

Talking Points

Insights From Morningstar's Fund Analysts

Quotable

"The Fed is focused on nominal GDP growth at all costs. So undoubtedly cost inflation will increasingly impact margins as we move forward and in that environment you want to invest with "price makers" instead of "price takers." The former is generally found as you move further away from the final consumption of goods."

Ron Sloan
Invesco Charter CHTRX

"We aren't buying companies that have direct exposure to commodities. We are buying the firms that help Big Oil either find new energy plays or help get [commodities] out of the ground."

Bill D'Alonzo
Brandywine Blue BLUEX
Brandywine BRWIX

"The consumer discretionary space is a group that tends to underperform when inflation expectations are rising, especially when you have oil and cotton prices increasing at the rate that they have been. Bed Bath & Beyond BBBY is a good company that did extremely well last year, but we thought that it was a stock that, as it approached \$50, would be an underperformer, and we shorted the stock as a hedge to rising oil, cotton, and general commodity prices."

Patrick Kelly
Alger Spectra SPECX

Earnings Uncertainty Rises With Commodity Prices

The Issues

Rising commodity prices have clouded some managers' corporate-earnings outlooks. Third Avenue's Marty Whitman recently asked if anyone can "name a commodity that hasn't spiked this year" other than natural gas. That may make natural gas stocks, like Third Avenue Value TAVFX holding Nabors Industries NBR, look cheap, but others worry that rising input costs, such as oil, cotton, and copper, will hurt corporate profits.

There are signs of a budding economic recovery, but so far not much buzz about demand and revenue growth. For the most part, corporations have trimmed their fat. Since the recession, many companies have grown profits and improved margins—to

peak levels in some cases—by cutting costs. Some managers say there's nothing left for businesses to cut, but they're beginning to see signs of organic growth. "It's not rip-roaring growth," said Matt Berler of Osterweis OSTFX. "But it is real growth."

Many managers are favoring companies that can pass rising costs on to customers without risking sales. As Warren Buffet told the Financial Crisis Inquiry Commission in June 2010, "If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you've got a terrible business."

The Points

► Bob Lee, who manages Fidelity Select Consumer Staples FDFAX, is worried about the effect rising commodity prices will have on consumer staples companies despite these firms' typically stable revenue streams. Lee notes that 20% to 30% of their revenues often come from emerging markets, where the influence of rising commodity prices will be harder-felt because emerging-market consumers spend a higher percentage of income on necessities like food and heat, leaving less left over for other "staples" like those sold by Coca-Cola KO (which was one of the fund's largest holdings at the end of January 2011).

► Matthew Ferretti of American Century Small Cap Growth ANOAX is underweighting consumer discretionary stocks because he worries many such companies are exposed to the higher costs of commodities like cotton and oil. Among consumer companies, he's keen on firms with strong brands and pricing power, including G-III Apparel GIII, which

produces Calvin Klein clothes and collegiate and professional sports-team outerwear, and UGG bootmaker Deckers Outdoor DECK.

► Diamond Hill Small Cap DHSCX manager Tom Shindler is focusing on stocks with franchise power and the ability to push commodity input costs through to the end user. Companies like children's apparel retailer Carter's CRI and baker Flowers Foods FLO fit the bill.

► First Eagle US Value FEVAX comanager Kimball Brooker likes construction-materials companies, including Martin Marietta Materials MLM and Vulcan Materials Company VMC. Concern about residential construction hit their stock prices, attracting the value manager, but Brooker said these businesses "operate as local oligopolies" and notes that they have been able to increase prices even as their businesses have been soft.