Annualized Total Return from 12/31/69 through 11/30/12 was 9.89% with dividends reinvested quarterly.
A Half-Hearted Recovery

The U.S. is expanding more rapidly, but the pace is still lackluster.

It may not really feel that way, but looking at the numbers, a sustained and strengthening economic recovery awaits the U.S. in the year ahead. It just won’t be that exciting.

The job market is improving, if slowly. The housing market has apparently reached bottom and is now starting to revive as well. Consumer confidence is fairly strong, keeping auto sales buoyant. Interest rates are low, and the Federal Reserve has promised to keep them low — provided inflation stays tame — “at least” until unemployment drops below 6.5%. That might take a while.

“We have some solid reasons to feel optimistic,” says Beth Ann Bovino, Standard & Poor’s Economics deputy chief economist. “It looks like the economy could finally be in a self-sustaining recovery, and even Hurricane Sandy is unlikely to stop this trend.”

Don’t get too excited, though: the U.S. economy won’t heat up much in 2013.

Bovino forecasts gross domestic product growth of 2.3% next year, compared with 2.1% for 2012, but that should accelerate again to 2.7% in 2014 and 3.1% in 2015, led in large part by a rebound in housing.

Of course, the major threats to the domestic and global economy are still far from resolution. In the U.S. a January 1 deadline hangs over income tax rates and automatic federal spending cuts, and further acrimony lies ahead as the government is set to reach its legal borrowing limit sometime in the first three months of the year.

In Europe, bond yields have receded from their 6% “Red Alert” levels, but Spain has not yet requested the bailout it is widely believed to need and brinksmanship over funds needed by Greece to avoid default has almost become a spectator sport.

China’s economy appears to be reversing a worrisome slowdown earlier in the year, though a return to the days of better than 10% annual growth seems unlikely any-time soon.

How these threats impact global equity markets in 2013 is anyone’s guess. While the potential is there for any of them to widen and put a damper on the recovery, so too is there the chance for a positive resolution that would clear the way for a significant rally.

For now, markets will draw strength from the “proactive” attitude of the Federal Reserve, says Sam Stovall, S&P Capital IQ chief equity strategist, especially its decision to directly link interest rate policy with employment rates. “By indicating that they will maintain this asset-purchase program until unemployment and inflation thresholds have been met, rather than focusing on a fixed-date target, we believe the Fed is signaling that they aim to stimulate inflation-controlled economic growth,” he says.

— Vaughan Scully

S&P Capital IQ Editorial

MARKET MEASURES

CLOSE CHG. CHG.
INDEX 12/14/12 YEAR TO PAST OPERATING EARNINGS P/E RATIO 12/14/12 ANNUAL DIVIDEND YIELD
S&P 500 Composite 1413.58 12.4 15.9 96.44 993.46 14.21 32.40 2.29
S&P MidCap 400 1001.53 13.9 17.0 50.51 955.51 18.04 15.42 1.54
S&P SmallCap 600 461.39 11.2 14.3 20.59 922.57 20.44 8.24 1.79
S&P SuperComposite 1500 326.33 12.5 15.9 21.50 922.32 14.63 7.22 2.21

Dow Jones Industrials 13135.01 75 10.7

Nasdaq Composite 2971.33 14.1 16.3

BBB Indus. Bond Yield (10-yr.) 3.80 -0.69 -0.69

Data through 12/14/12. E-Estimated. 1Based on estimated 2012 earnings. 2Before special factors. 3Actual change in yield (not percentage change). Sources: S&P Capital IQ and Thomson ONE.

S&P Capital IQ’s The Outlook

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S&P CAPITAL IQ EVALUATION SYMBOLS

STARS Rankings
Our evaluation of the 12-month potential of stocks is indicated by STARS:

Strong Buy — Total return is expected to outperform the total return of a relevant benchmark by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

Buy — Total return is expected to outperform the total return of a relevant benchmark over the coming 12 months, with shares rising in price on an absolute basis.

Hold — Total return is expected to closely approximate the total return of a relevant benchmark over the coming 12 months, with shares generally rising in price on an absolute basis.

Sell — Total return is expected to underperform the total return of a relevant benchmark over the coming 12 months, with shares falling in price on an absolute basis.

Not ranked.

Quality Rankings [QR]
Our appraisals of the growth and stability of earnings and dividends over the past 10 years for STARS and other companies are indicated by Quality Rankings:

A+ Highest
A High
A Above Avg.
B+ Average
B Below Avg.
B- Lower
C Lowest
D Poor
NR Not ranked

Quality Rankings are not intended to predict stock price movements.
Global Asset Allocation Update

The allocation model is unchanged.

Going back to 2011, the S&P Capital IQ Investment Policy Committee has advised holding a neutral asset allocation: the recommendation is presently 45% domestic equity, 15% foreign equity (10% developed and 5% emerging market), along with 25% fixed income and 15% cash. This recommendation takes into account both fast changing market conditions and the delicate balance between equity valuations and expected earnings growth on one hand, and political risks among others to the global economy on the other.

The last time the recommendation was changed was in March, 2011, when the committee voted to reduce its 20% foreign equity allocation to 15%, and raise its fixed income allocation from 20%.

The 45/15 split between domestic and international equities is in line with the committee’s custom benchmark, says Alec Young, S&P Capital IQ global equity strategist, but allocating 5% within the international allocation to emerging markets is something of a departure, and represents the committee’s bullish view on emerging market equities relative to developed international.

