

The Long View

2010 Review / 2011 Outlook

Gaining ground slowly

Uneven and incomplete — that's how a status report on the recovery of the global economy might read at the beginning of 2011.

The world's economy, which embarked on a recovery in mid-2009, continued to show gradual signs of improvement during the past year, but it has sometimes felt like one step forward, two steps back.

Portfolio counselor Jim Dunton says that it's not unusual for a recovery to proceed in fits and starts, especially after a deep recession. "But it's also important to bear in mind that once recoveries are under way, they typically go a long time," he said. "We're in a recovery mode, which I believe is going to go on for the next eight or 10 years. I realize we are gaining ground slowly, but gaining ground nonetheless."

Moving ahead, in low gear

Jim and other investment professionals say there are significant concerns about the health and trajectory of the current economic recovery, particularly in the developed world. With stimulus spending now waning, there seems little in the way of catalysts to help economies grow at their previous pace. At the very least, slower economic growth seems like a reasonable expectation for the coming year.

"My best-case scenario has us sort of grinding it out, with a flat economy for a while, at least in the U.S. and Europe,"

"I realize we are gaining ground slowly, but gaining ground nonetheless."

—Jim Dunton, *portfolio counselor*

says portfolio counselor Gordon Crawford. "So when I look at the world, I want to look for companies that aren't going to be affected by that. I do think the developing world is in good shape. The countries generally don't have a lot of debt, and they're seeing growth."

