

Sector Strategy



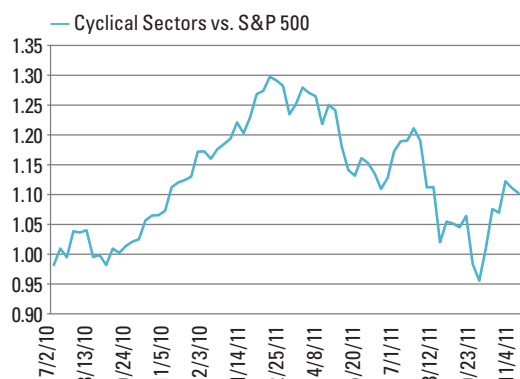
November 2011

Overview

The Big Picture

- Favor cyclicals to help take advantage of excessive economic pessimism
- Solid business spending drives Industrials and Technology, while consumer continues to defy the skeptics
- Natural Resources may benefit from improving Emerging Market growth outlook, weaker dollar

1 Cyclical Sectors' Relative Strength vs. Defensive Sectors



Source: FactSet, LPL Financial 11/18/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

2011: The Year of the Defensive Sector? Not So Fast!

Until very recently, this has been the year of the defensive sector. Double-dip recession fears in the U.S., the debt ceiling debate and downgrade of the U.S. credit rating, the European debt crisis and slowing growth in China have all pressured investor sentiment and growth expectations. Cyclical stocks have borne the bulk of the selling pressure, while depressed yields in high quality fixed income investments have fueled a massive flight to dividend paying stocks that are mostly found within the defensive sectors such as Consumer Staples and Utilities.

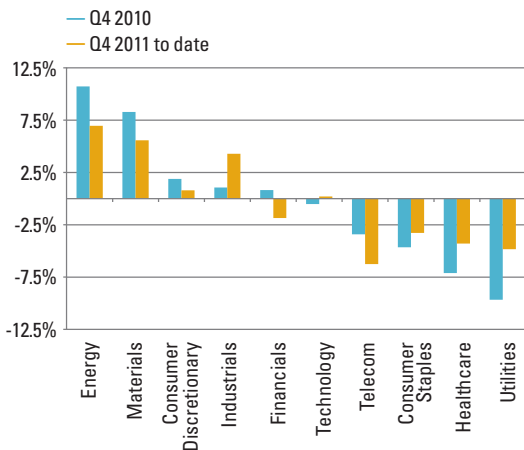
After leading the market for much of the year, defensive sectors have started losing relative strength in recent weeks while cyclicals have gained ground [Chart 1]. After cyclical sectors perhaps priced in an overly optimistic outlook earlier in the year, the pendulum swung too far in the other direction as the most economically sensitive sectors priced in a recession in the U.S. and Europe and a sharp slowdown in Asia. The turn began in early October as markets became more comfortable with the prospects for a comprehensive plan from European policy makers to contain their debt crisis while domestic economic data provided further evidence of continued, albeit moderate growth rather than recession.

Looking Forward

Looking forward, our preference for cyclical sectors is predicated, first and foremost, on where we think we are in the business cycle. Our view based on the hard data, not on sentiment, remains that the U.S. economy will avoid recession and continue to grow, albeit at a moderate pace as it did during the third quarter, based on the latest GDP data. Though there is no panacea for the European debt crisis, policy makers have taken positive steps with the latest plan from the European Union, thereby reducing the odds that contagion drags the U.S. and potentially other key economies outside of Europe into recession. When emerging from recession, whether real or perceived, investments most exposed to economic growth tend to perform best, as seen in the fourth quarter rally of 2010 which was led by Materials, Energy, Consumer Discretionary and Industrials [Chart 2]. Bottom line, when the market prices in recession and one does not occur, sectors most sensitive to economic growth normally perform better.

The other key driver of our preference for cyclical sectors over defensives is valuation. As shown in Chart 3, the cyclical sectors are quite a bit

2 Sector Excess Returns During Fourth Quarter Rally In 2010 Vs. Fourth Quarter 2011 To Date

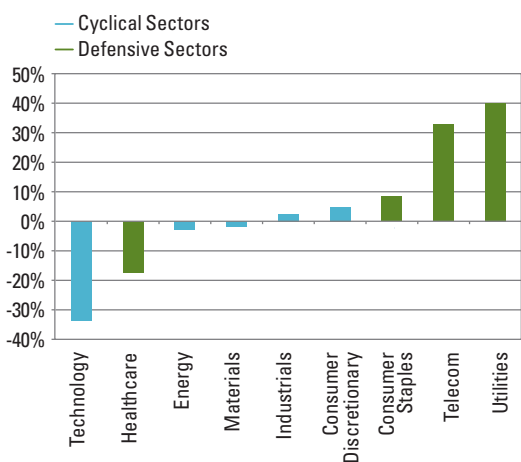


Source: FactSet, LPL Financial 11/18/11

Note: S&P 500 returned 10.8% during the fourth quarter, 2010. Quarter-to-date, the S&P 500 has returned 7.8%.