“The reasons for our ‘overweight’ stance include our view that emerging markets will outperform developed international equities in 2013,” Young says, based in part on the discount valuation emerging markets trade at compared with both their long-term average and current valuations for developed nations such as Canada, Australia, Europe, and Japan. He sees an improvement in emerging market economic growth, including a rebound in China’s growth in late 2013, as well as a stabilization of the European sovereign debt crisis helping emerging market equities rally in the year ahead.

Young recommends investors gain emerging market exposure via broadly diversified funds than trying to single out a single country or region for outperformance. “Country calls matter less when broad index performance ramps up as you’re maintaining solid returns despite having less risk,” he says. “We’d rather play this via the broad index given our bullish outlook.”

On a sector basis, the committee recently upgraded its recommendation for industrials to “overweight” from “marketweight.”

“We believe this sector is positioned to outperform the broader market as investors discount further Fed policy accommodation, an expected gradual improvement in global GDP in 2013 and economic stabilization in China on the heels of the recent improvement in Chinese economic data,” Stovall says, “despite the sector’s slight valuation premium on 2013 EPS estimates of 12.8, versus the broader market’s 12.6 multiple.”

In addition to its industrials recommendation, the committee has “overweight” recommendations on the consumer discretionary and health care sectors, and “underweight” recommendations on materials and utilities.

Portfolio Changes:

BB&T [BBT 28.58 ★★★★★] and Trinity Industries [TRN 34.17 ★★★★★] were added to, while Express Scripts [ESRX 54.12 ★★★★] and Travelers [TRV 73.23 ★★★] were deleted from, the Platinum Portfolio effective Tuesday, December 11.
2013 U.S. Equity Outlook

Modest appreciation expected, with upside surprise potential.

The election is over, the status quo has been re-elected, and the global headwinds remain unchanged. Where do we go from here?

S&P Capital IQ’s Investment Policy Committee has a 12-month forward target on the S&P 500 of 1550, implying an 8.5% advance from the December 12 close. Our base case scenario calls for gradually accelerating growth in the U.S. and global economy, a sequential quarterly recovery in S&P 500 earnings-per-share (EPS) growth rates, and share prices that are supported by modest valuations, low rates, and bearish sentiment. Despite the potential for higher tax rates on dividends, we still recommend high-yielding equities, provided they carry above-average S&P Capital IQ Quality Ranks and STARS.

If This Were a Normal First Year

If this were a “normal” first year of a president’s term in office, we would not expect too much out of the U.S. equity market. Since 1900, the S&P 500 has posted its weakest performance in the first year of the four-year presidential cycle, rising an average 4.3% and recording a positive performance 57% of the time. Following the re-election of the President or his party, the “500” did a little better, however, gaining 4.7% and rising in price 65% of the time. Both returns are higher than what history says, but doesn’t guarantee, could have been expected had the Republicans regained control of the presidency, as the S&P 500 rose only 3.7% on average, and increased in price only 45% of the time, when the incumbent was replaced.

Yet first-year stock market results have traditionally been weak, as the party in power seeks to address national ills early on, so they may be resolved (or forgotten) by re-election time. This typical lack of stimulus — and at times outright recession — weighs heavily on investor confidence. This time around, we have an additional worry: the gridlock that has historically come from a divided Congress, which will likely have quite a dampening effect on the stock market’s performance.

The S&P 500 has risen by an average 6.7% during all calendar years since 1901. During years when the executive and legislative branches of government were controlled by the same party (which happened 66 years out of 112), the S&P 500 advanced an average 7.6%. Whenever the President was from one party but both houses of Congress were from another party, which occurred 34 times, the market gained an average 6.2%. Yet when Congress was split, which happened only 12 times, the market’s average annual advance dropped to 3.7%, or less than half of the average performance under a totally unified government. (An interesting factoid is that the S&P 500 performed best under Democratic presidents, regardless of Congressional makeup.) This year, pressure will fall upon a split Congress to prove that they can lead rather than impede.

Factors in Our Favor

Despite the plethora of obstacles facing investors today, we are cautiously bullish on the coming year for a variety of reasons:

- A U.S. economy that is likely to gain, rather than lose, altitude.
- The projected trough in global gross domestic product (GDP) growth.
- A modest “V”-shaped trajectory in EPS expectations.
- Attractive trailing and projected valuations.
- Improving international equity expectations.
- Excessive bearish sentiment.

EPS Deceleration Reversal?

The deceleration in quarterly year-over-year growth for S&P 500 operating earnings per share has been of concern for many investors over much of the past year, but the summer slump is expected to be the low point for this earnings cycle. Wall Street estimates call for sequentially higher growth between the fourth quarter of 2012 and the fourth quarter of 2013.

Granted, these estimates could be vulnerable to further downward revisions, encouraged by still-weak revenue growth, but not likely in isolation. Revisions to the expected quarterly trough in global GDP growth, indeed the general outlook for most growth drivers in the coming year, would be required in order to justify a dramatic reversal in EPS growth projections, in our opinion.

Attractive Valuations (if You Believe the Estimates)

As of November 23, the S&P 500 traded at 13.9-times trailing 12-month operating EPS, representing a 22% discount to the median multiple of 17.9 since 1988. The market is currently trading at only 12.4-times projected 2013 results, a 31% discount to the median. Since some call operating results “earnings before bad stuff,” we note that the S&P 500 is trading at 16.1-times GAAP earnings per share, which is a 21% discount to its median since 1988. What’s more, if you are like the author James Michener and prefer to go back to the beginning of time, you will see that the S&P 500 is trading near its median multiple since 1936, and at an 11.5% discount on 2013 estimates.

