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From Capital Group

Q&A

With portfolio manager  
Alan Berro

September 2013

## Despite rising rates, a constructive view on U.S. stocks

Portfolio manager Alan Berro shares his views on the U.S. stock market and why he remains optimistic despite a rising rate environment. As an income-oriented investor, he is finding investment opportunities in pharmaceuticals, technology and industrials and is not that enthusiastic about traditional dividend payers. He also discusses:

- Prospects for banks to further increase their dividends
- Whether companies will use their cash stockpiles for acquisitions
- The allocation to equities and bonds in American Balanced Fund®
- Options for investors in a rising rate environment



Alan Berro is an equity portfolio manager for American Balanced Fund® and Washington Mutual Investors Fund<sup>SM</sup> as well as for the asset allocation funds within American Funds Insurance Series®. With Capital since 1991, he previously had research responsibilities for U.S. utilities, capital goods and machinery companies. He is based in Los Angeles.

*The U.S. market has rallied strongly in the last couple of years. What are your thoughts on the market today? Is there room for earnings to grow and for multiples to expand from here?*

I remain constructive on U.S. equities, based on my view that the U.S. economy is continuing to improve, that Europe has probably bottomed and will show some improvement, and that the Japanese government is trying to do everything it can to stimulate that economy. Many economies around the world seem to be all moving in the right direction. So in my view, there are still opportunities in equities.

The market has risen about 20% over the last eight months. About three-quarters of that came from P/E expansion and the rest came from earnings growth. I think 5% to 6% – maybe even 7% – earnings growth is probably a reasonable prospect for the next couple of years. We're at a price-to-earnings multiple in the mid to high teens based on this year's earnings on the Standard & Poor's 500 – that's a

pretty fair multiple, and maybe it can rise a bit more. But I don't expect much in terms of further multiple expansion. What I'm focused on as a portfolio manager is trying to identify the companies that have true earnings growth.

*The recovery in the housing sector has helped fuel optimism about the U.S. economy. Does the recovery still have legs?*

I am a bottom-up, fundamental investor, so my macro viewpoint is not where I start. But let me take you through the macro framework that I'm using today.

I would say U.S. consumers on average are much healthier today compared to a few years ago. Their balance sheets are in better shape, their debt service is lower, their house is probably worth more than it was a few years ago at the bottom of the housing crisis. They've probably been able to refinance their mortgage at a lower rate, which has put more cash into their pockets and given them more

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disposable income. So the consumer balance sheet is in much better shape.

Likewise, the business sector has stayed very healthy. Corporate margins have remained quite strong and are at or near all-time peaks. Corporate balance sheets are probably as strong as they've ever been, particularly given that we just went through a recession, and companies probably have more cash on hand today than they've ever had before.

The real issue is the government sector. People have been worried about the deficit and so on. Those problems I think have peaked and are starting to get better. We've had an increase in taxes, tax receipts are going up and deficits will start to come down. State and municipal governments were particularly weak and we saw a lot of layoffs there. That has stopped. I would say that the government sector is stabilizing, and may even be getting a little better.

I think the economic outlook is pretty good overall. We've spent the last five or six years working off the housing bubble overhang and homeownership is now

near an equilibrium level. But we add population every year in the United States and new households form every year, so we will need housing. My view is that we're going to get back to a more normal housing cycle and it will continue to be a positive underpinning for the economy going forward.

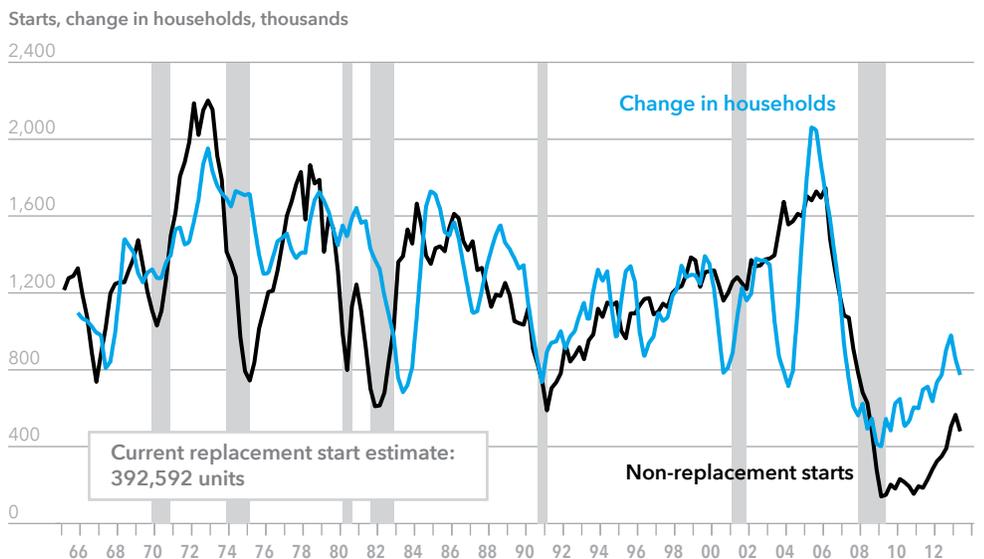
**As an income-oriented investor, where in the market are you seeing the greatest value?**

