

U.S. Equity

review and outlook — first quarter 2012

Market review

U.S. stocks rose in each month of the first quarter, extending the rally that began in late 2011. A strong start to quarterly earnings season, progress in resolving the European debt crisis and some improvements in U.S. economic data helped lift equities. The Federal Reserve's announcement that it expected to keep interest rates near zero through 2014 also supported markets. The pace of the advance slowed in March, however, as investors appeared to reassess stocks' prospects in light of moderating expectations for global growth. Nonetheless, the Standard & Poor's 500 Composite Index gained 13%. The tech-heavy Nasdaq Composite Index rose 19%, while the less growth-oriented Dow Jones Industrial Average ticked up 9%.

The S&P 500 index's rise was underpinned by its two largest sectors, information technology and financials, which both gained more than 20%. Shares of Apple climbed almost 50%. The company reported record quarterly earnings and revenues, and also announced a share repurchase program and its first-ever dividend payment. Other technology stocks leveraged to an expansion in mobile computing also rose, including a number of suppliers to Apple.

Commercial and investment banks and diversified financial services providers posted strong results, benefiting from stimulative policies in the U.S. and Europe and assurances the Federal Reserve would consider additional measures if the economy faltered. In March, the Fed announced that 15 of 19 major U.S. banks had passed the latest round of stress tests designed to assess whether the institutions had enough cash to withstand a serious financial crisis. Several banks announced dividend increases and share buybacks after the stress test results were released. The five largest mortgage servicers agreed to a \$25 billion settlement with state attorneys general, ending a probe into allegations of abusive foreclosure practices and removing some litigation risk for the companies.

The energy and materials sectors rallied early in the year but retreated in March as the outlook for global growth became more muted. Crude oil prices touched a 10-month high in late February, pushed up by tensions in the Middle East. Natural gas contract prices, on the other hand, fell to a decade low amid booming production in North America. Defensive areas also lagged, with utilities providing the only negative sector return.

Portfolio review

The portfolio rose in value but lagged its benchmark. The investment in Apple was the leading individual contributor to portfolio results in absolute terms; however, its very large weighting in the index also led it to be among the biggest detractors on a relative basis. Broadcom, Qualcomm and Jabil Circuits, which supply components used in iPhones, iPads and other mobile devices, also gained, as did payments processor Visa. But stock choice in the information technology sector detracted overall, influenced significantly by the less-than-index weight in Apple and a more meaningful investment in Google, which was essentially flat over the period. Additionally, First Solar declined after reporting a drop in its fourth-quarter earnings amid a general weakening in the solar technology industry.

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The selective stance in financials, which helped in 2011 when the sector lagged, has hurt thus far in 2012 as many stocks not owned in the portfolio have rebounded. Still, investments in a range of financial companies, including investment bank Goldman Sachs, JPMorgan Chase, insurer Allstate, discount brokerage Charles Schwab and regional bank BB&T, made positive contributions in the first quarter. The large investment in cell-phone tower operator American Tower — which was reclassified as a financial stock as it completed its conversion to a real estate investment trust — weighed on relative results.

Having relatively few investments in defensive areas such as utilities, consumer staples and telecommunication services benefited the portfolio. The choice of health care stocks, including Cerner, Seattle Genetics and Express Scripts, also helped. However, Gilead Sciences, which was added to the portfolio during the quarter, was a significant detractor; its shares fell after the firm reported a high percentage of relapses in a small clinical trial of a hepatitis C therapy acquired in its purchase of Pharmasset.

The large exposures to energy and materials and stock choice in both sectors detracted, particularly the investments in Allegheny Technologies, Halliburton, Baker Hughes and Royal Dutch Shell. Managers started a position in Cobalt International Energy, whose share price surged on news of positive results from its Cameia-1 well off Angola. In a sharply rising market, the cash position weighed on results.

Outlook and strategy

The portfolio's positioning continues to be geared to economic growth in the U.S. and emerging markets. Managers maintain this long-term view even though growth expectations have been scaled back for the U.S. and China, now the U.S.'s third-largest trading partner. Gains in employment and personal income should be supportive of consumer spending in the U.S., although this positive trend could be derailed if gasoline prices stay elevated.

Information technology remains the portfolio's largest sector exposure. Managers continue to find value in companies involved in mobile computing and the Internet, including smartphone, tablet and networking equipment manufacturers as well as the makers of chips and other components. They retain significant investments in energy and materials, on the view that both sectors will benefit from long-term demand growth and supply constraints over the long term. Managers have invested in media companies as well as specialty retailers and luxury goods makers with global brand appeal. The portfolio has few investments in consumer staples, utilities and telecommunication services as stocks in these sectors appear fully valued on the whole. In the health care sector, managers are invested in companies they believe will do well regardless of the outcome of challenges to health care reform. ■

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 for client use only. It aims to highlight issues and is not intended to be comprehensive or to provide advice. © 2012 Capital Guardian Trust Company. All rights reserved.

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