The gap between bottom-up EPS estimates for the S&P 500 (based on individual company forecasts brought up to the S&P 500 level) and top-down (based on global GDP growth estimates whittled down to the S&P 500 level) is again...
relatively wide. The 2013 bottom-up estimate, according to Capital IQ consensus estimates, is $113.19/share, versus our top-down estimate of $107.73/share. Based on the current multiple of 13.9, these two numbers point to very different possible year-end 2013 valuations of 1573 and 1497, respectively. Also, this target band could widen further should investors expand or contract the multiple due to changing assumptions: A multiple of 15 on $113.19 supports a target of 1698, while 12.5 on $107.73 justifies an S&P 500 target of 1347.

**Equities: Focus on Quality**
There have been a variety of recommendations by strategists on which sectors and stocks are likely to be beneficiaries of a President Obama re-election. Yet many of these groups and issues have already been bid up, in our opinion, and are now less attractive. One approach that we believe will never go out of style — regardless of party in power or tax policy embraced — is the focus on reasonably priced quality. Whatever the conclusion of the current fiscal cliff standoff, higher taxes on dividends will likely be included, in our opinion. Yet, that doesn’t mean that investors should avoid dividend-paying stocks. First, it is becoming increasingly difficult to find stocks without a yield, as 80% of S&P 500 companies now pay a dividend. Second, the tax on dividends, at worst, will be equal to that on bonds, in our opinion. And with the yield on bonds near historical lows, and the economy likely to pick up the pace rather than slip back into recession, we believe there is greater risk to owning bonds than dividend-paying stocks.

So there you have it. S&P Capital IQ’s Investment Policy Committee sees the S&P 500 posting a modest advance in price to 1550 in the coming 12 months on a gradual increase in global economic growth rates, sequential improvement in quarterly earnings, attractive trailing and projected valuations, and still-bearish investor sentiment. Granted, the case for another recession and bear market may sometimes sound convincing, yet this negative scenario has been in place for months and the S&P 500 has advanced more than 10% from its early-June low. We believe the market is looking beyond the troughs in GDP and EPS growth. And while debt discussions from Europe and the combative rhetoric from Washington will likely keep investors’ nerves on edge, we believe equities offer a more attractive investment opportunity than bonds. We recommend screening for high-quality issues with favorable relative valuations that offer above-market dividend yields.
2013 International Equity Outlook

Modest prospects for 2013 make dividend yield a key.

Consensus economic projections reveal only cautious optimism for global growth in 2013. The U.S., U.K., eurozone, Japan, and Canada — which combined represent 60% of global gross domestic product (GDP) — are all seen growing by 2% or less. Growth is forecast to reach an annual rate of 3% by the fourth quarter from 2.2% in the first quarter. Overall, global real GDP growth is estimated at 2.6% in 2013, up slightly from the 2.2% seen for 2012, according to a Bloomberg consensus estimate. We believe this cautious outlook reflects three significant macroeconomic risks to the health of the global economy: the resolution to the U.S. “fiscal cliff,” Europe’s recession and debt crisis, as well as the still unknown trajectory of China’s growth. All three will go a long way to shape corporate profitability, and hence our analysis of the 2013 overseas equity outlook begins there.

The U.S. Fiscal Cliff

Consensus expectations for 2% U.S. GDP growth in 2013 clearly imply markets expect a solution that would mitigate the effect of the $668 billion in spending cuts and tax increases set to take hold on January 1, 2013. We believe the mere possibility of such an unprecedented macro headwind has served to dampen both U.S. and international growth expectations and with it, equity performance. An extension of current U.S. tax rates for at least six months coupled with a bipartisan agreement to tackle comprehensive tax and entitlement reform in 2013 is needed to diffuse investor concern over this issue, in our view.

The European Sovereign Debt Crisis

Still ailing from its three-year-old sovereign debt crisis, Europe dipped back into recession in the third quarter of 2012 as austerity-induced spending cuts and tax increases stoked rising unemployment, especially in southern European countries like Spain, Italy, and Greece. However, in part due to a proactive monetary policy from the European Central Bank, the consensus sees the eurozone recession ending by the third quarter of 2013. With Europe’s economy recording little or no growth for several years now, markets have largely discounted the region’s weakness, in our view.

While the pace of any 2013 recovery will have some bearing on earnings-per-share (EPS) growth and equity performance, we see equities trading more in correlation with sovereign stress indicators in European bond markets. Over the past few years, international stocks have moved in virtual lockstep with peripheral-nation sovereign bond yields. After a brutal spring swoon, equity performance has improved since July when European Central Bank President Mario Draghi vowed to defend the euro at all costs and introduced a bailout plan that drove down borrowing costs for heavily indebted nations. Overall, we think the worst of the European sovereign debt crisis is behind us.

Chinese Growth

As the world’s fastest-growing major economy, we think China’s ability to maintain strong growth is key to the global outlook, especially given Europe’s recession, anemic growth in Japan, and the risk of fiscal drag in the U.S. Recent news has been encouraging, with industrial production, retail sales, and exports all

### Consensus Sees Modest, Uptick in Global Growth in 2013

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<thead>
<tr>
<th>Region</th>
<th>Q3 ’12E</th>
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<th>Q1 ’13E</th>
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Source: Bloomberg, IHS Global Insight (through 11/15).
rebounding from their summer troughs. In addition, Chinese manufacturing moved back into expansionary territory in October led by a rebound in new orders and production. With inflation tame at less than 2%, we see room for additional fiscal and monetary policy easing in the second quarter of 2013. The consensus sees China's 2013 growth in "soft landing" territory at 8.1%, according to Bloomberg estimates.