I find value in many different places. I think several drug stocks still offer attractive yields of 3% or more, with good underlying fundamentals and reasonable valuations. There are good opportunities in select industrial companies that have started to increase their dividends in fairly significant ways. And the telecom companies continue to be a very strong source of income.

Technology stocks have historically not been thought of as a yield-oriented group. Yet some of the biggest technology stocks offer fairly healthy yields today, such as recent dividend initiator Cisco.

**Exhibit 1:  
 A faster rate of household formation could support a much higher level of housing starts**

U.S. household formation and housing starts as of June 30, 2013.



Sources: U.S. Census Bureau, Capital Group.

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“As interest rates go up, investors have much better alternatives than a utility with a 4% dividend yield that is not growing at all. The industry doesn’t offer a lot of earnings power or future earnings growth, and all the cash flow is going to have to be plowed back in the business.”

***How do you construct your portfolio? Do you hold a barbelled portfolio at times, where you have some growth stocks and some that pay very high dividends, or do you want a certain amount of yield from every company?***

I’m a value investor, so I tend to buy value stocks. I look for companies that are out of favor, unloved. Gilead Sciences, for example, was basically a leader in AIDS drugs and didn’t have a lot else. For some reason the investment community started to discount its pipeline 10 years ahead of when the patents actually expired, so it became a very cheap stock. But management has transformed the company, and now it is a leader in developing treatments for hepatitis C, which affects around 150 million people globally. That has given the stock a whole new life. I didn’t buy it because it was a growth stock, or a hot stock based on hepatitis. I bought it because it was a down-and-out AIDS drug maker.

The stocks in my portfolio have come to me in all sorts of ways. Microsoft is another example: it is a great franchise with an embedded user base. You can’t get off of it very easily; the switching costs are so high that it’s not worth it in most corporate environments. That’s really what drives these companies – their corporate users, not individuals. So it was out of favor. Microsoft loses a lot of money in activities that it probably should just give up on, but if you boil it down to the core business, it’s a very attractive franchise. And when you can get a 3% yield with pretty good visibility, those are the kind of investments that I look for.

***Are you concerned that dividend-paying stocks have become too expensive?***

Some yield-oriented groups are or were expensive. As the Fed signaled a potential pullback of its bond-buying programs, real estate investment trusts were hit the hardest. Electric utilities were also hit somewhat. As a group they do not offer much in the way of earnings or dividend

growth – they have modest growth prospects and a fairly rich valuation. So you’re paying a premium to the market multiple for less-than-market growth just because they have larger-than-market dividends. I’m not sure that trade-off works in a rising rate environment. As interest rates go up, investors have much better alternatives than a utility with a 4% dividend yield that is not growing at all.

Finally, the utilities are very capital intensive and their infrastructure is really getting old. So the industry doesn’t offer a lot of earnings power or future earnings growth, and all the cash flow is going to have to be plowed back in the business. It’s not obvious that these capital expenditures are going to allow them to sell any more of their product. So to me, the utilities don’t appear to be very attractive businesses.

But there are drug stocks, industrials and select technology stocks that all offer decent yields, and some of those groups are not traditional sources of dividends. About 15 or 20 years ago, the drug stocks paid almost no income and had very high P/E ratios. That has definitely unwound. They are not as cheap as they were a year or two ago, but I believe they still offer relatively good value.

***What are your thoughts on the banks and other financials as they emerge from the financial crisis?***

The last crisis was a financial crisis, and several banks went down significantly. Some don’t exist today, but some came through in fairly good condition. We were lucky, particularly in American Balanced Fund, that we were focused on companies that emerged from the crisis even stronger. We continue to like those banking groups that went from strength to strength.

In the last year or two there has been an opportunity to invest in some of the other banks, ones that had been in some trouble, as they become recovery

stories. Our view is that the banking sector is getting healthier across the board. Banks have gotten out of businesses that they probably didn't belong in and are returning to their basic fundamentals and becoming pure banks – which we believe is an OK business. If you buy a bank at or below book value you probably have a pretty good shot at making money over time. These bank stocks carry fairly low P/E ratios, many of them below 10 times earnings, and have fairly good earnings prospects. Most of them eliminated or reduced significantly their dividends during the financial crisis and are now bringing back those income streams. I don't think they'll ever have the kind of dividend income that they had previously, but I still think they can be an interesting source of yield.

