THE Equity View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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# Mid-Year 2011 Equity Outlook
# Equities Remain Best Game in Town… GARP and Dividends Lead

Our Mid-year Equity Outlook is focused on four themes. We believe that:

1. **US equities are not expensive** despite the 100%+ run in the S&P 500 since March 2009.
2. Middle-innings **strategies that emphasize stock picking** will be most effective.
3. Stock pickers will be drawn to stocks that offer **Growth At Reasonable Prices** (GARP)
4. **Equities will benefit from an influx of former bond investors** who need to supplement low-yielding bond portfolios.

**US Equities Are Not Expensive**

The typical reaction of investors to a market that has doubled in less than three years is skepticism. Investors generally find it difficult to justify such an extreme move, worry that the market is running out of gas, and conclude that it is too late to buy. However, anyone who concludes that the market is expensive simply because prices are up is only considering half the story. The average company, as measured by the S&P 500, is currently delivering twice the *earnings* that it delivered in March 2009; therefore, we think it's logical for it to trade at twice the price. In the top panel of the chart below, the earnings-per-share (EPS) growth generated by S&P 500 is visible, as is the fact that those earnings have now surpassed their 2007 high. Despite this earnings strength, the S&P 500 as measured on a forward price-to-earnings (P/E) basis (middle panel) or price/cash flow basis (bottom panel) is less expensive than it was a year ago, and significantly cheaper than it was over the 2003-2007 time period.