India's growth should rebound somewhat to 6% next year from an estimated 5.6% this year, according to consensus, although stubbornly high inflation of 7.9% is precluding more aggressive central bank stimulus. As for Brazil, growth is expected to rebound to 4% from 1.5% in 2012. Lastly, other major developing economies like Mexico, Russia, South Africa, and Turkey are all seen posting healthy 3% to 4% growth next year. Overall, IHS Global Insight, an independent forecasting firm, sees emerging economies posting collective GDP growth of 5.2% in 2013, up from an estimated 4.9% in 2012.

Since we don’t see 2013 as a banner year for international stocks, we recommend a focus on equity income as a means of supplementing total returns. International equities generally yield more than their U.S. counterparts, with developed European markets leading the way. However, high yields don’t tell the whole story. Instead of reaching for yield, we suggest seeking out high levels of current income combined with dividend payout ratios below 60%. On that basis, we see the emerging market asset class offering attractive income potential, as its 3.1% yield is paired with only a 36% dividend payout ratio, well below the elevated 87% payout ratio of the MSCI EAFE Index of developed overseas stocks. At the country level, Brazil jumps out to us as attractive, with a healthy yield of 3.8% and a dividend payout ratio of 49%. On the developed side, we see Switzerland and France as the best overall income plays since they offer yields of 3.8% and 4.4%, respectively, while maintaining what we consider to be reasonable dividend payout ratios of 59%, and 56%.

**Conclusion**

While 2013 global macroeconomic visibility is less than stellar, we see both developed foreign and emerging market stocks rising modestly next year, with dividend yields key to total return. Given our view that the full brunt of the U.S. fiscal cliff will be avoided, China will maintain growth in the 7.5%-8% range, and a Lehman moment will likely fail to transpire in Europe, we see mid-single digit EPS growth in 2013, and we believe current valuations leave room for modest equity price appreciation.

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**2013 International Equity Outlook (Continued)**

![LOWER DIVIDEND PAYOUT RATIOS ENABLE DIVIDEND GROWTH](chart)

Source: Bloomberg (through 11/16).
The imminent arrival of a new year marks as good occasion as any for updating market conditions in the year ahead. To help with that, equity analysts at S&P Capital IQ have compiled a list of predictions for 2013, organized by sector.

**Consumer Discretionary**

We expect companies in the consumer discretionary sector to keep up a healthy pace of share buybacks in 2013. Among retailers, we see moderating top-line growth for specialty apparel retailers due to tougher comparisons and increasing international competition. Strong demand for low-priced items will likely push dollar stores to expand their square footage.

We project e-commerce retail sales growth of approximately 15%, driven by increased shopping on smart phone devices. We think retail sales channels will move towards convergence, with consumers viewing online, mobile, and brick-and-mortar offerings as one integrated channel.

We expect hotels to see improved results in 2013, helped by supply growth of less than 1% and a rebound in group travel. While Las Vegas and other regional markets should experience uneven performance for casinos and gaming companies, Macau should be relatively healthy.

**Consumer Staples**

We see consumer staples companies increasing their use of the Internet for marketing, promotion, brand-building, and identification of consumer interests/trends.

There should be a further shift toward what are perceived as healthier and environmentally friendly products. We think branded goods companies will have limited ability [and interest] in raising prices due to a sluggish consumer environment and competitive factors, including private label.

For tobacco, we expect pricing to rise, albeit offset from time to time by promotions, and the introduction of new products such as e-cigarettes and other smokeless nicotine products. Spirits sales should be healthy on higher pricing and emerging market growth. We are cautious on beer given what we see as increasing competition, particularly in the craft segment, consumer preference moving away from beer, and higher input costs. In non-alcoholic beverages, we expect product news to be driven by non-carbonated beverages, natural sugar substitutes, and mid-calorie carbonated beverages.

**Energy**

With 2013 should come a slight narrowing of the spread in price between the international benchmark grade, Brent Blend, and the U.S. benchmark West Texas Intermediate. We expect the Brent-WTI differential to vary from $15 per barrel to $18 per barrel. Although our forecast is below November’s $22.52 per barrel spread, it is still well above the $3 per barrel to $4 per barrel average from 2006 to 2012. We expect infrastructure build-out from the trading hub at Cushing, Oklahoma to the Gulf Coast and from the Permian Basin to the Gulf Coast to help narrow the spread. We estimate new and expanded pipelines from Cushing and the Permian Basin to the Gulf Coast will add more than 1.3 million per day of capacity in 2013.

U.S. land rig counts should decline in 2013. As of December 7, 2012, the U.S. lower 48 rig count stood at 1,800 rigs, down almost 10% from a year earlier. We see a further reduction of about 5% in 2013, as customers use improved drilling techniques and technology to drill the same number of wells with fewer rigs.

We see the U.S. Gulf of Mexico deepwater recovery extending in 2013. The count of active deepwater drilling units in the U.S. Gulf stood at 33 at the time of the April 2010 oil spill, and now stands at 39 units. We think that by year-end 2013, the active deepwater rig count will number 45 or more, an uptick of more than 35% versus pre-spill levels.