While investment professionals at American Funds pay close attention to macroeconomic issues, their focus remains on companies. Portfolio counselors and investment analysts believe that through their bottom-up intensive research process, they can uncover potential investments in almost any environment.

Opportunity amid volatility

"Frankly, I'm seeing opportunities in nearly every market," says portfolio counselor Claudia Huntington. "Every week, our analysts discuss companies that seem really interesting and are worth a close look. There are so many cross currents now that where I get the most comfort is to focus on the individual investment opportunity. So, I look at companies with respect to the continuum of their evolution, how they might grow, whether their strategy makes sense and other issues that guide our decision. Even in a volatile economic environment, you can have great companies that are growing revenues and market share and have very fair valuation. And this is one of those times."

Companies adjust, and advance



Jim Rothenberg
Portfolio counselor
40 years of investment experience

From unemployment to the debt crisis in Europe, the past year has not been without its trials. Clearly, the global economy still faces significant challenges recovering from the Great Recession.

But we shouldn't overlook the fact that many companies have responded to adversity by building a stronger foundation for future growth. Corporate America and many companies abroad have made changes during the recession that have strengthened their business and increased their value to investors.

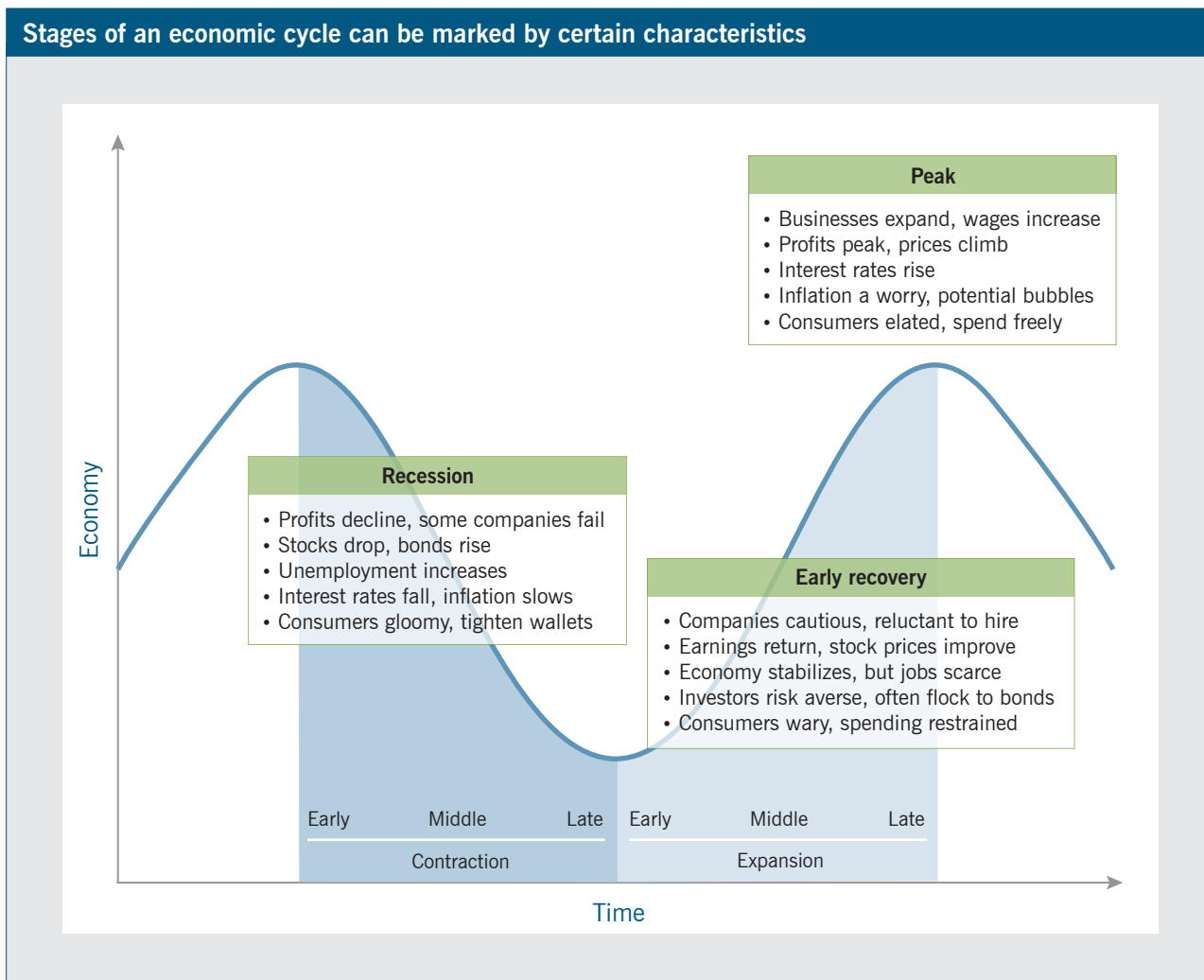
In fact, profits at major corporations have risen sharply. Companies have repaired their balance sheets and built up cash. They now have many opportunities to pay dividends, buy back stock and participate in mergers and acquisitions. All of these become likely because of their improved balance sheets and the strength of their cash positions.

