Capital Guardian℠

International (Non-U.S.) Equity

review and outlook — third quarter 2009

Market review

Stocks extended their rally as the global economy showed further signs of improvement, with many countries emerging from recession and the combination of lower interest rates and mild inflation increasing investor appetite for riskier assets. Merger activity showed signs of life with several cross-border deals announced during the quarter. The financials sector continued to lead as several banks returned to profitability. All sectors and countries posted double-digit returns except Japan, where stocks lagged. A sweeping opposition victory ushered in a new political era even as Japan dealt with a sluggish economy and a rising yen. The euro also rose, although sterling was weaker.

Financials were up more than 25%, led by several European banks as profits stabilized. Germany's Commerzbank rallied after it announced plans to return €5 billion of unused state debt guarantees. In the U.K., Lloyds Banking and Royal Bank of Scotland gained on hopes for an early sale of the government's stakes in those institutions.

The materials sector rose sharply amid higher commodity prices, while industrials benefited from an improved business cycle. Airline stocks posted strong returns on expectations of an uptick in travel and also on speculation of further consolidation in the industry. Merger activity also helped lift the telecommunication services and health care sectors. Elsewhere, Kraft made an unsolicited bid for Britain's Cadbury, which was rejected.

Germany and France reported positive economic growth for the second quarter although several other economies in Europe continued to struggle and unemployment remained high across most of the region. However, inflation was subdued, allowing central banks to keep rates at historically low levels. In Japan, economic growth for the period fell from its initial reading and the rising yen further pressured exporters. Newly elected Prime Minister Yukio Hatoyama promised economic reform and hinted at more market regulation.

Portfolio review

The portfolio's value rose with the markets, but returns trailed the benchmark. In a rapidly rising market, the cash position was a drag on relative returns. Stock selection across a number of sectors was positive, but fewer investments in financials and the lack of exposure to a broad swath of the sector held back returns. Among those that we held, HSBC was the top contributor to portfolio returns. Avoiding some Japanese banks was helpful, but those we own, such as Sumitomo Mitsui and Mitsubishi UFJ Financial, declined amid concerns they needed to raise more capital. Our investment in Industrial and Commercial Bank of China also detracted as a shift in government policy advocating slower loan growth held back shares of major Chinese banks. As we continue increasing our exposure to financials, we have focused on companies with strong ties to Asia and other fast-growing emerging markets, such as BBVA in Latin America, as well as those with strong balance sheets and diversified businesses.

Our large investment in information technology held back relative returns as the sector lagged the market. Although several investments in Asian companies had strong results, including Samsung Electronics and Delta Electronics, Japan's Nintendo was a detractor. Shares fell amid ongoing concerns about slowing demand for its Wii video game consoles. Among telecommunication services stocks, SoftBank lagged the market as Japanese rival NTT DoCoMo surpassed it in new mobile subscribers for the first time in three years.

Consumer and industrial stocks helped the portfolio as cyclical sectors showed strength. L'Oréal jumped after posting a rise in second-quarter sales, benefiting from rising demand in emerging markets. Shares of Cadbury soared on Kraft's takeover offer and were trading at a premium to the initial offer price, highlighting market expectations for an improved bid. While the deal will most likely go through, the downside risk is greater if it does not. We took advantage of the elevated price and sold shares.

The selection of industrials and consumer discretionary stocks also contributed, including European firms Bouygues, which rose after increasing annual sales targets for its construction business, and Siemens, which stands to benefit from a long-term trend of increased infrastructure and energy spending. In these sectors, we have also looked to take advantage of tactical investment opportunities in a number of airline and auto companies, including Toyota Motor.

Outlook and strategy

The global economy appears poised to make a recovery as industrial output increases, although questions remain about the sustainability of consumer demand. Investors are also focusing on how markets will react as governments gradually withdraw fiscal and monetary stimulus. Another key question is whether or not equities can sustain their upward momentum as markets enter a traditionally difficult period, although higher consensus earnings estimates bode well for equities.

Stocks with exposure to fast-growing emerging markets remain a key theme in the portfolio. Several of our top holdings are in companies that are enjoying rising sales as a result of growing consumer demand among the middle class in Asia. We also have direct investments in several large companies in Asia, as we believe long-term secular trends remain positive. On the other hand, we have become more cautious on Japan, the largest developed economy in Asia. We now have a less-than-benchmark exposure to Japan as we worry about export demand, the rising yen and uncertainty related to a new political regime. However, within Japan, our investments are in strong, world-class companies — from auto makers to machinery firms — that continue to benefit from growth in Asia and elsewhere.