**Chart 1: Earnings have Back-filled Price Appreciation**

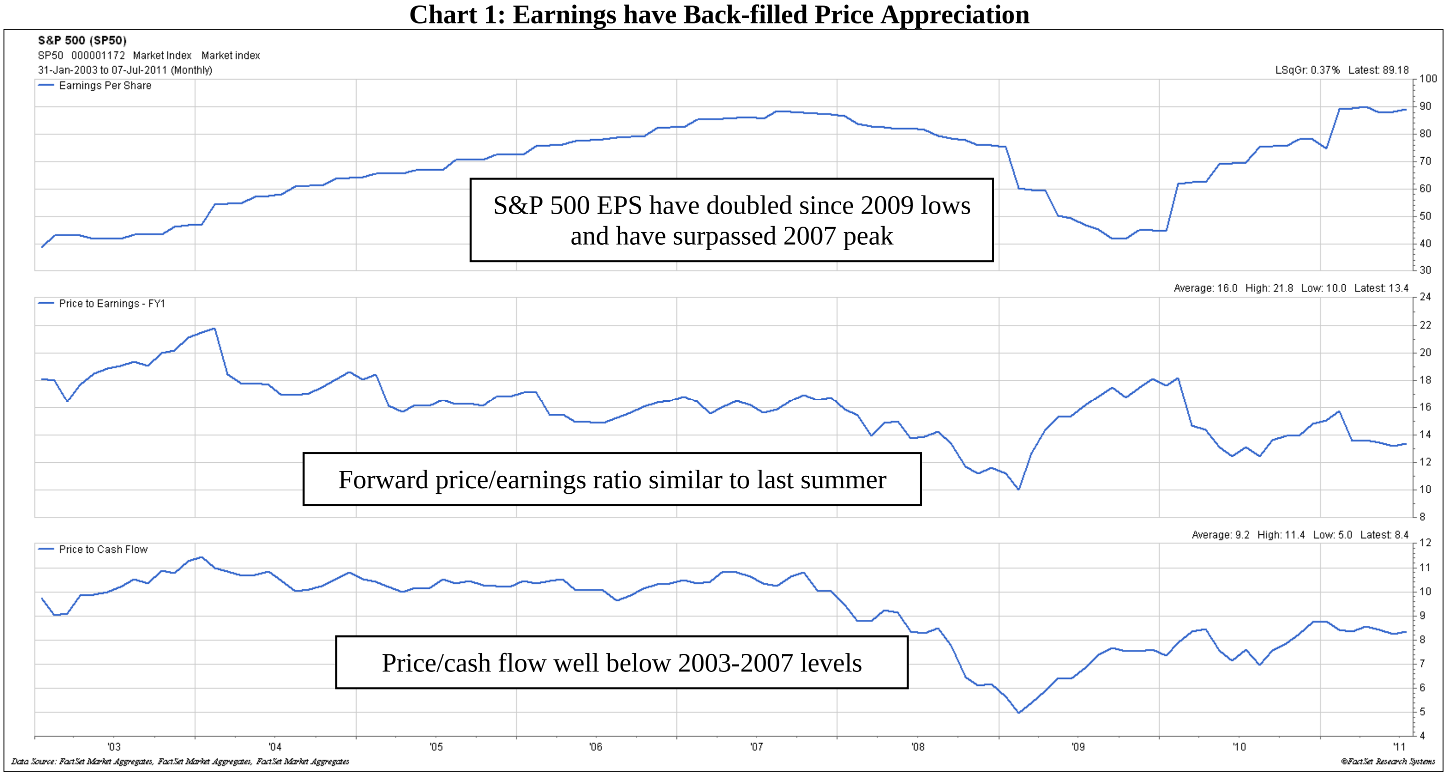



*Chart courtesy FactSet Research Systems; Past performance is no guarantee of future results.*

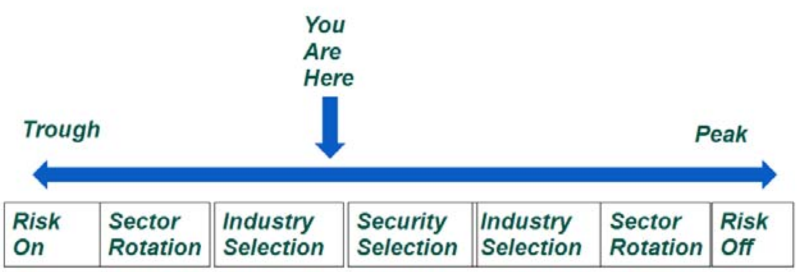
While some argue that earnings are vulnerable because they are a result of record-breaking profit margins, we see few pressures on these margins in the near term. On the contrary, we continue to see an environment supportive of profit-margin expansion. For example, high unemployment rates should keep wages in check (in fact, analysis by Ned Davis Research suggests that the S&P 500 historically performs best when unemployment rates are elevated and falling); operating leverage should increase as idle manufacturing capacity is utilized; and a slowdown in world economic growth should ease the rising pressure on raw material prices such as cotton, oil, and corn. Furthermore, analysts' future earnings estimates are suggesting significantly less risk than they did one or two years ago. Today, a double-dip recession is becoming increasingly unlikely, there are fewer worries about a collapse in the banking system, and the employment environment is beginning to improve. The fact that there are fewer risks today than a year ago supports P/E expansion in addition to continued earnings growth. *In an interesting contrast, while the risks facing the equity markets have fallen, the risks facing the bond market -- especially the potential for inflation -- are growing.* However, like stock investors, fixed income investors appear to be late in repricing bonds to reflect the new reality, and both stocks and bonds remain stubbornly valued near year-ago levels.

RiverFront's portfolio managers apparently aren't the only ones who recognize the value in equities. We continue to see other "smart" investors who have arrived at similar conclusions. Historically, among the smartest groups of investors are corporate CEOs and "activist" investors (investors who buy a meaningful portion of a company with the intention of influencing management decisions). CEOs, in our view, qualify as "smart" because they have their fingers closest to the pulse of the economy and their industries. They confirm our bullishness nearly every day through their actions when they buy back their own stock, and the stocks of their competitors, via near-record share repurchase plans and merger & acquisition activity. The second smart group comprises activist investors. Activists are smart because they can go anywhere, tend to only buy when they perceive a significant margin of safety, and are willing to buy large enough stakes that they can control a company. In our view, the greater prevalence of activists in stable, mega-capitalization stocks recently (such as Microsoft and Fortune Brands) suggests that publicly traded equities offer one of the more attractive opportunities in the investment world.

**Middle Innings Strategies That Emphasize Stock Picking Should Outperform**

As we wrote in the January 2011 *Equity Outlook,* we expect the stock market's preoccupation with macro economic and political factors to continue to fade throughout 2011. Many of the questions that are at the top of equity investors' minds, such as "Will the economy experience a double-dip recession?" or "What will Washington do?", are likely to be replaced by a more equity-centric debate, such as "Which companies are gaining market share?" or "Who has the most pricing power?" This evolution is normal and generally consistent with the progression of a bull market. With valuations remaining attractive, we think it is too early to reduce equity weightings or overweight defensive sectors such as Consumer Staples or Utilities. Likewise, the market is no longer so cheap that an investor can outperform by simply carrying more risk than the market. We believe that future outperformance will be a function of industry and security selection as we enter the middle innings of the bull market (Figure 1).