These periods can be unsettling, but they can also offer opportunity for long-term investors. Some of the best investments can be made in such an environment, and we are committed to searching for companies that have the potential to prosper and help investors pursue their financial goals.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

Past results are not predictive of results in future periods.

Stages of an economic cycle can be marked by certain characteristics



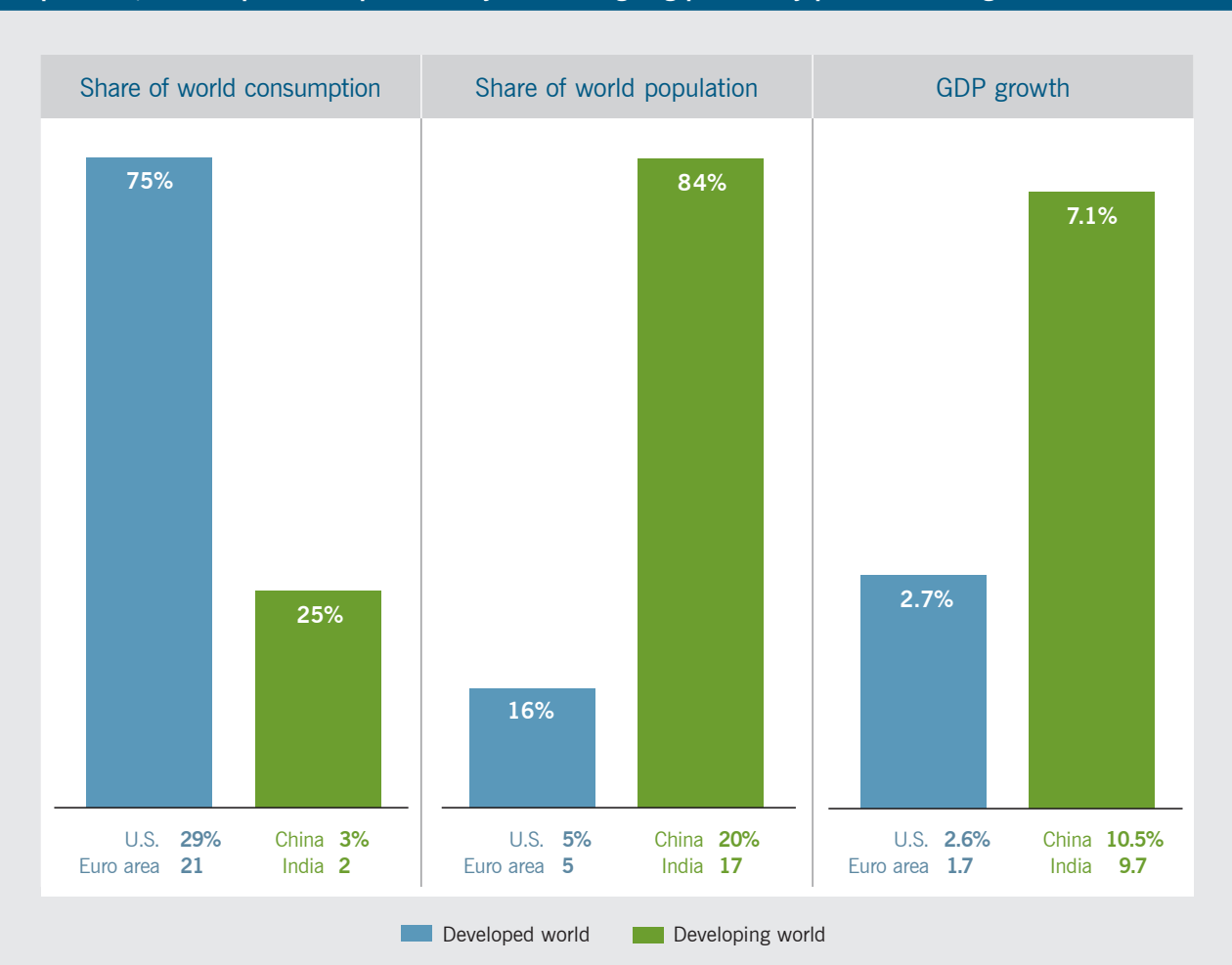
This diagram is for illustrative purposes only and is not representative of a particular economic cycle. Not every cycle will experience each of these characteristics.

