AMERICAN FUNDS®
From Capital Group

Q&A
With portfolio manager
Joyce Gordon

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The expanding search for dividend yield across global markets

Portfolio manager Joyce Gordon tackles the challenge of finding yield in today's market, where many traditional dividend-paying stocks have risen sharply, making valuations more expensive. She is finding newer sources of dividend growth, such as technology companies, as well as attractive opportunities outside the U.S. She is also bracing for higher U.S. interest rates and the implications for funds such as Capital Income Builder and American Mutual Fund.

Joyce Gordon is a portfolio manager with responsibilities in several funds, including Capital Income Builder® and American Mutual Fund®. She has 32 years of investment experience, all with Capital Group, and is based in Los Angeles.

U.S. economic growth has been steady, corporate earnings are strong and the equity market is at record highs. As an investor, what does all of this say to you about the U.S.?

U.S. companies are in terrific financial shape; they have a lot of cash on their balance sheets and many are increasing their dividends. It continues to be a good environment for U.S. equities, largely driven by the ongoing rebound in the housing and auto markets. Another area that looks attractive is industrials, where many firms are gaining strength and starting to increase their dividends. It's not just one sector that is going to propel the economy, but small contributions from all of them as hiring trends improve. We're not at the point where inflation is creeping back yet and we probably won't be for some time, which should create a nice environment for U.S. equities.

While the stock market is up quite a bit, it's still not trading at overly lofty levels. Earnings do not appear to be vulnerable and should continue to grow and bring with them dividend growth, which is a good underpinning for valuations in the market. However, there are some sectors of the U.S. equity market at lofty valuations by historical standards, such as consumer staples and utilities.

How do you think about investing in Europe, given the problems there and the long road ahead?

One can look at Europe in two parts. The northern region, including the U.K., Germany and Scandinavia, is in decent shape and coming out of recession. But Southern Europe is more troubled, with countries like Spain, Italy and Greece still dealing with sovereign debt issues, high unemployment rates and stark austerity measures.

There are many opportunities in Europe, where dividend yields are typically higher and I can get "paid to wait." In other words, I can invest in a high-yielding company with a safe annual dividend while waiting for the economy to turn — once it does and the company's earnings increase, I get the growth in the dividend and the price appreciation in the stock. However, it is important to make sure the company is strong and that you don't get in front of a dividend cut.

But one also has to be careful when investing in Europe. The greatest area for potential share price appreciation is Southern Europe, which is also the region I worry about the most. There are inexpensive companies that have good long-term growth prospects, but the risk is that the government raises taxes in order to pay its bills. The market does not usually anticipate this and companies can be punished by investors when it happens. Taxation can be difficult to analyze so one has to be very careful when investing in certain countries, because some are more likely than others to increase taxes.

Are there any particular sectors or companies that excite you and look more promising than others?

