

Sector Strategy



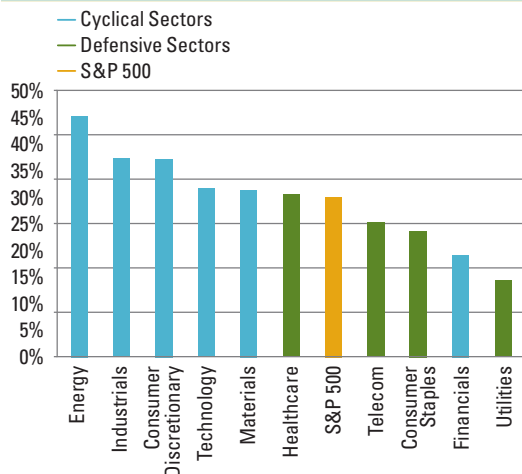
May 2011

Overview

The Big Picture

- Business cycle continues to favor cyclical sector positioning as economic expansion continues
- Favor business-driven cyclicals to capitalize on strong business spending trends
- Reflation theme supportive of natural resource sectors

1 Cyclical Sectors Have Led the Rally Since Bernanke Signaled "QE2"



Source: FactSet, LPL Financial 5/12/11
Performance from 8/31/10 through 5/12/11

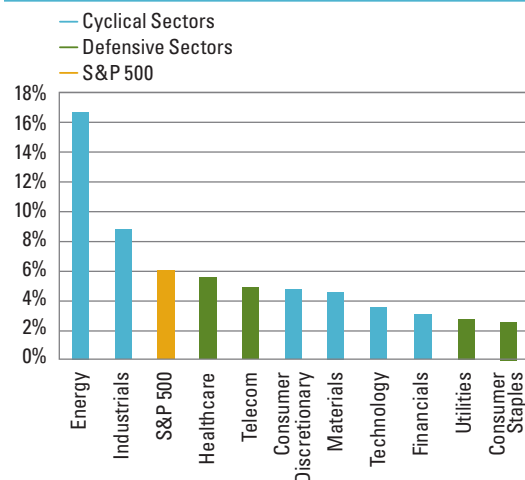
Our sector views continue to be shaped by the performance of cyclicals at various stages of the business cycle. Cyclicals tend to outperform as the economy emerges from the initial soft spot coming out of recession. Currently, we are emerging from this soft spot as the economic expansion approaches the end of its second year, corresponding with expectations for improving economic growth and corporate profits. The cyclical sectors are those with the most sensitivity to economic conditions. Conversely, defensive sectors tend to lag behind the broad market in this environment, as they have done for much of the bull market that began back in March 2009. These are the sectors with the least sensitivity to economic and market conditions. This pattern has been evident during the market rally that began at the end of August 2010 after Ben Bernanke announced more quantitative easing, dubbed "QE2" was on its way [\[Chart 1\]](#).

This pattern is also evident in first quarter performance, with Energy and Industrials as the only two sectors that outperformed the S&P 500, although the story was not as clear-cut. Led by Energy, the cyclical sectors returned an average of 7%, versus 4% for the defensive sectors. Industrials enjoyed solid performance, driven by strong manufacturing activity and growth in developing economies. However, it should be noted that the defensive sectors held up surprisingly well, while two key cyclical sectors struggled. Healthcare and Telecom came within 1% of the S&P 500, while Technology and Financials struggled. Mortgage and growth concerns plagued Financials during the quarter, while Technology suffered from earnings deterioration at some of the largest market capitalization companies, weakness and supply chain disruption in Japan and sluggish PC demand [\[Chart 2\]](#).

We continue to believe that the backdrop for business-driven cyclical and resource sectors is positive despite recent weakness. Solid business spending and demand from developing economies have benefited Industrials. Although supply chain disruptions in Japan have created near-term uncertainty, technology companies reported solid first quarter results as companies effectively manage through these challenges and take advantage of rebounding business spending and strong growth in developing markets. We expect the global growth story and weak dollar to support the natural resource sectors, though recent volatility has led us to take a slightly more cautious short-term view.

The flip side of those high energy prices is some pressure on consumer spending and company profit margins, which lead us to approach the Consumer Discretionary and Consumer Staples sectors with some caution. We are taking a cautious approach to Financials as well, in which

2 Energy Dominated First Quarter Sector Performance



Source: FactSet, LPL Financial 05/12/11

performance has suffered recently due to lackluster loan growth and ongoing concerns about the mortgage and housing markets. We do find the Banks attractively valued and expect dividend increases, along with a still favorable credit cycle to be recognized with potentially better performance in the coming months.

We maintain our negative views toward three of the four defensive sectors—Consumer Staples, Telecom and Utilities. However, we have upgraded our Healthcare view in light of the recent improvement in technicals, reasonable valuations and improving, but still moderate, growth prospects. Consumer Staples have benefitted from lower oil prices and increased market volatility. Interest rate risk is still concerning for the dividend-rich Telecom and Utilities sectors, although the Telecom sector may benefit from consolidation. Utilities continue to struggle with the fallout from Japan's nuclear crisis, lackluster growth and a weak pricing environment, but have benefitted the recent shift toward defensive sectors.