- Whether they are called booms and busts, or expansions and contractions, the economy has demonstrated that it moves in a cycle through periods of relatively rapid growth and periods of decline. After a recessionary phase, the expansionary phase typically starts again.
- Although it seems to be an up-and-down process, several signs now seem to indicate that the economy is in the early stages of recovery, or climbing up the curve depicted in the chart. The sense that the recovery is sluggish may be partly attributable to the severity of the Great Recession, which lasted 18 months and ended in June 2009, according to the National Bureau of Economic Research.
- But the economy may now be coming out of the long shadow of the recession. During the latter part of 2010, manufacturing activity increased, the services side of the economy recorded gains and consumer confidence rose. Granted, the economy still faces challenges. But as the year ended, a number of surveys continued to indicate the U.S. economy is improving.

“The overarching issue, as with any recovery, is that it will be an up-and-down process. The way to invest in this kind of period is to identify the best companies, with good fundamentals, and don't worry so much about the economic backdrop.”

— Tim Armour, *portfolio counselor*

Population, consumption and productivity are undergoing potentially profound changes



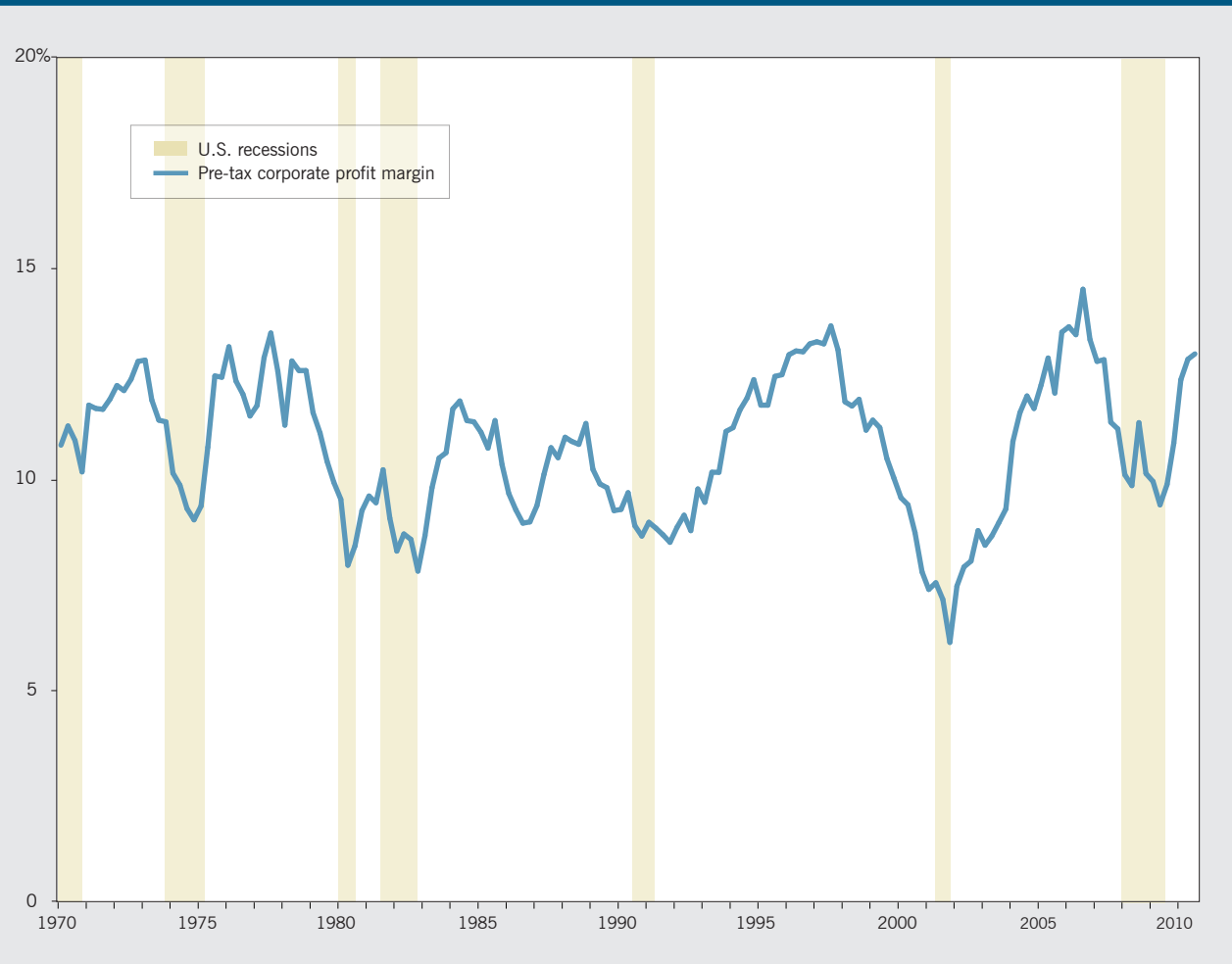
Sources: The World Bank World Development Indicators (WDI) database and International Monetary Fund (IMF) World Economic Outlook (WEO) database. The developed world represents 33 countries comprising IMF’s group of advanced economies, and the developing world represents 150 countries in the group of emerging and developing; IMF’s group of the euro area constitutes 16 countries. Figures for consumption and population are as of 2009, and those for GDP are based on partially estimated data for 2010.