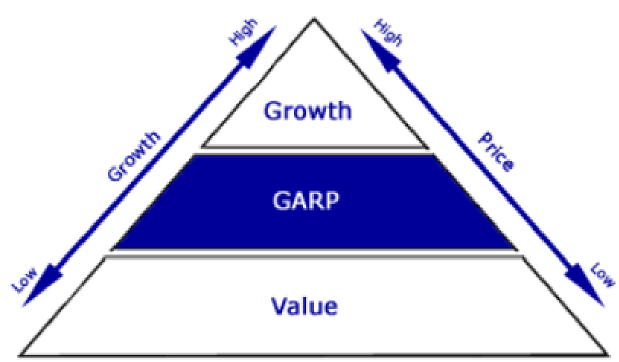
**Figure 1**




**In a Stock-Picking Environment, GARP Strategies Usually Win**

We continue to recommend investors embrace a stock-picking strategy that employs a Growth At A Reasonable Prices (GARP) methodology. This was the central thesis in our 2011 *Equity Outlook,* and we see little reason to change focus now. A GARP investment style is often most effective in the middle innings of an economic expansion, after value-oriented strategies have bid up the most deeply oversold stocks from the preceding bear market, but before prices have become so extended that stocks only appeal to growth investors (Figure 2). GARP investing was last popular in the mid-1990s, following the savings & loan crisis and prior to the late '90s technology bubble. We believe that companies with GARP characteristics will continue to garner the lion's share of investor attention for the foreseeable future.

**Figure 2**




*Source: Investopedia*

**Where to Find GARP?**

Stocks that deliver growth at a reasonable price are not particular to a specific market cap or sector. We've identified a few themes that have created pockets of GARP stocks and appear to have been missed by the market.

1. **Cyclicals Priced like the Cycle is Ending:** Long-time investors in energy, industrial or material stocks have been conditioned to anticipate the end of the cycle and get out of their cyclical stocks before the rest of the investment world comes to the same conclusion. To aid their retreat, this grizzled group of investors looks to a number of early warning signals, such as the new orders component of the monthly manufacturing report from the Institute for Supply Management (ISM), that give them clues about when they should employ exit strategies. We believe that the self-inflicted economic slowdown in China, the earthquake in Japan, and a slower-than-average economic recovery in the United States have triggered false alarms, causing many investors to abandon their stocks before the current cycle ended. As a result, companies with attractive growth characteristics are now trading at valuations that are unjustified for the level of earnings growth they are likely to experience in the coming years. Furthermore, because of the blossoming infrastructure needs within the emerging markets, a number of these companies face revenue opportunities that are more secular than cyclical, and the duration of the cycle may be longer than average. This is important, in our view, because a company like Caterpillar, which is priced at around $110 per share, will quickly become "too cheap to ignore" if it can continue to deliver peak-level earnings quarter after quarter (currently nearly $10 per year).
   - **ETF:** SPDR S&P Oil & Gas Equipment & Services ETF (XES-NYSEArca-$41.47)
   - **Stocks:** Halliburton (HAL-N-$52.49), Caterpillar (CAT-N-$108.16), Aecom Technology (ACM-N-$27.01)
2. **Not all Americans are experiencing job frustrations (and the companies that can benefit from this):** One provocative fact about the nation's current 9%+ unemployment rate is that it is highly bifurcated among age, education, and skill levels. For instance, while unemployment among Americans between the ages of 18-24 is exponentially higher than average, and joblessness for those without a high school diploma is more than 14%, college graduates have less than a 4.5% unemployment level currently (source: Bureau of Labor Statistics, Ned Davis Research). Anecdotally, we believe there is meaningful job creation happening for well-educated 30- and 40-something workers with high levels of skill in fields such as engineering, natural resource management and information technology. *For a meaningful and demographically desirable segment of the U.S. population, things actually are improving.* These consumers tend to have disposable income for discretionary items that have high perceived emotional or practical value, such as entertainment and luxury goods.
   - **ETF:** PowerShares Dynamic Leisure & Entertainment Portfolio ETF (PEJ-NYSEArca-$20.07)
   - **Stocks:** Apple Inc. (AAPL-NasdaqGS-$354.00)[1], Tiffany & Co. (TIF-N-$80.58)
3. **Financial Regulatory Beneficiaries:** An interesting parallel can be drawn between the government's forced break-up of AT&T in 1983 and the re-regulation of financial institutions today. While AT&T and its remnants were relatively successful in the years following the break-up, the true success story of telecomm deregulation occurred outside of the Baby Bells. The intent of telecomm deregulation was to crimp the growth of the industry's leading player, which created a vacuum of power in the industry. The existence of this vacuum brought about a wave of innovation and competition by industries and companies that wanted to fill the void. Huge industries, such as wireless, telecom equipment, and perhaps even the Internet, can count telecomm deregulation as an important event in their creation. Today, the purpose of financial re-regulation seems to be similar -- i.e., to rein in the influence of the industry's largest participants. If successful, a similar vacuum could be created, spawning a wave of innovation along with new industries and companies to fill the void. Under that scenario, we think investors are best served by shifting their investment focus from the old banking leaders to the prospective leaders operating in non-bank industries, such as consumer finance, financial services, and community banks.
   - **ETF:** First Trust NASDAQ ABA Community Bank ETF (QABA-NasdaqGM-$24.40)
   - **Stocks:** Moody's Corp. (MCO-N-$37.60), American Express (AXP-N-$52.27), People's United Financial (PBCT-NasdaqGS-$13.46), East West Bancorp (EWBC-NasdaqGS-$19.76)
4. **Companies that benefit from Corporate America's increasingly short-term focus:** A lot has been written lately concerning the idea of large enterprises "hoarding" their record-sized war chests of cash. While true to a certain extent, this only captures half of the story. A more accurate depiction may be that companies are spending, but are doing so in different ways than they had in previous economic recoveries. For instance, instead of investing capital in more typical longer-term focused corporate growth initiatives, such as hiring or research & development, as we saw in previous economic recoveries, we think corporations are increasingly spending it on shorter-term initiatives that demonstrate a more immediate return on investment ("ROI") for managers and shareholders alike. These initiatives not only include the previously mentioned share buybacks, acquisitions, and restructurings, but also investments in products, services or actions that show an almost immediate ROI benefit. *Companies that can provide their clients with immediate ROI increases are seeing high demand for their products and services in the current economic environment.* This can be true whether they are selling a drug delivery system that cuts down a hospital's error incidence rate, thus lowering legal liability; a medical device that can increase patient survival rate and throughput; billing and customer relationship software or temporary staffing services that can help minimize