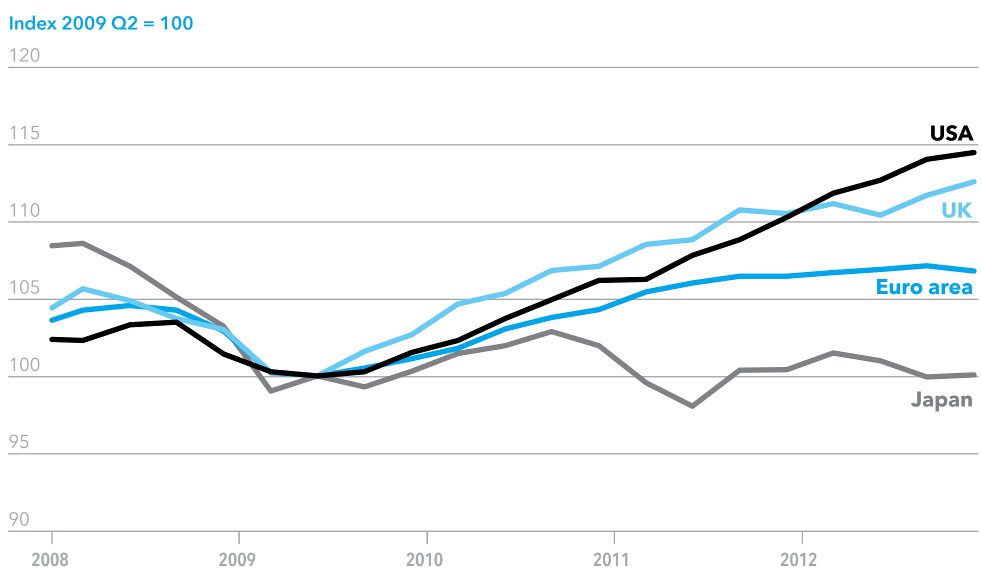
The pharmaceuticals industry is a really interesting area – one where a good analyst doing in-depth research can make all the difference. Our pharmaceuticals analyst was previously a practicing physician so he has a good feel for which drugs a doctor is more likely to prescribe and which ones a patient will not be able to tolerate. This allows him to have a stronger understanding of a company's drug pipeline, the likelihood of obtaining regulatory approvals and, finally, which drugs doctors will actually prescribe that will lead to higher sales for the company. There are quite a few firms with promising drug pipelines that we think are under-appreciated by the market. Some of our larger pharmaceuticals holdings have a strong base of business that would allow for solid share price growth, but when you add our analyst's view of their drug pipelines' future impact on earnings, they become much more attractive from an investment standpoint.

Are you concerned that dividend-paying companies are becoming too expensive, especially in some of the traditional sectors? Where are you finding alternate sources of income?

The dividend-paying companies that have taken part in the recent rally include many of the consumer staples and household products companies. Some of them do look very expensive, but they are not in uncharted territory. Still, they are high by historic standards, so we are digging a little deeper and looking for companies that offer more value in other industries and around the globe.

Exhibit 1:
Global economic growth is diverging as regions recover from the financial crisis at different speeds

Nominal GDP developments, 2008–2012



Source: Capital Group.

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In the U.S., one sector seeing a lot of dividend growth is information technology, which has not traditionally been a large source of dividends. Many technology companies have started paying dividends in recent years, including Apple and Cisco Systems. Another technology company, Texas Instruments has increased its dividend twice in the past 12 months. This trend is likely to continue in the technology sector, which will probably be the biggest area of growth for dividends in the market.

Overseas, we're finding more value in European utilities versus those in the U.S. They offer better dividend yields and much lower multiples on earnings. Part of it is the culture in Europe, which tends to have very strong dividend-paying companies with yields over 6%. Furthermore, they are attractively priced because the ongoing euro-zone crisis has kept a lid on the market. Being able to look globally for dividend payers is extremely helpful both in meeting our yield targets and finding companies with more attractive valuations.

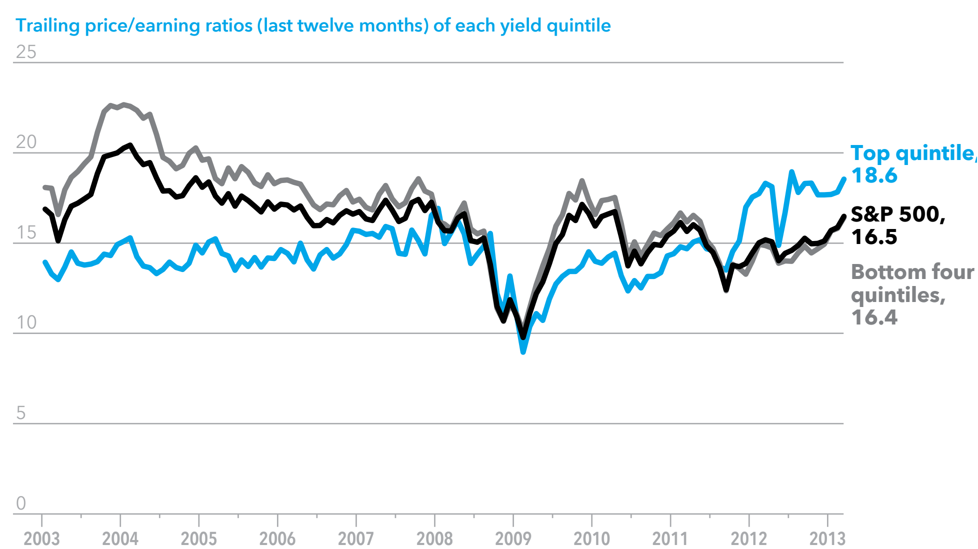
In the telecommunication services sector, however, the opposite is true. A lot of telecom companies in Europe have already cut their dividends and are not as appealing as those in the U.S., where many companies have yields above 4%. There are also greater competitive pressures in the European telecom industry than in the U.S., where the market has become more consolidated with just a few key players. The pricing environment is still favorable in the U.S. as well, which is not the case in many European countries. As investors, we have to understand what is going on at the country level and how that impacts business there.