- Many developing countries have been through a broad and potentially profound demographic and economic transition during the past two decades. Brazil, Russia, India and China, for example, now represent such a significant percentage of the global economy that they are changing the way many companies do business, and the way investors should look at the world.
- Developing nations now represent about 84% of the world’s population. As these countries have evolved, there has been an increasing demand for products ranging from detergents to cell phones, and for such facilities as airports and hospitals.
- Despite having most of the world’s population, consumption in the developing world is still only 25% of the world’s total. The discrepancy suggests demand for goods and services is likely to grow over the long run, and could represent a vast market for companies around the world.
- Investing outside the U.S. continues to entail additional risks, such as currency fluctuations, periods of illiquidity and price volatility. These risks may be heightened in connection with investments in developing countries. At the same time, many developing countries now have more competent fiscal and monetary policies than in the past. Indeed, the political and financial systems in many developing countries have matured during the past two decades.

“My expectation is that over the next 10 to 15 years, consumption growth will shift to China, India and other emerging economies like Vietnam and Brazil. The middle class in the developed world is passing the baton to the middle class in the developing world.”

— Elizabeth O’Connor, *economist*

After a rough ride, corporate profit margins have been on the climb



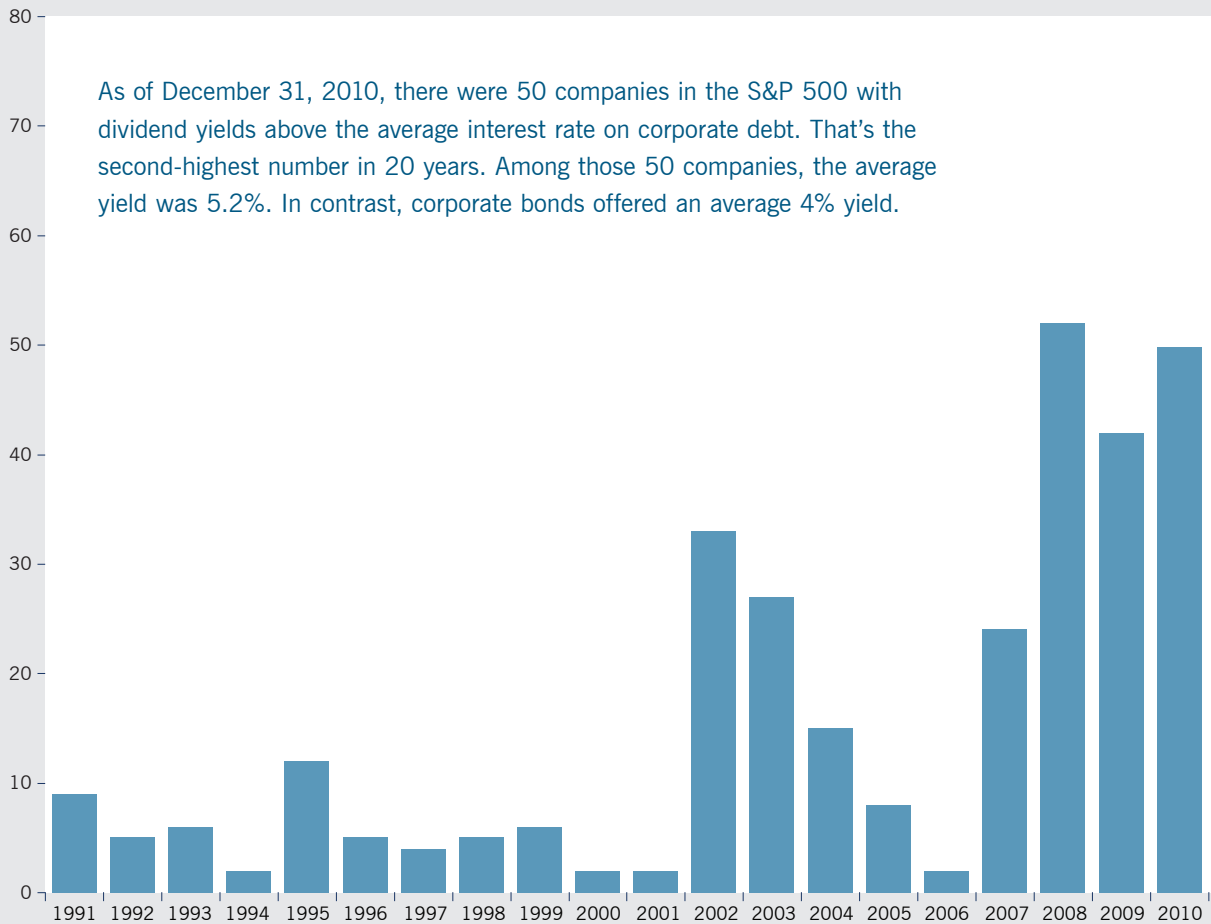
Sources: IHS Global Insight and the National Bureau of Economic Research, Inc. Data are based on the non-financial corporate sector.

- Corporate profits continued to rebound during 2010. For all U.S. companies, the Bureau of Economic Analysis estimates third-quarter pre-tax profits rose to an annual rate of \$1.7 trillion, up 27.8% from a year earlier.
- The \$1.7 trillion is the highest figure recorded since the government began keeping track 80 years ago, at least in nominal or non-inflation-adjusted terms.
- The chart shows that over the past 40 years the end of recessions in the U.S. has generally been followed by a period of sustained improvement in corporate profit margins. After falling to about 9.4% near the end of the recession in 2009, the pre-tax corporate profit margin has rebounded to nearly 13% as of September 30, 2010.
- While U.S. companies are rebounding relatively quickly from the recession and posting near-historic profits, some of the increase in profits can be attributed to aggressive cost cutting and increased productivity as corporations reorganize to cope with lower revenue and a somewhat uncertain outlook. In short, many companies are doing more with less.

“In the financial crisis decline, we saw U.S. companies, more than others, adjust their cost structures. Sometimes, that’s a painful process, but then when things get better, you can be at the forefront again.”

— Don O’Neal, *portfolio counselor*

Number of companies with a dividend yield above the average interest rate on corporate bonds