The insurance stocks were not really affected by the financial crisis in quite the same way, particularly the property and casualty insurers that we invest in. They are not what you would call a high-yield group. I would characterize them more as offering some growth, some income, and, I believe, the potential for P/E expansion.

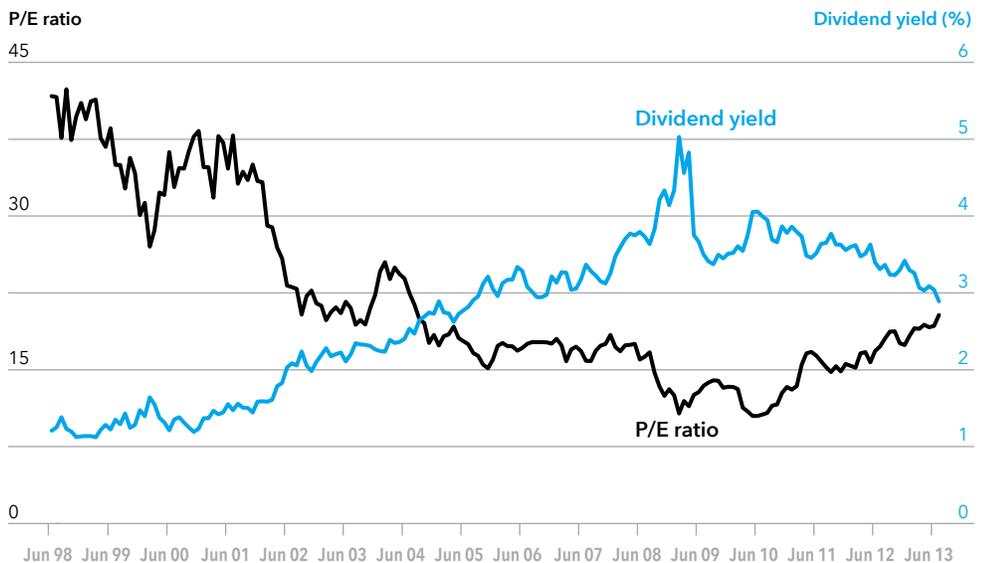
**What ideas are the analysts most excited about in the U.S.?**

I've mentioned the health care sector. Within biotechnology, we're in a sort of renaissance period. Biotech was out of favor for many years; now it's at the forefront of what's going on in the whole pharmaceuticals industry. So we're lucky that we have very good analysts in that area and have been able to invest in many biotech companies.

We continue to be excited about the home improvement retailers, because we see that as one of the best ways to participate in the housing recovery. Home Depot, one of the largest companies in the sector, had its own turnaround story, so we were getting a double play there. Home Depot had basically the best embedded industry position and the best real estate, but it had been mismanaged, morale was low and it was behind on its systems. A new management team is now in place – they're fixing the systems, they've totally turned around employee morale and they've reinvigorated the company. And this internal fix is happening against a great external macro backdrop.

**Exhibit 2:  
 The P/E ratio for drug stocks has fallen from lofty levels**

MSCI USA Pharmaceuticals Index as of July 31, 2013.



Source: RIMES.

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In the aerospace defense sector, Boeing has a bigger order backlog than ever before. There has been controversy about some of its newest products, but when you wade through that and determine that the plane does work and it will continue to fly and there is a thousand-order backlog, that gives you a very long runway of visibility into its future prospects and cash flow.

***We've seen consolidation activity in a couple of industries, including pharmaceuticals and food producers. What is your view of the recent M&A activity, and should we expect it to continue?***

Given that interest rates have been at historically low levels and that corporations have been sitting on huge cash hoards, I'm actually surprised we haven't seen more consolidation. But I think managements today are held a lot more accountable, in that they are, to some extent, evaluated on return on invested capital. When you make a large acquisition, you're committing a lot of capital and if you have to pay any sort of premium, it's not always a given that the returns are going to be improved over the long term. You may get a one- or two-year boost, but then you're carrying a much bigger asset burden. Given the metrics that most managers are measured on today, the math of doing large acquisitions is a lot tougher than it used to be. Looking at the history and the results of large acquisitions, there are not that many that have produced great returns. As a result, there is a lot more discipline in the system and it makes it harder for corporate managers to buy something for the sake of getting bigger.

Furthermore, there are not that many small deals out there. In the food sector or pharmaceuticals, the deals typically range from \$20 billion to \$100 billion, and those don't happen very often. Those are big companies. It's not clear that you get a lot of synergies taking two \$25 billion companies and creating a \$50 billion company.