Excess Returns are the returns in excess of the risk-free rate or in excess of a market measure, such as an index fund.

3 Relative Forward PE by Non-Financial Sector vs. Long-Term Average
Cyclical Sectors Are Cheaper Than Defensives Versus Long-Term Averages



Source: LPL Financial 11/18/11

Note: Relative valuations are versus the S&P 500

Past performance is no guarantee of future results.

Financials are excluded due to book value being our preferred valuation metric. The sector is trading at a depressed price-to-book value multiple of 0.85 as of 11/18/11.

cheaper relative to their historical averages than the defensive sectors. For example, Technology is currently trading at a 4% premium to the S&P 500, compared to its long-term average of a more than 35% premium. Even when excluding the Internet bubble period in the late 1990s and early 2000, the average multiple is still north of a 25% premium, suggesting Technology is potentially undervalued by 20% or more. Conversely, Utilities historically trade at an 18% discount to the S&P 500, on average, but now trade at a 22% premium. Among defensive sectors, this analysis is supportive of Healthcare, though growth and reform challenges keep us on the sidelines. Among cyclical sectors, Consumer Discretionary appears most overvalued though we remain positive on the sector due to resilient consumer spending amid still low expectations. Reasonably valued and favored sectors include Energy, Materials and Industrials as well as Technology. Sectors currently not favored that appear overvalued include Consumer Staples and Telecom as well as Utilities.

In summary, we have become increasingly positive on the cyclical sectors in recent weeks, given the excessive level of pessimism reflected in valuations.

- Our positive Industrials and Technology views reflect resilient earnings and our expectation for continued solid growth in business spending and emerging markets
- Our positive Materials view is based on continued growth in the U.S. economy, an expected soft landing in China and the likelihood of renewed US dollar weakness
- We expect higher oil prices to benefit the Energy sector through year-end
- Our positive Consumer Discretionary view reflects resilient consumer spending trends amid excessively bearish sentiment
- Our negative Financials view reflects the challenging interest rate and regulatory environment and constrained growth outlook, though the outlook is beginning to improve for Regional Banks
- We continue to under-emphasize the four defensive sectors (Consumer Staples, Healthcare, Telecom and Utilities), as we expect investors to increasingly favor attractively-valued cyclicals in the months ahead as economic and profit growth exceeds market expectations

In addition to likely business cycle headwinds, each defensive sector faces fundamental challenges:

- **Consumer Staples** – input cost pressures
- **Healthcare** – austerity measures pressuring government spending
- **Telecom** – risk of unwinding of consolidation premium
- **Utilities** – clean energy push and interest rate risk

Earnings Season Much Better Than the Market Had Been Pricing In

One of the reasons our view of the equity markets and the cyclical sectors has become increasingly constructive in recent weeks has been the continued resilience of corporate America. The market correction in August

and September, as well as valuations and commentary from market pundits suggested earnings were poised to stagnate, if not contract.

The numbers are impressive, as the S&P 500 has increased earnings per share (EPS) and revenues by 16% and 11%, respectively—6% and 2% above estimates entering earnings season. More than 70% of companies have exceeded Wall Street’s EPS target, while over 60% have beaten revenue forecasts, both impressive even considering that the bar had been lowered. Importantly, guidance has generally been better than expected, leading only to modest 4–5% reductions in estimates for the rest of the year and early 2012, far less than had been priced in, and in line with our expectations.

Below is an overview of what we view as the key factors driving our sector views. The sector snapshots that follow go into further detail.

S&P 500 Sector Snapshots	
Consumer Discretionary	Consumer spending growth accelerated in Q3 2011 amid historic lows in consumer confidence. Watch what consumers do, not what they say.
Consumer Staples	Some input cost relief helps but rich valuation and market shift toward cyclicals are headwinds.
Energy	Inventories have improved in recent weeks while prices are likely to be supported by improving economic data in the U.S. and Emerging Markets.
Financials	Valuation, improving loan demand and easing interest rate pressure are positives but anemic job growth, European debt issues, and regulatory challenges remain.
Healthcare	Growth is being challenged by government spending cuts and reform; continue to favor cyclicals over defensive sectors.
Information Technology	Positive business spending outlook, resilient earnings performance and compelling valuations.
Industrials	Expect business spending growth to continue to exceed market expectations; Emerging Market demand and valuations are supportive.
Materials	Valuation reflects overly pessimistic global growth outlook; supply constraints and weak dollar are supportive.
Telecom	Rich valuation, interest rate risk, potential removal of catalyst if regulators reject large acquisition.
Utilities	Earnings weakness, rich valuations, interest rate risk and nuclear disruption may outweigh attractive yields

Our accompanying individual sector profiles are delivered as individual profiles or as a full report. Our sector views are outlined in the *Portfolio Compass*, which is published on a bi-weekly basis. It 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 soon-to-be published *2012 Outlook* publication and our weekly market and economic commentaries. 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.

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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.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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