Given your background as a banking analyst, do you see financials becoming a major source of dividends again as they return to health? Are some banks better positioned than others to increase their dividends?

When I covered banks in the 1980s and early 1990s, they were always a very good source of current income and dividend growth. Coming out of the financial crisis, many banks had to essentially cut their dividends to zero. I think it's going to be difficult for them to get back to where they were, as regulators are only allowing banks to pay up to 30% of their earnings as dividends. Some banks, including Bank of America and Citigroup, currently pay out small dividends, and it is going to take

Exhibit 2:
Higher yielding stocks are looking more expensive than the rest of the market after rising sharply in recent years

Quintiles of yield for the S&P 500, January 2003–March 2013



Source: Capital Group.

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a while for them to show the stability and growth necessary to increase them. But other banks have a greater capacity to increase dividends: Wells Fargo has been more stable and shown stronger growth, in large part because of its mortgage business. The company already has been able to increase its dividend and with its payout approaching the 30% limit, the bank is likely to ask regulators if it can go higher.

With Capital Income Builder's greater flexibility to invest in companies across the globe, what has your approach been in pursuing the fund's income objectives and yield goals?

Capital Income Builder's 30-day SEC yield was just above 3% as of June 2013. One way we're able to achieve this high a yield is by investing globally, since non-U.S. companies typically pay more in dividends. We have been able to find quite a few companies and industries in Europe that are very favorable for dividends. Some of the technology companies in Asia also have high dividend yields between 5% and 7%. It would be very challenging for the fund to achieve its higher yield by investing only in the U.S. market, so being able to invest globally really helps.

Historically, fixed income has been a good provider of yield for CIB – but that is not the case currently. We still have quite a few holdings in fixed income, but a lot of it is to help provide stability and lower volatility. Bonds do not have great yields right now, but as interest rates rise, fixed income will again become an important source of yield. In the meantime, we continue to look for some higher-yielding bonds, but we have to be very selective given their valuations.

Our cash position in CIB is fairly low, partly because the yield on cash is zero. If the yield gets back to 2% or 3%, we would likely hold more cash. Since we have not been able to hold cash because of the yield, many of us have looked to bonds and tobacco stocks as a way to be more defensive. While these are not direct substitutes for cash, they are much more defensive than other securities and can help protect on the downside while still offering some yield.

What are your thoughts on the direction of interest rates in the U.S. and how does this affect your investment approach in a fund like Capital Income Builder?

Long-term interest rates peaked in about 1980 and have since gone steadily down, so it has been a 30-year bull market for bonds. We now know that is not likely to continue and rates are not going any lower. They may move a little sideways before they start going back up, but it does not mean that bonds themselves are dead. There are still a lot of opportunities to be selective and invest in individual bonds and make some money – but the easy money has been made. It would probably be prudent for people who have a lot of money in the bond market to start looking elsewhere, but I don't think bond investing is dead by any means. While there is still opportunity in fixed income, I think equities are going to be more attractive in the near future.