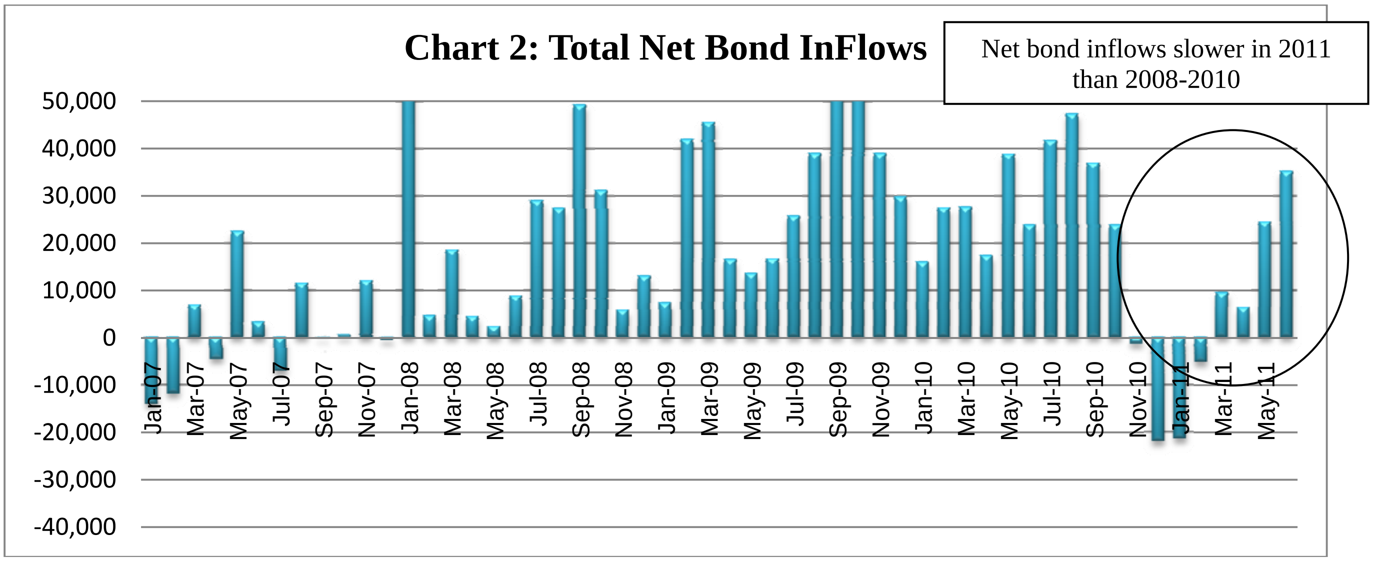
[1] *Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