**Financials**

We see investment banks and brokerage firms are reducing risk levels and capital to match lowered expectations for sales and trading and investment banking. We see retail real estate investment trusts benefitting from healthy demand for retail space and a lack of new supply.

While we see the three largest banks — JPMorgan Chase [JPM 42.78 ★★★★], Bank of America [BAC 10.54 ★★], and Citigroup [C 37.29 ★★★★★] reporting little if any revenue growth in 2013, that’s a significant improvement from a 5% decline seen in 2012 and a 10% decline in 2011.

We see retail real estate investment trusts benefitting from healthy demand for retail space and a lack of new supply, with occupancy and rental rates improving over the year.

We believe that life insurers will be adversely affected by low interest rates, but their diversified business models should help offset that. Property-casualty insurance pricing will firm, we believe, though there still exists excess underwriting capacity in the marketplace.
What to Look for in 2013  (Continued)

For custody banks, consumer finance, and asset management companies, we see a slow and slightly volatile economic recovery bringing improved consumer confidence.

Health Care
We see 2013 as likely to be a relatively uneventful year compared to the tumultuous past two years and to 2014, when it is anticipated as many as 29 million currently uninsured Americans will join the health insurance system.

Although we expect pharmaceutical sales growth to be challenging in 2013 as additional drugs go off-patent, we don’t anticipate the large declines witnessed in 2012. On the flip-side, we see generic drug manufacturers benefitting from patent expirations and we look for low double-digit sales growth for generic drugs.

The medical device industry is challenging the 2.3% excise tax that will be applied to all U.S.-based sales beginning in January 2013. We believe the tax is manageable and many firms will simply implement larger price increases.

Industrials
We believe demand for building products will become particularly robust in 2013. We see repair and remodeling markets rebounding, with the rebuilding from Hurricane Sandy further boosting home repair spending over the coming year. In addition, new housing starts have started to pick up from their depressed levels of recent years, and should soon start to boost building products markets.

We expect airlines to benefit from strong pricing power in 2013. We think there is pent up demand for both corporate and leisure travel, and that a better economy will keep planes full at fares that are favorable to the airlines. Moreover, we think energy prices will be low enough to allow solid profitability for airlines.

We see logistics companies recording volume growth in both the U.S. and foreign markets, and we expect a shift towards faster, higher-priced delivery methods as the economy improves. We think that UPS’s [UPS 73.35 ★★★★] planned $6.8 billion purchase of TNT Express will go through despite challenges by EU regulators, and that FedEx [FDX 89.71 ★★★★★] will respond with acquisitions of smaller package delivery companies in Europe.

Information Technology
We think the semiconductor equipment industry is nearing a sequential trough in orders, and anticipate improving demand trends in the first half of 2013. However, we still think industry sales will fall by about 5% to 10% during the year. We forecast PC shipments will decline by at least 3% in 2013, as demand for tablets rises.

As for tablets, we expect to witness growth of 30% to 40% in the coming year.

We think Apple [AAPL 529.69 ★★★★★] will more specifically pursue emerging market opportunities, with efforts that could include an alliance with China Mobile [CHL 57.06 ★★★] and/or a lower-priced iPhone. We think Google [GOOG 702.70 ★★★] will make a large strategic move, via internal investment or acquisition, focused on e-commerce and/or payments. We believe Microsoft [MSFT 27.11 ★★★] will generate some success in the mobile category in 2013, as the adoption of Windows 8 slowly progresses.

We expect Microsoft’s greatest success in 2013 to be in tablets and see a possibility the company also develops its own smartphone. While Apple and Google are likely to still dominate the mobile operating system space in 2013, Microsoft should see notable share gain, albeit from low levels.

Materials
We see gold prices rising in 2013, and even with flat production in 2013, overall we’re expecting solid earnings per share (EPS) growth from gold miners.

Paper and forest product companies should turn in a nice 2013. Lumber and panel prices are up, and paper packaging prices rose in October for the first time after two years.

Steel producers can expect a relatively weak year in 2013. While many steel producers have tried to raise prices in recent months, the price hikes are not taking, due in part to domestic overcapacity.

Telecommunication Services
We predict further wireless consolidation in 2013, with further smaller deals as well as spectrum sales and swaps. We believe Sprint Nextel [S 5.64 ★★★★★] could be a further consolidator once its deal with Softbank closes.

We believe regional carriers such as Leap Wireless [LEAP 6.75 ★★★] could look to sell excess spectrum and underperforming markets in order to maximize their earning potential and raise cash to pay down debt and build out advanced LTE networks.

We believe the increased adoption of smartphones will also result in a sharp spike in data usage as the LTE smartphones will be more conducive to downloading and accessing video. We believe companies such as Qualcomm [QCOM 62.76 ★★★★★] and the tower providers including American Tower [AMT 76.09 ★★★★★], Crown Castle International [CCI 70.48 ★★★★★] and SBA Communications [SBAC 69.06 ★★★★] will benefit from this trend. 

[Continued on page 10]
Money flooded into taxable bond mutual funds again in 2012, a trend that has been underway for several years now. While equity mutual funds have experienced outflows, hurt we think by a focus on income generation and competition from lower cost ETF alternatives, investors still sought out new bond strategies and, in general, taxable bond mutual funds had a good year. For the year to date through November 2012, taxable bond mutual funds posted a total return of 7.7%, up from 4.4% in 2011. As investors look to 2013, when interest rates are expected to remain low, it’s tempting to jump into one of this year’s top performing funds, but not all of this year’s winning funds earn a top ranking from S&P Capital IQ.

