

Conference call highlights

US equities

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Increased growth forecast

We have recently increased our US GDP growth forecast for 2011 from 2% to 3%, reflecting the extension of the Bush-era tax breaks and unemployment benefits as well as some better data on corporate capital expenditure and employment. However, significant headwinds to growth remain, principally in the form of budget deficits and the parlous condition of state and local finances. These headwinds, together with high levels of unemployment and excess capacity, suggest that inflationary pressures should remain muted in 2011 despite recent commodity price strength. In this context, we do not expect any increase in interest rates in the coming year.

Employment picture skewed

Overall unemployment remains close to 10% and we do not foresee a meaningful decline in this rate in the near term. However, we have discerned a significant skew in the employment picture by age, experience and pay bracket. In general, employment prospects remain weak for younger, less skilled parts of the labour force, many of whom have seen their jobs move to cheaper overseas destinations.

Good prospects for higher earners

Conversely, more experienced workers with specialist skills are seeing a much stronger picture, with low levels of unemployment and consequently greater wage bargaining power. These higher-earning individuals also have greater gearing to equity markets and less exposure to weak house prices. As such, they have been the prime beneficiaries of the recovery in corporate profits and the Fed's liquidity injections over the past two years. Our portfolios have benefited in recent months from holdings in consumer discretionary stocks whose earnings are focused on this part of the population, such as luxury goods company Polo Ralph Lauren.

Capital expenditure recovering

Over the past two quarters we have seen a return to healthy levels of corporate capital expenditure growth, following the contraction in spending witnessed during the recession. We expect this trend to continue in the coming quarters, given the catch-up in spending that is required after the weaker period in 2008 and 2009, and the robust cash flows being generated by many companies.

Healthy profits growth

Moreover, closer examination of the data reveals that a good proportion of this expenditure is occurring in the domestic market. In other words, companies are starting to invest in their businesses, and the benefit of this investment is not all going to overseas suppliers as some commentators had feared. This virtuous circle of expenditure bodes well for corporate profits; we are expecting aggregate earnings growth of around 17% in the US this year.

Attractive valuations

This level of earnings growth places the market on a 2011 price to earnings ratio of just under 14 times, which is well below its long-term average. On other measures such as price to book value and price to cash flow, the market is similarly attractively valued relative to history. Meanwhile, the market also remains cheap versus bonds, despite the recent uptick in treasury yields.

An unloved asset class

Fund flows data shows that corporate and emerging market bonds have been the main beneficiaries of liquidity flows to date. However, with bond yields at unappealing levels, companies continuing to deliver healthy earnings growth, inflation pressures rising in some pockets of the global economy and investor

confidence recovering, we expect flows to turn increasingly in favour of equities over the coming months. The US market should be a prime beneficiary of this trend.

Current fund strategy

Our portfolios remain biased towards quality stocks across the sector spectrum, as we believe that balance sheet strength, cash flow generation and astute management will remain key ingredients of success in a world in which growth is relatively hard to come by. We believe that stock selection will be the key driver of returns in 2011, but we also have some high conviction sector views. For example, we are overweight in industrials, technology and consumer discretionary, although we have trimmed a number of holdings in the last category recently as stocks have reached our price targets. On a cap-weighted basis we are underweight in energy, but our holdings are skewed away from the mega-cap names and towards higher beta exploration and oil services stocks. Therefore, most portfolios are overweight when adjusted for beta. Key sector underweights include utilities and consumer staples.

Added to financials

We have recently added to financials, via higher quality names such as Wells Fargo, which is one of the best-run of the larger banks and is demonstrating healthy returns on tangible equity. We continue to avoid regional banks, where we do not believe that valuations are justified by the likely returns.

A strong end to the year

Our funds ended 2010 with a strong quarter relative to their benchmark indices. The American Select Fund benefited from positive sector strategy and stock selection during Q4. Stock-level highlights included Foot Locker, Compuware, Brigham Exploration and Tiffany. In terms of sectors, the underweight position in consumer staples worked well as investors rotated away from more defensive areas and concerns also arose around the impact of rising input prices on future profits. A zero weighting in utilities also proved beneficial.

Summary

The US economy is showing signs of improvement and the recent extension of the Bush-era tax breaks increases our confidence. We have revised our 2011 growth forecast upwards accordingly, but we still believe that inflation will remain muted and that accommodative policies will be maintained in the medium term. Meanwhile, company fundamentals continue to impress, with a wide variety of businesses generating robust levels of profit and cash flows. Market valuations are attractive relative to history and to bonds, and we expect fund flows to turn increasingly in favour of equities in the coming months. Our funds are biased towards quality and are overweight in the technology and industrials sectors. We have recently added to financials, with Wells Fargo among the companies purchased. Performance was strong in the fourth quarter and we believe that the portfolios are well positioned to perform well in 2011.