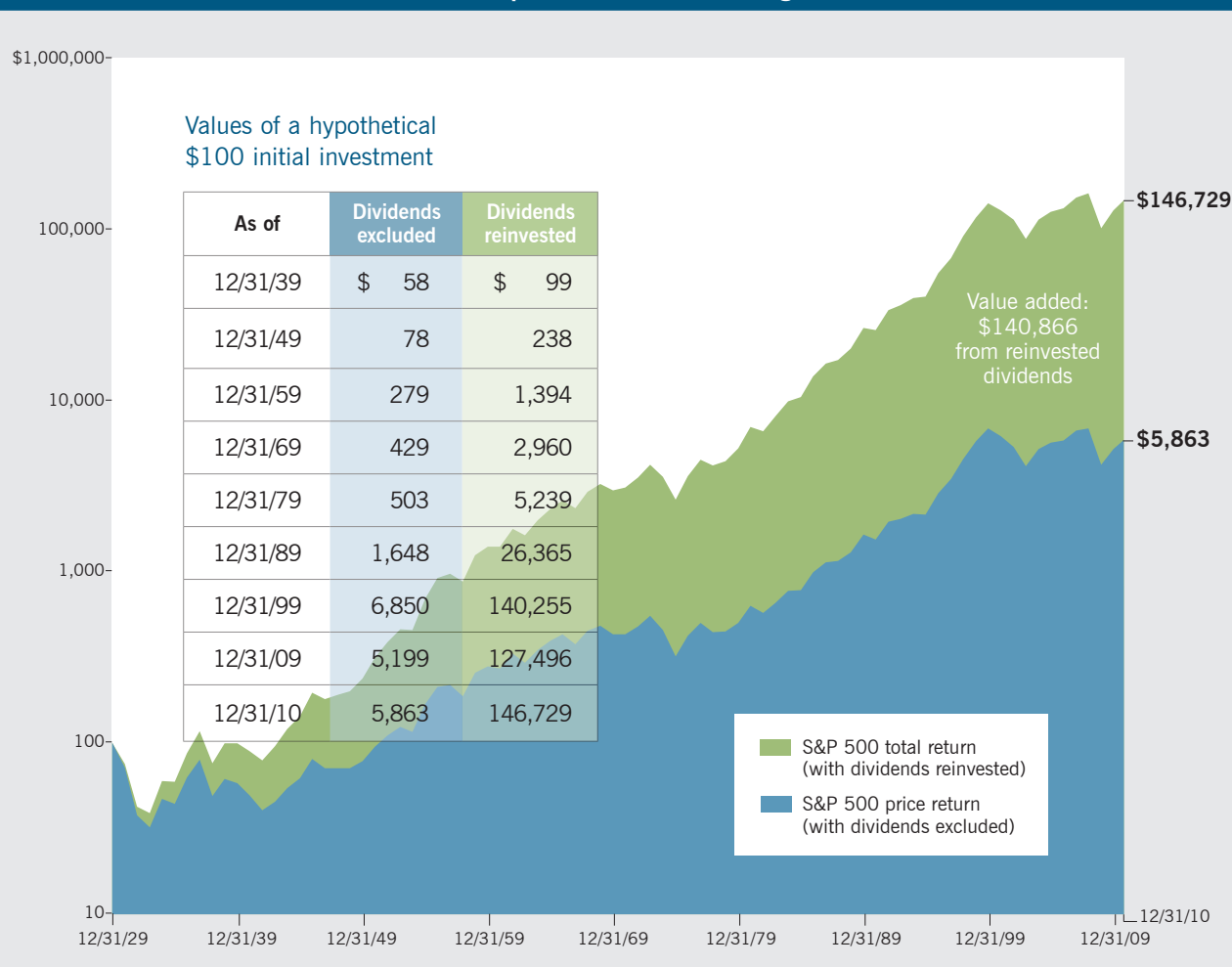
Source: FactSet. The data are based on the constituents of the S&P 500 Index for each year ended December 31. The dividend yields of the S&P 500 companies were compared with the yield on corporate bonds, as represented by the Barclays Capital U.S. Corporate Index.

- Dividends paid by S&P 500 companies declined by a record amount in 2009, but during the past year there have been several changes that may bode well for long-term investors who focus on income.
- One significant change is the increase in the number of companies with dividend yields higher than the average yield on corporate bonds (see chart).
- There are also signs that companies are beginning to reconsider dividend payments to shareholders. Year-to-date ended December 31, 2010, S&P 500 companies increased or initiated dividends 256 times, compared with only four decreases and one suspension.
- The yield on corporate bonds is low partly because of high demand, in some cases by risk-averse investors who have opted for the relative certainty of bonds and as of December 2010 are receiving the average yield of 4% rather than assuming equity risk. But for long-term investors, there may now be an opportunity to invest in companies that provide a higher yield, and have the potential for capital appreciation.

“Many of the companies that are increasing dividends are the ones that didn’t run into huge problems as a result of the downturn. In our view, these are good, long-term oriented companies with steadier incomes and a history of increasing payouts.”

