Long Live Diversification!

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In our 2010 Outlook – A Slow Recovery, market strategists Jim Kochan, Brian Jacobsen, and I highlighted the importance of fully diversified strategies for long-term investors. We organized our discussion according to the economy, monetary policy, and the financial markets. Since periods of low nominal Gross Domestic Product (GDP) growth, like the one we envision, have historically been accompanied by increased market volatility, our thoughts centered on the traditional asset class decisions (bonds and stocks) facing investors. Yet these periods of slow growth have also shown a propensity for active management styles within the equity markets to outperform more passive strategies. Consequently, I've decided to broaden the discussion and expand my thoughts to the sector level, where slight "tweaks" to holdings may enable diversified equity portfolios to outperform their passive indices in 2010.

It should be noted that these comments are meant to be general in nature, given the varying risk tolerances and time horizons of investors. Factors likely affecting performance (total return, earnings-per-share growth, price/earnings ratios, and dividends) are highlighted in Chart 1, and represent analysts' consensus forecasts. In addition, my outlooks are listed below as underweight, overweight or market weight, relative to consensus forecasts on each sector, along with additional thoughts (both positive and negative). When making investment decisions, these thoughts should not be construed as ironclad, time-tested rules for investing, but rather for investors to consider in making portfolio decisions and investment changes. Finally, the recommended "tweaks," as they relate to overweight, market weight, and underweight for each sector, constitute my own top-down analytical process and may differ from those used by your portfolio manager. For example, I may not be currently enamored with the consumer discretionary sector, yet a classic value style manager would likely emphasize the group given the Fund's diversified long-term strategy.

CHART 1 – 2010 S&P SECTOR FORECASTS

Sector	Level	2009 TR (%)	2010 EPS	2010 %	2010 P/E	Div. Yld.
Consumer Discretionary	240	41.3	14	4	17	2.5
Consumer Staples	275	14.9	19	8	14	2.9
Energy	445	13.9	33	40	13	2.0
Financial Services	205	17.2	13	na	15	1.4
Health Care	365	19.7	30	7	12	2.0
Industrials	250	20.9	15	1	17	2.4
Technology	370	61.7	22	35	17	0.8
Materials	205	48.6	12	120	18	1.7
Telecommunications	110	8.9	8	-6	14	5.6
Utilities	155	11.9	13	6	12	4.3
S&P 500	1135	26.5	76	35	15	2.0

Source: Bloomberg.

TR = total return; EPS = Bloomberg consensus earnings per share estimate; % = Bloomberg consensus annual percentage earnings growth; P/E = price/earnings ratio on 2010 consensus forecast; Div. Yld. = dividend yield.

2010 Sector Outlooks Consumer Discretionary—Underweight

Positives

- Low interest rates
- Economy recovering
- Relative P/Es below long-term averages
- Profits: easy comparisons compared with last year
- Energy prices well below 2008 levels
- Consumer confidence stabilizing
- Technical picture strong

Negatives

- Unemployment at 10%
- Weak housing prices
- Consumer deleveraging of debt in favor of increasing savings rate
- Declines in consumer credit and credit availability
- Companies have weak pricing power

Consumer Staples—Market Weight

Positives

- Weak U.S. dollar combined with international diversification
- Many companies in sector have more than 50% top line from foreign exposure
- Uncertainty about extent of recovery bodes well
- Dividend yields greater than the index
- Relative P/Es below the index and below long-term averages

Negatives

- Perception of global recovery minimizes demand for space
- Technical picture weakening

Energy—Overweight

Positives

- Geopolitical risks bode well for energy
- Global stimulus spurs demand, especially in developing markets
- Sector melds between cyclical bounce and secular, or long-term, growth
- Profits increasing quarter over quarter and year over year
- FTM (forward 12-month P/E less than index but greater than long-term average)

Negatives

- Product pricing still well below 2008 levels
- P/E greater than long-term averages
- Technical picture mixed

Financial Services—Market Weight

Positives

- Yield curve exceptionally steep and broadly supportive for sector
- Cyclical bounce/recovery
- Monetary policy still very accommodative
- Technical picture continues to improve

Negatives
- Consumer/corporate deleveraging
- Loan availability still tight
- Difficult regulatory environment looms
- FTM P/Es greater than long-term average

Health Care—Market Weight
Positives
- Relative P/Es well below long-term averages
- Total return play with earnings and income
- Demographics
- Cash on balance sheets
- Weak U.S. dollar and foreign exposure
- Merger and acquisition possibilities
- Technical picture strong

Negatives
- Significant headline risks with proposed health care legislation
- Sub-industries facing increased regulatory and tax burdens
- Pipelines
- Pricing power as generics continue to gain share

Industrials—Overweight
Positives
- Global stimulus measures
- Steep yield curve supportive for growth
- Cyclical recovery
- Lower input costs
- Technical picture

Negatives
- Limited pricing power
- Tough profit comparisons
- Excess capacity/low utilization rates

Information Technology—Overweight
Positives
- Global stimulus measures
- International diversification
- Weak U.S. dollar
- Large cash positions
- Solid profit growth, quarter over quarter and year over year
- Cyclical bounce
- Productivity gains/replacement cycle
- Solid technicals

Negatives
- Still low business sentiment readings

Materials—Overweight

Positives

- Global stimulus measures, especially infrastructure
- Cyclical bounce, domestic and global, particularly emerging space
- Solid profit growth potential
- Pricing power
- Inventory growth
- Technical picture

Negatives

- Free trade/protectionism
- Excess capacity
- Valuation

Telecommunications Services—Underweight

Positives

- Dividend yield

Negatives

- Pricing power
- Profit growth
- Regulatory risks
- Capacity–limited bandwidth
- Technical picture weakening

Utilities—Underweight

Positives

- Low interest rates provoke demand for yield
- Valuation
- Industry consolidation? (meaning potential mergers?)

Negatives

- Regulatory risks, potential impact of Cap & Trade policy
- Profit growth
- Technicals weakening

To summarize these sector perspectives, massive global stimulus measures may result in leadership from areas that have traditionally been considered “late cycle” or “defensive” plays, such as energy, materials, and industrials. Technology may benefit from increases in corporate productivity spending, while the performance of the consumer staples sector hinges on the confidence investors have in the extent of the recovery. Considering 10% unemployment and weak home prices, though, we believe the consensus may prove to be too optimistic on the consumer discretionary sector. In addition, health care, financials, telecommunications, and utilities are all likely to experience both political and headline risk in the year ahead. As always, we continue to recommend a fully diversified, long-term strategy for investment portfolios.

Market Index Descriptions

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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