

# Foreword

BECAUSE I'M THE founder of Morningstar, you might think I invest most of my personal assets in mutual funds. The truth is I own few mutual funds. Nearly all of my assets are in stocks. Although I love funds, I have an even greater passion for stocks. Funds are great for those who don't want to spend a lot of time doing research. But if you enjoy analyzing companies—and I think it's a tremendous amount of fun—you can do perfectly well investing in equities yourself.

My interest in equity analysis began in business school at the University of Chicago. There I learned about efficient markets and how collectively security analysts add little or no value. That did little to excite me about stock investing. Why, after all, spend time studying companies if a market basket of stocks will do just as well? After graduation, though, I stumbled across *The Money Masters* by John Train and read about Warren Buffett.

Now that was exciting. Buffett used an approach I could readily grasp and inspired me by showing how much fun and intellectually challenging investing could be. Moreover, Buffett's track record—and the record of others

who shared his philosophy—was stellar. I went back and read all the Berkshire Hathaway annual reports. My life changed course as a result.

I went to work as a stock analyst at Harris Associates in Chicago. I chose Harris because I admired its value-oriented, Buffett-like approach, and I liked the people. It was a great job, and I worked with some terrific financial minds—Clyde MacGregor, Chuck McQuaid, Bill Nygren, Ralph Wanger, Sherwin Zuckerman, to name a few. They all practiced a rigorous, bottoms-up investment style that involved looking for companies selling at a discount to their true worth. I spent my days reading annual reports, talking to company managers, and learning from my peers. And I got paid to do it.

The idea for Morningstar came from trying to teach myself equity analysis. I called regularly to get the mutual fund reports from managers I admired—people such as Kurt Lindner (Lindner Funds), George Michaelis (Source Capital), Michael Price (Mutual Shares), Bill Ruane (Sequoia Fund), John Templeton (Templeton Funds), and Ralph Wanger (Acorn). I examined their holdings to see what stocks they were buying and tried to figure out why they were buying them.

One day, when I had all these shareholder reports scattered across my dining room table, I thought it would be useful if someone compiled all that valuable information into a book. The proverbial light bulb clicked. I started to research the mutual fund industry. I could see that it was growing nicely and that there were few sources to help investors make intelligent decisions about funds. Thus, Morningstar was born.

I left my stock analyst job at Harris, cleared out the living room of my apartment, bought several PCs, and got started. I wrote to all the funds to get their materials, entered everything into a database, and six months later a 400-page *Mutual Fund Sourcebook* was sitting on my desk. In 1984, this in-depth fund information was very hard to get—and certainly not available for \$32.50. The *Sourcebook*, for example, provided complete portfolio holdings. It took five pages just to list the 800 stocks in Peter Lynch's Magellan Fund. I sold 700 copies of that first publication, and Morningstar was on its way.

By bringing a stock perspective to the mutual fund world, we began to define the Morningstar approach to fund investing. It's hard to believe now, but back then investors purchased mutual funds based on recent returns and

not much else. Morningstar brought rigorous, fundamental analysis to the industry. We realized that by looking carefully at the stocks a fund owned, we could understand the manager's strategy more clearly. So we developed our equity expertise as a way of doing better fund analysis.

While Morningstar began by serving fund investors, over time, we broadened our mission to help all investors. And that meant stock investors, too. This wasn't soulless corporate expansion, but logical growth based on a passion for equity analysis. And the more we looked at information available for stock investors, the more we realized that we had something innovative, useful, and unique to offer. There was little new in equity research, and many existing products seemed dated and not particularly helpful. We thought we could do better.

Our approach to equity analysis builds on the Ben Graham and Warren Buffett school of investing. It would be hard to find two better mentors—and we're grateful and indebted to them for all that they have done for investors. You'll find some of their key lessons embedded in our advice—concepts such as *margin of safety* and *economic moats*. We add value by systemizing, broadening, and explaining their approach so you can do it yourself. The result is a robust framework that should serve you well in making your own investment decisions.

But we haven't cornered the market on advice. We've included a reading list, and I urge you to use it as a guide. There aren't many great books on investing, so you should be able to master most of them. If you aren't doing so now, I suggest you begin reading the major business magazines regularly—*Barron's*, *BusinessWeek*, *Forbes*, *Fortune*,—as well as *The Wall Street Journal* daily. You'd be surprised how many investors neglect to do these basic things. Among our own publications, you'll find Morningstar.com and *Morningstar StockInvestor*, our monthly newsletter, helpful. I also recommend all the Berkshire Hathaway annual reports and *Outstanding Investor Digest* for its lengthy interviews with leading money managers.

You need to read widely to build a "latticework of mental models," as Berkshire Hathaway's Charlie Munger says. By looking closely at many companies, you'll see common themes that drive their success or failure. And you'll begin to form models that you can apply to situations you want to

analyze. Then you must ask some questions. How is the world changing? How will those changes affect this company's prospects? You can begin to see the challenge and the fun of investing.

*The Five Rules for Successful Stock Investing: Morningstar's Guide to Building Wealth and Winning in the Market* is the effort of Pat Dorsey, the head of equity research at Morningstar. Among his many talents, Pat can communicate in a clear and engaging way, and he has the rare ability to distill complex questions to a form so that the answer appears obvious. Pat works closely with Haywood Kelly, Morningstar's chief of securities analysis and editor-in-chief of Morningstar.com, and Catherine Gillis Odelbo, president of securities analysis and head of our retail business, to guide our equity effort. We're indebted to all three for what they've created at Morningstar and for defining the investment philosophy that is the framework for this book.

A common quality of successful investors is the steadfast ability to think independently. Don't be swayed by what the "experts" say—even us. Graham and Buffett often point out that if your reasoning is right, that's all you need to worry about. I hope you read this book with a questioning mind. I hope you challenge our thinking. Above all, I hope you learn guiding principles that will shape your personal investment philosophy. Although no one can guarantee success, if you apply the precepts in this book and think for yourself, you'll be well on your way.

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