

U.S. Equity

review and outlook — third quarter 2009

Market review

Stocks had a strong quarter, helped by better-than-expected earnings, improved economic data and some M&A activity. Investors also took comfort in assurances by the Federal Reserve that short-term interest rates would be kept low for an extended period. The dollar slipped against most major currencies, undermined by a lack of yield support and renewed demand for riskier assets.

Financials had the best returns against the backdrop of a steep yield curve as profitability and investor sentiment continued to improve from depressed levels. Reports of impressive quarterly results from Goldman Sachs and JPMorgan Chase in July helped reinvigorate the market rally. Trading was cited as an area of strength in an environment of less competition and abundant low-cost capital. A broad group of companies representing commercial banks, diversified financials, consumer finance, capital markets, insurance and real estate had exceptionally strong gains. Many smaller banks and thrifts, however, had a difficult quarter. The Federal Deposit Insurance Corporation reported that bank closings had strained its insurance fund and the number of banks at high risk of insolvency was on the rise.

The industrials, materials and consumer discretionary sectors provided returns close to or in excess of 20% as companies began to restock inventories and investors anticipated the resumption of a long-term trend of rising demand. Information technology stocks were led higher by strong profit reports and upbeat outlooks from market leaders including Intel, IBM, Google and Apple. While cyclical stocks raced ahead, returns lagged for defensive areas such as utilities, telecommunication services and health care.

U.S. economic output in the second quarter fell less than previously estimated, with the Commerce Department revising its GDP figure to -0.7% from -1.0%. Economists believed economic growth resumed in the third quarter and numerous market observers, including President Obama and Fed Chairman Bernanke, stated the recession was likely over. Housing prices were firmer and home sales increased. The pace of layoffs, however, remained brisk, with ADP reporting 254,000 private-sector jobs lost in September.

Portfolio review

The portfolio appreciated in value, led by returns in excess of 20% from large holdings including Goldman Sachs, Cisco Systems, Cerner and JPMorgan Chase. However, it did not match the gains of the S&P 500 Index during the broad market advance.

In a repeat of the previous quarter, the portfolio's positioning in the financials sector was the largest detractor to relative results. Our emphasis in this area remains on a small group of companies that are, for the most part, in stronger financial condition than their peers and are benefiting from diminished competition. As is often the case, the weakest firms have felt the greatest initial benefit as equity markets have sharply rebounded from depressed levels.

Stock selection among industrials was a secondary hindrance despite strong returns from transportation stocks. Stock selection among materials was also a negative factor. Potash Corp. of Saskatchewan had a negative return due to declining fertilizer prices. The portfolio's small cash position was also a drag in a rapidly rising market.

The Capital Group Companies

Capital International

Capital Guardian

Capital Research and Management

Capital Bank and Trust

American Funds

We have a relatively large exposure to the health care sector. While the return for this sector lagged the broader market, our stock selection in this area helped results. Celgene shares jumped after the company beat profit estimates and reported strong sales growth for its cancer drug Revlimid. Cerner is expected to benefit from government incentives to electronically store and share medical records.

Stock selection was also positive in the areas of consumer discretionary, which was helped by an array of retail and media holdings; energy, where the portfolio de-emphasizes large integrated oil companies; and telecommunication services, where we have a limited number of holdings. Select technology stocks were also among the top contributors to portfolio returns.

Outlook and strategy

The economy has clearly turned a corner: housing prices have troughed; access to credit has been restored in the capital markets; leading indicators point to resumption of growth; and inventory restocking is expected to be supportive for several quarters. Financial markets have been helped by ample liquidity, and the current benign inflation environment should allow central banks to maintain loose monetary policies.

The catalyst for stocks' renewed verve after a pause in June has been better-than-expected earnings. Much of that, however, was the result of aggressive cost cutting rather than top-line growth. Future earnings surprises may be harder to come by in an environment shaped by consumer deleveraging, the rebuilding of bank balance sheets, and the eventual withdrawal of monetary and fiscal stimulus measures.

Themes among the portfolio's holdings are the outcome of many individual bottom-up stock decisions rather than a macro view. Health care continues to be an area of focus; we anticipate that legislation will benefit some and will not be as harmful to profits as feared for many. Consumer discretionary is another area where the portfolio has more exposure than the index, with an emphasis on select retail and media. The portfolio also has a larger weighting than the index in a variety of materials stocks, including chemicals, mining and steel. The largest area of investment on an absolute basis is information technology, where product cycles are expected to revive revenue growth.

The portfolio de-emphasizes energy, where we have concerns about demand, and utilities, where we find valuations unattractive. We continue to be highly selective among financials: while some firms should benefit from decreased competition, many of the larger houses are struggling to consolidate diverse businesses and for others, sources of revenue have diminished. ■