Societe Generale. The firm's management team maintains 40% of the company, but the transition to majority ownership by private equity funds does raise some uncertainty. While neither TCW nor Carlyle has divulged concrete plans, many such transactions are followed by efforts to cut costs, increase margins, and streamline businesses in order to make them more-attractive candidates for IPOs or other sale down the line.

While it may not be directly related to the transition, the firm has had several noteworthy non-investment-team departures over the past year. Most recently that included the firm's chief compliance officer and chief risk officer. While those high-level departures raise some concern, the investment team has remained very stable. At the time of the deal, key portfolio managers, including the MetWest founders, signed five-year contacts. The firm has also put a greater emphasis on awarding equity ownership, which should help ensure key team members stay put.

Meanwhile, other factors keep the fund firm's stewardship profile from being above average. Unfortunately, manager ownership across the fund complex is very poor. And while fees for some of the firm's largest fixed-income offerings are competitive, overall fees are average.

Price Pillar

The fund's no-load share class, where 43% of its $25.7 billion in assets resides, charges 0.63% per year, which is 5 basis points cheaper than the typical no-load intermediate-term bond fund. The fund's Institutional shares, which have grown more rapidly in recent years and now account for 55% of the fund's assets, charge 0.42%, 13 basis points below the median levy for institutional share classes in this category. While both are reasonably priced, neither falls in their respective comparison group's cheapest quintiles, though both have ticked slightly lower since 2010 as the fund has received inflows.