In ranking bond funds, our approach uses a combination of relative performance metrics together with other important traits about the portfolio. We want to provide perspective on the risk being incurred, either through duration [interest rate sensitivity] or credit quality, to generate yield. In 2012, we have seen yields come down amid strong demand. As such, some of the better performing funds in 2012 do not receive a five-star ranking because of their weakened risk/reward profile. Additional ranking inputs include cost factors, the most prominent being a fund’s expense ratio. In light of currently low interest rates and competition from a growing number of exchange trade fund [ETF] alternatives [see page 11 for more details], we highlight two taxable bond mutual funds that earn a five-star ranking, have had relative success thus far in 2012, and incur an expense ratio of less than 0.50%.

**TCW Total Return Bond Fund**

This strongly performing diversified bond fund [TGLMX 10.33 ★★★★★] owns a mix of mortgage, asset-backed, and U.S. Treasury bonds and keeps duration well under control, according to our research. The fund was up 12.4% for the year through November, making it the best performing fund in its peer group, an accolade it just barely missed in calendar 2010 when it was the third best in a group of 85 funds. The fund’s recent 30-day SEC yield of 3.93%, well above the 1.73% peer average, stems in part from taking on some credit risk as 21% of assets were in bonds with credit ratings of B or below. However, half of the fund’s assets were in AAA or AA-rated bonds. The expense ratio is a modest 0.44%.

**Vanguard Long-Term Investment Grade Fund**

Posting the same 12.4% year to date gain, this fund [VWESX 10.95 ★★★★★] has been having a good year also after besting its peers in 2010 and 2011 as well. As the name suggests, it takes on greater duration risk than the average bond fund, but holds securities with mostly investment-grade credit ratings; as of September 2012, 53% of assets were in bonds rated A and 25% in bonds rated AA. In contrast to the TCW fund, 71% of the assets were in U.S. corporate bonds and 8% were in foreign corporate bonds, with just 19% in U.S. government or agency bonds. Its recent yield was 3.97%. The expense ratio is just 0.20%.

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**What to Look for in 2013** (Continued from page 9)

**Utilities**

We believe Exelon [EXC 29.68 ★★★] will reduce its dividend in 2013. Exelon could reduce its dividend by $0.70 (33%) to $1.40, and still have a yield of around 4.7%, above the 4.4% current peer average.

We expect to see Edison International [EIX 44.49 ★★★] deconsolidate its Edison Mission subsidiary following its anticipated bankruptcy filing. Edison International’s earnings would then reflect only the regulated Southern California Edison and the holding company.

We believe ITC [ITC 78.09 ★★★★★★] will successfully acquire Entergy’s [ETR 63.57 ★★★] transmission system, making ITC the largest U.S. power transmission company.

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**Todd Rosenbluth**
S&P Capital IQ
Fund Analyst
It’s been a busy 2012 for the exchange traded fund (ETF) industry. As more assets flow into both equity and fixed income funds, new ETFs have been launched. At the same time, however, some funds haven’t fared so well, with several funds either closing or cutting expense ratios to attract more assets.

Before we offer some predictions for the year ahead, we want to provide some perspective on the industry. Investors had $1.45 trillion in assets held in U.S. exchange traded products at the end of November. S&P Capital IQ had data on 1,276 exchange traded products available at the end of November, compared with 707 three years ago. New ETFs keep coming to market and within equity funds we’ve seen a focus on emerging market products. As for fixed income, new active and credit-quality focused ETFs gained traction in 2012.

This has been the year of the expense ratio cut. While we think investors should look at more than an ETF’s expense ratio before making a purchase, the ETF industry has been acting recently as if cost is all that matters. In October 2012, the largest ETF provider iShares announced expense ratio reductions for six of its ETFs, including the iShares Core S&P 500 Index. This came on the heels of Charles Schwab’s September 2012 cutting of expense ratios on all 15 of its ETFs, including Schwab US Large Cap ETF. PowerShares has since followed with its own expense ratio cuts and even famously low-cost Vanguard has positioned itself for a further reduction in 2013, with announcements of new benchmarks for many of its widely known ETFs such as its Vanguard Emerging Markets Stock Index Fund.

While many forecasts for 2013 are tied to the state of the U.S. economy and the resolution of the “fiscal cliff” issues in Congress, S&P Capital IQ believes the ETF industry will gather more assets again in 2013.

One such prediction we have is that diversified international and emerging market funds will garner further attention as investors seek out low-cost, diversified ways to take on added risk in hopes of achieving higher returns. Alec Young, S&P Capital IQ global equity strategist, notes that consensus estimates call for emerging market economies such as China, Mexico, Russia, and Turkey to exhibit relatively strong economic growth in 2013. The addition of new, low cost ETFs such as iShares Core MSCI Emerging Markets ETF and PowerShares S&P Emerging Markets Low Volatility Portfolio adds more options for investors. We think these portfolios offer competition to Vanguard Emerging Markets Stock Index Fund.

We also predict money will flow into fixed income ETF at rapid pace, as investors hunt for yield. Through November, PIMCO Total Return ETF, an actively managed fixed income ETF that follows a strategy similar to the mutual fund with the same name, gathered $3.7 billion in assets despite only launching in March. SPDR Barclays Capital Short Term High Yield Bond added more than $500 million in just nine months. With the 10-year Treasury yield likely to remain below 2% in 2013, we think investors will see the benefits of these ETFs and others such as iShares Core Total U.S. Bond Market and Vanguard Total Bond Market Index Fund.