— Joyce Gordon, *portfolio counselor*

The real value of reinvested dividends is expressed with a dollar sign



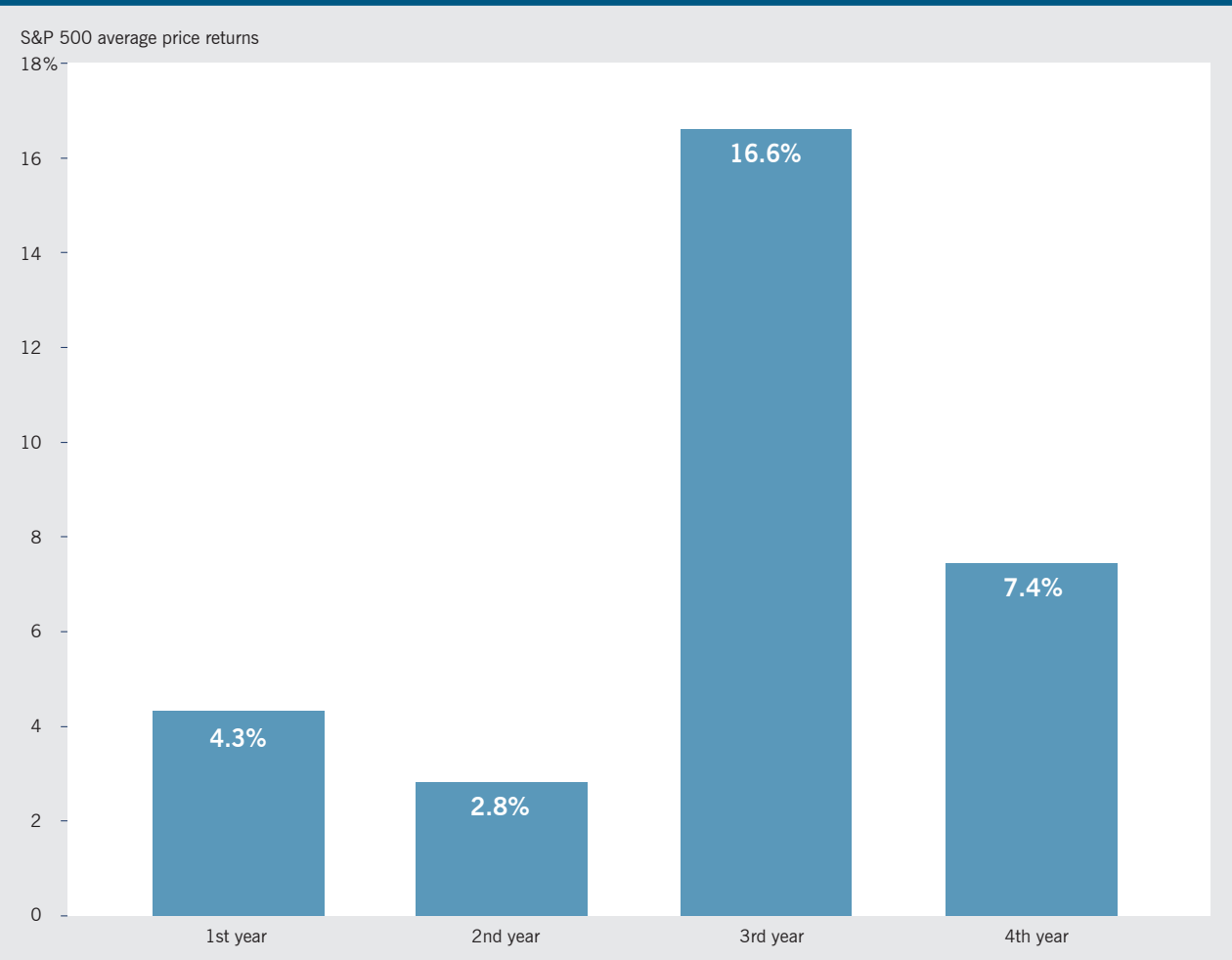
The ending value of \$5,863 for the S&P 500 price return does not include dividend income totaling \$2,554 taken in cash. The index is unmanaged, and its results do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

- Dividends have historically accounted for a relatively significant portion of investors' long-term total returns. Of course, these are historic returns and not predictive of future results. In this example, with dividends reinvested, a hypothetical \$100 investment in the S&P 500 would have grown to \$146,729 from December 31, 1929, through December 31, 2010. The \$100 invested in the price-only S&P 500 would have grown to \$5,863. In addition, the investor who chose to take dividends in cash during the period would have received \$2,554.
- How did the ending value of one hypothetical investment reach a level so much higher than the other? Part of the answer lies in the power of compounding. Reinvested dividends buy more shares, so the number of shares can increase over time. Because dividends are paid on a per-share basis, the greater number of shares leads to more dividend income, which can be used to purchase more shares, thus completing the virtuous cycle of compounding.

“Good companies may very well emerge from this downturn less interested in growing for growth’s sake and more interested in rewarding investors with dividends and dividend growth.”