Among sectors, we continue to hold large investments in information technology and telecommunication services, although our exposure has not necessarily been to specific industries within these sectors. For instance, we have shifted some assets from mobile carriers to fixed-line companies, primarily for the dividend growth. Meanwhile, we have steadily increased our investments in health care, as we believe several pharmaceutical stocks have attractive valuations and dividend yields. ■

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Emerging Markets Equity

review and outlook — third quarter 2009

Market review

Emerging markets stocks extended their rally, taking year-to-date gains to 67% as evidence of economic recovery mounted, initial public offerings gained momentum and corporations reported better-than-expected earnings. The rally paused in August over concerns about the sustainability of Chinese economic growth but resumed in September, sending the MSCI Emerging Markets Investable Market Index up 21% for the quarter.

Russia and Brazil climbed as commodities edged higher, while Turkey and Indonesia continued to soar. Korea rebounded 32% and some Eastern European markets gained sharply. Information technology, materials, financials and the consumer areas led; the more defensive telecommunication services and utilities sectors lagged.

Asian economies showed further signs of life, supported by positive manufacturing data and rising consumer confidence: China's annualized GDP approached 8%, while growth in India, Korea and Indonesia proved resilient. Brazil emerged from recession with aplomb, growing 1.9% in the second quarter. Mexico's economy was a notable exception, with GDP contracting 10.3% in the second quarter from a year earlier — its sharpest decline on record.

Chinese stocks proved volatile as the government announced plans to tighten capital requirements for banks to curb excessive credit growth. The MSCI China IMI ended the quarter up 8%; auto and technology stocks jumped, while property and real estate developers fell. Information technology boosted the South Korean and Taiwanese markets as heavyweights Samsung Electronics and Taiwan Semiconductor Manufacturing benefited from rising chip prices. Indian equities advanced 21%, cheered by supportive economic data and robust corporate earnings, despite the country's driest monsoon season in years. Brazil rose on positive economic data, surging commodities stocks and higher profits among the nation's banks, while metals producers and financials buoyed Russia.

China led global IPOs, with China State Construction Engineering raising more than $7 billion in July. Merger-and-acquisition activity also picked up, though India's Bharti Airtel and South Africa's MTN terminated discussions on their long-anticipated deal.

Portfolio review

Portfolio results largely kept pace with the benchmark, with stock selection in China heavily boosting returns. The portfolio's Chinese investments returned 20% compared with 8% for those held by the benchmark. Battery maker BYD continued to soar following its release of the world's first mass-produced hybrid plug-in car last December. Nine Dragons Paper, China's largest producer of containerboard, also continued its rise as domestic demand increased.

Selection in technology was another boon, particularly investments in Samsung Electronics, which reported better-than-expected earnings amid increased television and mobile phone sales. China's Tencent Holdings and Perfectworld lifted results, helped by the Chinese internet boom.

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Selection in materials further contributed. South Korea's largest chemical company LG Chem rose about 70%, spurred by news of a joint venture with Hyundai Mobis to produce lithium-ion batteries for hybrid cars. A number of metals and mining companies proved beneficial as commodities climbed, including Kazakhstan-based Eurasian Natural Resources, Canada's Ivanhoe Mines and New World Resources of Central Europe. Russian steelmaker Evraz also jumped as domestic steel demand firmed up, as did Novolipetsk Steel and Magnitogorsk Iron & Steel Works.

The portfolio's cash position had a negative impact, along with investments in several Chinese banks and real estate developers that suffered from worries about tighter credit conditions. DLF was a bright spot, however, as the Indian real estate firm won the country's largest land sale in two years.

Choice among energy stocks detracted from overall portfolio returns, with South African oil producer Sasol forecasting weaker earnings. Indian petrochemicals giant Reliance Industries was also held back by declining sales from its biggest gas field as a lawsuit with its subsidiary Reliance Natural Resources dragged on.

Outlook and strategy

Asian economies have proved relatively robust and China should continue to experience reasonably high levels of economic growth even as the government removes some stimulus. While we still own substantial investments in China at nearly a fifth of fund assets — the largest market weighting in both the portfolio and the index — our managers have been reducing a number of individual holdings that have enjoyed strong runs and are instead pursuing other more attractive opportunities throughout the emerging markets, especially in Asia.

Commodities producers constitute half of the portfolio's top 10 holdings, with a particular emphasis on energy stocks. In general, a number of the fund's largest investments vary considerably from those held in the index, including several coal companies as well as some technology firms. We are especially interested in technology companies that should benefit from a turn in the corporate capex cycle over the next few years and from exposure to the Asian consumer. While financial stocks in many emerging markets will most likely witness a longer-term expansion in consumer credit in markets such as India, China and Brazil, we currently find ourselves more attracted to opportunities in other sectors. We favor the telecommunications providers most poised for growth, and also like local brands in the consumer areas, as we believe these will continue to gain market share. ■

The portfolio review is based on preliminary data for a representative account. All returns are in U.S. dollars unless otherwise noted. The statements expressed herein are informed opinions, are as of the dates noted, and are subject to change at any time based on market or other conditions. This publication is intended merely to highlight issues and is not intended to be comprehensive or to provide advice.
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