The Federal Reserve has sent clear signals to the market that interest rates are not going any lower. But just because the Fed is starting to communicate that it's going to end quantitative easing, that doesn't mean that interest rates are going to

The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings.

Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility, as more fully described in the prospectus. These risks may be heightened in connection with investments in developing countries.

shoot up instantly. How quickly rates actually rise will likely be a function of how strong the economy is. If interest rates stay relatively low, it will continue to be good for the U.S. market.

We spend a lot of time thinking about what rising interest rates means to our portfolios. For one thing, it makes holding bonds less attractive. Since we invest in fixed income in Capital Income Builder, we have to think about what happens when interest rates rise. We've held the duration of the fixed-income portfolio pretty short so that it won't be severely impacted by rising interest rates. We also have been moving money from fixed income into equities – we're primarily looking for stocks with dividend growth over those with high yields and no growth, because the latter tend not to do as well when interest rates rise.

Higher rates also make real estate and real estate investment trusts less attractive, as well as some higher-yielding stocks that don't have much dividend growth. I have primarily been focused on companies with dividend growth because they tend to do better during periods when interest rates are increasing. Dividend growth also says something positive about the company's earnings and management's willingness to share profits with investors instead of spending capital on mergers and acquisitions, which have a checkered history of benefiting shareholders.

Given dividend-paying stocks' recent market rally, are you concerned that the traditionally defensive higher-yielding sectors may not provide as much downside protection for American Mutual Fund, or do the fund's other characteristics offset those concerns?

American Mutual Fund's 30-day SEC yield was just above 2% in late June, which was about the same as the market as measured by the Standard & Poor's 500 Index. We are not pushing too hard or reaching too far for yield and putting our shareholders at risk. We try to avoid companies whose shares have a high-yield but whose businesses aren't

Investment results for American Funds Capital Income Builder® and American Mutual Fund® – Class A shares

Figures shown are past results for Class A shares and are not predictive of results in future periods. Current and future results may be lower or higher than those shown. Share prices and returns will vary, so investors may lose money. Investing for short periods makes losses more likely. Results reflect deduction of the maximum 5.75% Class A sales charge. For current information and month-end results, visit americanfunds.com.

	1 year	5 years	10 years	Expense ratio	30-day SEC yield
Average annual total returns (%)					
Capital Income Builder	4.55	2.52	6.91	0.63	3.06
American Mutual Fund	11.22	6.17	6.87	0.63	2.06

As of June 30, 2013.

Source: Capital Group.

Expense ratios are as of the funds' prospectus available at the time of publication.

Annualized 30-day yields are calculated in accordance with the SEC formula.

Investment results assume all distributions are reinvested and reflect applicable fees and expenses. When applicable, investment results reflect fee waivers and/or expense reimbursements, without which results would have been lower. Please see americanfunds.com for more information.

growing; instead, we look for those that are increasing earnings as well as dividends. As consumer staples stocks have gone up in value and now look relatively expensive, we're trying to invest in other areas of the market, such as industrials and technology, where we expect to find dividend growth, quality management teams and attractive long-term valuations. Since the fund is right around the market yield, we are able to find those companies without having to stretch very far and take on too much risk.

It is also important to remember AMF's objectives: protect on the downside with preservation of principal, maintain a higher-than-average current yield, and provide some participation in the market when it goes up. We seek to achieve these objectives by investing in high-quality companies that are leaders in their respective industries; this helps us stay away from those that are a flash in the pan. We only invest in those that have a strong reputation, a good track record of growth and a quality management team.

Key takeaways

- U.S. companies are strong – however, investors also have to be more selective when looking for dividend payers and growers.
- Europe is a tale of two markets, but still offers many opportunities in certain countries and sectors.
- With traditionally defensive, higher-yielding areas of the market becoming expensive, industrials and technology firms offer many investment opportunities.
- While the bull market in bonds is coming to an end, some opportunities still exist in fixed income.