companies' need for costly permanent hiring; or expertise in helping companies integrate those cost-cutting restructurings or mergers. An interesting by-product of this focus on shorter-term results is that some of these ROI companies are also becoming potential takeover targets.

- **ETFs**: iShares S&P GSTI Software Index (IGV-NYSEArca-$63.72), PowerShares Dynamic Healthcare Sector Portfolio (PTH-NYSEArca-$31.95)
- **Stocks:** International Business Machines (IBM-N-$174.99), BMC Software (BMC-NasdaqGS-$55.19), Hologix (HOLX-NasdaqGS-$20.04), CareFusion (CFN-N-$27.66), Accenture (ACN-N-$61.49), Manpower (MAN-N-$54.82)

**Bond Investors Pressured Into Shopping In The Stock Market**

Our last equity theme for the second half of 2011 focuses on a new breed of investors entering the equity markets -- traditional bond market investors. Central bankers around the developed world are causing many bond investors to move up the risk ladder by keeping interest rates low, penalizing savers for keeping their money in low-risk fixed income assets. This has led to a migration from money market vehicles to riskier, long-term bonds and hybrid bonds, such as real estate investment trusts (REITs)[2]. Two years into the migration, we believe the next logical step for frustrated savers is into the equity arena, as even the highest risk bonds have appreciated to a point that they barely satisfy the desire for inflation-protected returns. Chart 2, which displays net bond mutual fund inflows, shows that the heavy 2008-2010 bond inflows are lessening, suggesting that bond investors may have started to explore the stock market.




*Source: ICI: "Trends in Mutual Fund Investing"*

Fixed income investors who have been forced into the equity world will, in our opinion, be looking for certain characteristics in the stocks they choose. Investors who can build their portfolios using stocks that possess these characteristics should be well-served when the migrating herd of former bond buyers materializes and moves share prices higher. In our view, the following characteristics will have the greatest importance to this group of investors:

1. **Yield:** Investors leaving the bond world will ultimately be foregoing a 3+% current yield; therefore, we believe any equity product considered must carry at least a comparable yield of greater than 2.5%.
2. **Low Risk**: Most bond investors own bonds because they are not comfortable with anything but the lowest possible risk to their principal -- they need to be able to sleep at night. As a result, we don't expect bond investors to be attracted to the shares of smaller, non-familiar companies, no matter what their potential yield. A certain level of market capitalization will be required, along with a recognizable name.
3. **Predictability**: Fixed income assets have earned their name because their coupon rate doesn't fluctuate. We expect migrating bond investors to be attracted to the same characteristics when they look at stocks. Companies that have consistently paid stable or rising dividends will likely be preferred over those that do not. *Dividends are not guaranteed and are subject to change or elimination.*

**Cheap Valuation and Emerging Leadership Combine for a Timely Recommendation**

*[2] There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.*

Aside from providing a steady and growing stream of inflation-beating dividends, we believe that attractive valuations and emerging leadership make dividend-paying stocks a timely recommendation. Recently, dividend-paying stocks as a group have begun regularly outperforming the broad stock market for the first time since the March 2009 low, which is typical behavior for stocks in the middle innings of a bull market. Below is a list of ETFs and companies that we believe represent attractive purchase opportunities within this space and could potentially be attractive to former bond investors.

- **ETF:** WisdomTree Large-Cap Dividend Fund (DLN-NYSEArca-$49.20)
- **Stocks:** Darden Restaurants (DRI-N-$52.18), Time Warner Cable (TWC-N-$77.83), Chevron (CVX-N-$104.41), Pfizer (PFE-N-$20.04), McDonalds (MCD-N-$85.35), Verizon (VZ-N-$37.12)

***Exchange Traded Funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest.***

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**Standard & Poor's (S&P) 500 Index** measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.