Moreover, many industries have been fully consolidated. All of the drug companies have already merged. The banking sector went through its period of consolidation during the crisis, but, for example, Bank of America already controls 10% of the U.S. deposit market – it can't buy anybody else. Most of these companies are so large they can't do much on that front. In fact, what you're seeing in some industries is deconsolidation.

***What about the idea of companies that have excessive amounts of cash becoming acquisition candidates?***

There have been a couple of examples of activist investors stepping in and trying to get the company to do something with that cash. I don't buy the argument, necessarily, that just because a company has a lot of cash it is going to get taken out. There has to be more than that to the story. There have to be operating synergies, there have to be strategic reasons that really make sense for the deal to go forward.

***As large investors, what sort of role are we playing in getting companies to increase their dividends and return that cash to shareholders?***

I think it's fairly well known among the companies that we talk to that we are interested in dividend income and that we think dividends are a good way to return capital to shareholders who want to stay shareholders in your company. Share repurchases have their place and purpose, but the folks who are the biggest proponents of share repurchases are usually people who want to sell their stock back – and we want to continue to invest in the stock and participate in their enterprise. And I think they've come around to understanding that.

Several studies have shown that share repurchases are usually ill timed. Companies tend to like their stocks most when they are up a lot, and they tend to totally go away and not be willing to buy their shares when the stock price is down. This was in full view during the financial crisis when most companies with share repurchase programs completely stopped them.

We really favor dividends. They're much more consistent; it's much more of a commitment for the company, and it's tended to work out better over time as a component of shareholder return.

***Many are touting the end of a 30-year bull market in bonds. What's your thinking on allocating between equities and fixed income, particularly in American Balanced Fund?***

At this point, American Balanced Fund is biased toward the upper end of its equity range. The fund, by prospectus, is mandated to always have at least 25% in fixed income. But we have not felt that we should go much beyond that minimum fixed-income threshold at this juncture, given that we are cautious on fixed-income markets. We all know that the Fed has kept rates artificially low, and we've had some hints that this is going to end at some point. The prospect of rising interest rates is probably higher than the prospect that rates will come down in any meaningful way. We think that the opportunities are better in equities, given our belief that the economy is improving and that there are still good investment opportunities available in the equity markets.

***What are some of the inputs you consider in the asset allocation process, and what sort of macro variables do you look for?***

We always start from a fundamental standpoint, so we don't have a macro-economic model. We're lucky here at the Capital Group in that, given our large size,

we have tremendous resources to draw on – our global macroeconomics team, our quantitative research team, our fixed-income asset allocation group. So there are a lot of inputs that go into the process.

We also have the benefit of getting a lot of external research from Wall Street, so we can read the viewpoints of other strategists and folks who are involved in allocating between asset classes. But we always come from a bottom-up view of the world rather than a top-down black box, so our process is probably a little more organic than others.

***How do the equity and bond portfolio managers work together in our balanced funds?***

We have a dual process. A principal investment officer sets the overall allocation of the fund among the portfolio managers, using The Capital System<sup>SM</sup>. Then within each fund, including American Balanced Fund, we have managers that have responsibilities over both fixed-income and equity assets, and they can, on a shorter term basis, shift between those asset classes as they find attractive securities. So they can use equities, they can use bonds, they can use convertible bonds. They have a lot of tools that will allow them to determine and take advantage of the best risk-return trade-offs in the market among the different asset classes at any given time.

***Bond funds have seen some outflows over the last few months, when investors became concerned about when and how the Fed would wind down its bond-buying programs. If an investor is thinking about reducing investments in the bond market, why should they invest in a balanced fund? Or are they better off being in an equity fund for a while?***

The reason to invest in a balanced fund is that it is an investment vehicle that can be your complete investment program. You don't have to worry about timing one

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market or another. Over long periods of time, we have found that balanced funds can really serve a purpose for an investor, particularly one that doesn’t want to have to be overly active in trying to figure out where to go at any particular time. A balanced fund gives you an anchor in any sort of storm – and we’ve been through a lot of storms. Whether it was the global financial crisis or Sept. 11 or the tech bubble, if you look at the long-term record of American Balanced Fund, I think you’ll see that it weathered those events pretty well and that it was a good idea to have a mix of assets.

The mix shifts over time – not drastically, but enough, we hope, to protect investors when protection is necessary and to participate in the rise of equity markets when that’s the right place to be. On the other hand, if you decide that you’re going to exit bonds and prefer a pure equity fund, a fund like Washington Mutual Investors Fund is a good alternative. It has a very similar portfolio to American Balanced Fund’s equity portfolio.

### Key takeaways

- U.S. stocks have some room for further earnings and P/E expansion
- Bonds provide diversification from unexpected risks
- Dividend-oriented stocks can be good source of income in any interest rate environment
- A balanced fund allows managers to make tactical shifts between stocks and bonds based on market conditions

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