ETF Strategies

ETFs in Focus for 2013

<table>
<thead>
<tr>
<th>FUND NAME / TICKER</th>
<th>SPB RANKING</th>
<th>CURRENT PRICE</th>
<th>YIELD (%)</th>
<th>INCEPTION DATE</th>
<th>HOLDINGS</th>
<th>EXPENSE RATIO (%)</th>
<th>ASSETS ($ MLNS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>iShares Core MSCI Emerging Market ETF / IEMG</td>
<td>NR</td>
<td>$50.55</td>
<td>2.55</td>
<td>10/18/2012</td>
<td>1,637</td>
<td>0.18</td>
<td>136</td>
</tr>
<tr>
<td>iShares Core S&amp;P 500 / IVV</td>
<td>OW</td>
<td>$143.26</td>
<td>1.99</td>
<td>5/15/2000</td>
<td>503</td>
<td>0.07</td>
<td>34,126</td>
</tr>
<tr>
<td>iShares Core Total U.S. Bond Market / AGG</td>
<td>NR</td>
<td>$111.15</td>
<td>2.38</td>
<td>9/22/2003</td>
<td>1,706</td>
<td>0.08</td>
<td>15,442</td>
</tr>
<tr>
<td>Powershares S&amp;P EM Low Volatility Port. / EELV</td>
<td>NR</td>
<td>$28.20</td>
<td>2.38</td>
<td>1/13/2012</td>
<td>200</td>
<td>0.29</td>
<td>87</td>
</tr>
<tr>
<td>Pimco Total Return ETF / BOND</td>
<td>NR</td>
<td>$108.92</td>
<td>2.22</td>
<td>2/29/2012</td>
<td>842</td>
<td>0.55</td>
<td>3,875</td>
</tr>
<tr>
<td>Schwab US Large-Cap ETF / SCHX</td>
<td>OW</td>
<td>$53.33</td>
<td>1.90</td>
<td>10/30/2009</td>
<td>748</td>
<td>0.04</td>
<td>985</td>
</tr>
<tr>
<td>SPDR Barclays Short Term High Yield Bond ETF / SJNK</td>
<td>NR</td>
<td>$63.56</td>
<td>4.50</td>
<td>3/14/2012</td>
<td>339</td>
<td>0.40</td>
<td>553</td>
</tr>
<tr>
<td>Vanguard Emerging Markets Stock Index Fund / VWO</td>
<td>OW</td>
<td>$43.51</td>
<td>3.39</td>
<td>3/4/2005</td>
<td>885</td>
<td>0.20</td>
<td>58,800</td>
</tr>
<tr>
<td>Vanguard Total Bond Market Index Fund / BND</td>
<td>NR</td>
<td>$84.49</td>
<td>2.71</td>
<td>4/3/2007</td>
<td>5,391</td>
<td>0.10</td>
<td>17,757</td>
</tr>
</tbody>
</table>

Building a Well-Balanced Portfolio
This portfolio affords diversification among major industry groups.

Investment pros frequently use the S&P 500 as a benchmark when constructing a diversified portfolio. The 500, which is market-value weighted, includes 10 sectors and more than 100 industry groups. Each stock’s weighting in the index is determined by multiplying the number of shares outstanding by the current share price.

The sample portfolio below is broadly representative of the S&P 500, though we also included some mid- and small-cap names for capitalization diversification purposes. We adjusted the sector weightings to reflect S&P’s investment policy and economic projections, so we expect the 20-stock list [composed entirely of stocks ranked 4- and 5-STARS] to outperform the index in the coming year. (Following the sector name in the table, the first figure in parentheses represents the sector’s approximate weighting in the S&P 500; the second figure is our suggested weighting.)

Choices from The Outlook’s Master Lists were used wherever possible. Performance of the portfolio is not tracked.