Bottom line, we maintain our preference for the business-driven cyclical and resource sectors:

- Our favorite sectors are currently Industrials and Materials, which we view as positive.
- Our view of Technology is moderately positive, and we are currently assessing opportunities to increase this sector's exposure given more clarity on the challenges in Japan. Our Energy view is moderately positive as well.
- We remain neutral but have become a bit more cautious on Financials and Consumer Discretionary, in which we are currently targeting near or slightly below market weight allocations.
- Among the defensive sectors, our views remain negative of Consumer Staples, Telecommunications, and Utilities, while we recently upgraded our Healthcare view to neutral.

First Quarter Earnings Season Reconfirms Our Cyclical Positioning

Our two primary concerns heading into first quarter earnings season, which were shared by many, were input cost pressures and Japan. The slowdown in U.S. economic activity, reflected in lackluster Q1 real GDP growth (+1.8%), and pressure on government spending are also concerns. Corporate America has answered these concerns with excellent first quarter results. The overwhelming majority of S&P 500 companies beat consensus expectations for revenues and profits and at least maintained their outlooks, as strength in overseas markets, effective cost controls and some favorable currency benefits have offset reduced Japanese demand and input cost pressures. Additionally roughly one quarter of the profits for the S&P 500 come from commodity-related companies in which high commodity prices are a boost, not a drag. The strong results have assuaged some of our concerns in the Technology sector, in which supply chain disruption in Japan was particularly acute, and the Industrials sector, in which fundamentals remain solid despite slowing economic growth in the U.S.

Below is a summary of our views for the 10 S&P 500 sectors and key factors supporting those views.

S&P 500 Sector Snapshots	
Consumer Discretionary	High energy prices remain a challenge, as was evident in weak first quarter GDP data that showed just a 2.7% increase in consumer spending on an annualized basis.
Consumer Staples	Higher input costs remain a drag on margins, but the pullback in oil prices and the broad equity market are helping relative performance.
Energy	The sector is benefiting from rebounding global growth, geopolitical unrest and tightening supplies, though recent volatility clouds the short-term outlook.
Financials	Tepid loan growth and mortgage concerns have been weighing on bank stock performance, but valuations remain attractive and dividends are increasing.
Healthcare	Regulatory and growth concerns remain, but technicals are improving and defensive sectors are starting to gain more favor.
Information Technology	Attractive valuations, manageable Japan supply chain disruptions and solid first quarter earnings are supportive.
Industrials	Sector is well positioned to continue to benefit from business spending growth and emerging market demand.
Materials	Global growth, reflation theme/weak dollar, Japan rebuild opportunity; China tightening nearing end.
Telecom	Valuations and interest rate risk are concerns, although the leaders may benefit from consolidation.
Utilities	Earnings weakness, rich valuations, interest rate risk and nuclear disruption outweigh attractive yields. Defensive bid likely temporary.

Our accompanying individual sector profiles are delivered as individual factsheets or as a full report. Our sector views are outlined in *Portfolio Compass* and discussed in *Compass Points*, both published on a bi-weekly basis. The *Portfolio Compass* highlights the three components of our investment philosophy—fundamentals, valuation and technical analysis—for equity sectors as well as equity, fixed income and Commodities asset classes. For more details on our macroeconomic and market views, please refer to our *2011 Outlook*, and soon, our *Mid-Year Outlook* publications. We also encourage you to read *Thematic Insights* for sector analysis, as well as insights into other investment themes across the broad equity, fixed income and alternative investment landscapes. For help implementing our sector advice, please refer to our Exchange-Traded Product (ETP) models or the currently recommended sector funds.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing involves risk including loss of principal.

Investments in specialized industry sectors have additional risk such as credit, regulatory, operational, business, economic and political risk which should carefully be considered before investing.

Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. You can obtain a prospectus from your financial representative. Read carefully before investing.

Principal Risk: An investment in an Exchange Traded Fund (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETFs involves additional risks: not diversified, the risks of price volatility, competitive industry pressure, international political and economic developments, possible trading halts and Index tracking error.

Consumer Discretionary: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Healthcare Sector: Companies are in two main industry groups — healthcare equipment and supplies or companies that provide healthcare-related services, including distributors of healthcare products, providers of basic healthcare services, and owners and operators of healthcare facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Also, companies that provide commercial services and supplies, including printing, employment, environmental and office services, or provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Manufacturing Sector: Companies engaged in chemical, mechanical, or physical transformation of materials, substances, or components into consumer or industrial goods.

Materials: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Technology Software & Services: Includes companies that primarily develop software in various fields such as the internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Telecommunications Services: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing is subject to substantial fluctuation and potential for loss.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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