— Steven Watson, *portfolio counselor*

The market has advanced in every year following a mid-term election since 1940



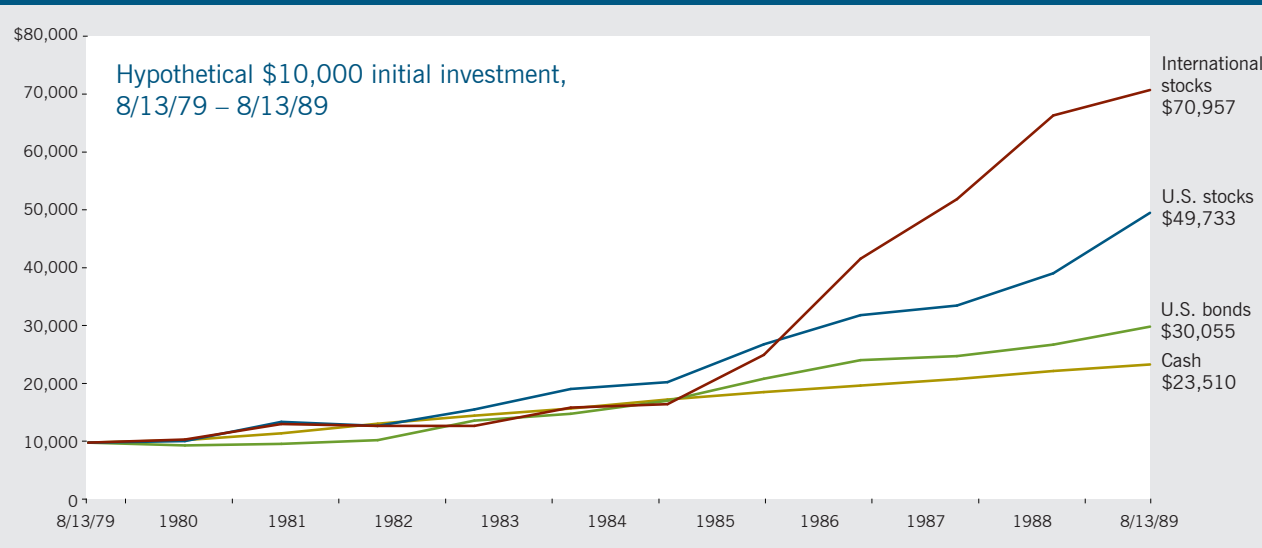
Average price returns based on election dates, 1940-2008. The index is unmanaged, and its results do not include reinvested dividends, distributions, sales charges, commissions, account fees, expenses or taxes.

- The mid-term elections in 2010 marked the beginning of the third year in the presidential election cycle. While elections can create feelings of uncertainty for some investors, there's one thing that can be said without debate about the third year of a president's term, regardless of which party is in power: Since 1940, the third year has been a good year for the stock market.
- From 1940 through 2008, Standard & Poor's 500 Composite Index has advanced in every third year of the presidential cycle, with the price return in 13 of the 17 years exceeding 10%. The highest return, 33.9%, came in 1955-56 during the Eisenhower administration; the lowest, 1.8%, came in 1987-88 during Ronald Reagan's presidency. The average price return for the S&P for those 17 third years since 1940 is 16.6%.
- The conclusion one could draw from these statistics is that the equity markets are a sure thing in 2011. However, the current economic and political environment can also affect global equity markets. While no period is without uncertainty, we believe successful long-term investors stay the course, relying on time rather than timing, regardless of an election's outcome. Over the long term, investment success has depended more on the strength and resilience of the American economy than on which party holds office, or what year of an election cycle we are in.

"In the second half of the four-year term, the people in political office begin campaigning again, and so they don't do so many disruptive things. So, the third year of the cycle has almost always been a very positive market year and the fourth year has also often been favorable."

— Jim Dunton, *portfolio counselor*

Defying doomsayers, stocks around the world rose from the “dead” in the 1980s



Sources: MSCI World ex USA Index (international stocks), S&P 500 Index (U.S. stocks), Barclays Capital U.S. Aggregate Index (U.S. bonds) and U.S. 91-Day Treasury Bills Index (cash). The indexes are unmanaged, and their results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or taxes. U.S. Treasury bills are guaranteed by the full faith and credit of the U.S. government.

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- On August 13, 1979, *BusinessWeek* published one of the most enduring and controversial stories in the history of the financial press. The story was called “The Death of Equities.” The piece claimed that investors, burned by years of poor returns in the 1970s, had abandoned stocks for good.
- At the time the story was written, the stock market had sustained serious losses and the long-term health of the U.S. economy was a significant concern, largely because of inflation. Indeed, the secondary headline on the story read “How inflation is destroying the stock market.”
- The period was fraught with bearish headlines, troubling events and disappointing economic news, all of which fueled feelings of uncertainty. The recovery from the dramatic market decline in 1973-74 was frustratingly slow due to tepid economic and market conditions.
- While the current headlines and economic news may resemble those of 1979, it’s important to remember that every market cycle is unique. The key is to stay focused on long-term goals. As the chart shows, investors who stayed the course were rewarded over time.

“In 1979, we experienced the same sort of situation that we have just gone through, when *BusinessWeek* published “The Death of Equities.” Each era is different, of course, but that was near the beginning of the greatest bull market we’ve ever experienced in this country.”

— Jim Dunton, *portfolio counselor*