### Portfolio Based on Suggested Sector Weightings

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>12-MONTH (% OF S&amp;P 500, CURRENT ANNUAL YIELD)</th>
<th>SHARE WEIGHTING</th>
<th>STARS RANKING</th>
<th>STYLE</th>
<th>PRICE</th>
<th>ANNUAL INCOME</th>
<th>YIELD (%)</th>
<th>P/E RATIO</th>
<th>PRICE COST</th>
<th>INCOME (%)</th>
<th>RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONSUMER DISCRETIONARY (12%, 13%)</td>
<td>120</td>
<td>Disney / DIS</td>
<td>5</td>
<td>A+</td>
<td>Medium</td>
<td>L-Growth</td>
<td>50</td>
<td>6,500</td>
<td>98</td>
<td>1.5</td>
<td>14.9</td>
</tr>
<tr>
<td></td>
<td>105</td>
<td>Target / TGT</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>L-Growth</td>
<td>62</td>
<td>6,510</td>
<td>151</td>
<td>2.3</td>
<td>14.3</td>
</tr>
<tr>
<td>CONSUMER STAPLES (11%, 11%)</td>
<td>145</td>
<td>Coca-Cola / KO</td>
<td>5</td>
<td>A+</td>
<td>Low</td>
<td>L-Growth</td>
<td>38</td>
<td>5,510</td>
<td>148</td>
<td>2.7</td>
<td>18.8</td>
</tr>
<tr>
<td></td>
<td>75</td>
<td>Wal-Mart Stores / WMT</td>
<td>4</td>
<td>A+</td>
<td>Low</td>
<td>L-Blend</td>
<td>72</td>
<td>5,400</td>
<td>119</td>
<td>2.2</td>
<td>14.6</td>
</tr>
<tr>
<td>ENERGY (11%, 11%)</td>
<td>50</td>
<td>Chevron / CVX</td>
<td>5</td>
<td>A+</td>
<td>Low</td>
<td>L-Blend</td>
<td>107</td>
<td>5,350</td>
<td>180</td>
<td>3.3</td>
<td>8.5</td>
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<tr>
<td></td>
<td>60</td>
<td>ExxonMobil / XOM</td>
<td>5</td>
<td>A+</td>
<td>Low</td>
<td>L-Blend</td>
<td>89</td>
<td>5,340</td>
<td>137</td>
<td>2.5</td>
<td>11.2</td>
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<tr>
<td>FINANCIAL SERVICES (15%, 15%)</td>
<td>65</td>
<td>Chubb / CB</td>
<td>4</td>
<td>A</td>
<td>Medium</td>
<td>L-Blend</td>
<td>77</td>
<td>5,005</td>
<td>107</td>
<td>2.1</td>
<td>15.1</td>
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<tr>
<td></td>
<td>110</td>
<td>State Street / STT</td>
<td>4</td>
<td>B+</td>
<td>Medium</td>
<td>L-Blend</td>
<td>45</td>
<td>4,950</td>
<td>106</td>
<td>2.1</td>
<td>11.6</td>
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<tr>
<td></td>
<td>75</td>
<td>T. Rowe Price Group / TROW</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>L-Growth</td>
<td>65</td>
<td>4,875</td>
<td>102</td>
<td>2.1</td>
<td>19.6</td>
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<tr>
<td>HEALTH CARE (12%, 13%)</td>
<td>95</td>
<td>Humana / HUM</td>
<td>5</td>
<td>B+</td>
<td>Medium</td>
<td>L-Growth</td>
<td>68</td>
<td>6,460</td>
<td>99</td>
<td>1.5</td>
<td>8.9</td>
</tr>
<tr>
<td></td>
<td>65</td>
<td>McKesson / MCK</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>L-Blend</td>
<td>97</td>
<td>6,305</td>
<td>52</td>
<td>0.8</td>
<td>13.1</td>
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<tr>
<td>INDUSTRIALS (10%, 11%)</td>
<td>130</td>
<td>Fastenal / FAST</td>
<td>5</td>
<td>A</td>
<td>Medium</td>
<td>L-Growth</td>
<td>43</td>
<td>5,580</td>
<td>109</td>
<td>1.9</td>
<td>29.0</td>
</tr>
<tr>
<td></td>
<td>365</td>
<td>Kelly Services / KELYA</td>
<td>5</td>
<td>B-</td>
<td>Medium</td>
<td>S-Value</td>
<td>15</td>
<td>5,475</td>
<td>73</td>
<td>1.3</td>
<td>10.1</td>
</tr>
<tr>
<td>INFORMATION TECHNOLOGY (19%, 19%)</td>
<td>10</td>
<td>Apple / AAPL</td>
<td>5</td>
<td>B+</td>
<td>High</td>
<td>L-Growth</td>
<td>545</td>
<td>5,450</td>
<td>106</td>
<td>2.0</td>
<td>12.0</td>
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<tr>
<td></td>
<td>25</td>
<td>Int’l Business Machines / IBM</td>
<td>4</td>
<td>A+</td>
<td>Medium</td>
<td>L-Growth</td>
<td>194</td>
<td>4,850</td>
<td>85</td>
<td>1.7</td>
<td>12.7</td>
</tr>
<tr>
<td></td>
<td>240</td>
<td>Microsemi / MSCC</td>
<td>4</td>
<td>B+</td>
<td>High</td>
<td>S-Blend</td>
<td>21</td>
<td>5,040</td>
<td>0</td>
<td>Nil</td>
<td>9.0</td>
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<tr>
<td></td>
<td>185</td>
<td>Microsoft / MSFT</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>L-Blend</td>
<td>27</td>
<td>4,995</td>
<td>170</td>
<td>3.4</td>
<td>14.6</td>
</tr>
<tr>
<td>MATERIALS (4%, 3%)</td>
<td>50</td>
<td>Reliance Steel &amp; Aluminium / RS</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>M-Blend</td>
<td>58</td>
<td>2,900</td>
<td>50</td>
<td>1.7</td>
<td>11.0</td>
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<tr>
<td>TELECOM SERVICES (3%, 3%)</td>
<td>375</td>
<td>Windstream / WIN</td>
<td>5</td>
<td>NR</td>
<td>Medium</td>
<td>L-Value</td>
<td>8</td>
<td>3,000</td>
<td>375</td>
<td>11.9</td>
<td>15.0</td>
</tr>
<tr>
<td>UTILITIES (3%, 1%)</td>
<td>20</td>
<td>Oneok / OKE</td>
<td>5</td>
<td>A-</td>
<td>Medium</td>
<td>L-Value</td>
<td>44</td>
<td>880</td>
<td>26</td>
<td>3.0</td>
<td>24.5</td>
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<tr>
<td>Total</td>
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<td>2,293</td>
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</tr>
</tbody>
</table>

* Master List issue. *Based on our analysts’ assessment of qualitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. Please note that all investments carry risks. †Based on S&P estimated fiscal 2012 earnings. L-Large cap. M-Mid cap. S-Small cap.