American Funds®

The Long View

July 2010

Climbing the wall of worry

Every era has its troubles. There are hardships, challenges, panics and crises. This period is no different. From Europe's credit crisis to the threat of inflation, there always seems to be a "wall of worry" when it comes to the global economy and the world's markets.

But economies and markets also share a remarkable history of resiliency, an ability to bounce back after being knocked down that can be both surprising and reassuring. Market rallies, of course, don't last forever. But history shows that neither have they just fizzled out.

Bumps in the road

"The market came off the bottom faster in this latest recovery than anything we've seen since World War II. So you have to expect, for one reason or another, that there will be a period when the market will give up some of its gains," says portfolio counselor Jim Dunton. "But my conviction is to stay basically fully invested, because business prospects are coming along and profits are coming back with them. The market ultimately will be largely driven by that continued recovery in profits."

Jim and other portfolio counselors say there are likely to be incidents or concerns that can rattle investor confidence regarding the strength and sustainability of the recovery. Indeed, it's possible the sharp rebound in the economy and corporate earnings since the first quarter of 2009 could give way to a period of more moderate growth.

Portfolio counselor Will Robbins says he remains optimistic but cautious. "I put inflation at the high end of my list of risks, especially if it's coupled with a slowdown in economic activity," Will says. "But I think there are still very good investment opportunities in the U.S. selectively by industry, as well as some of the markets outside the U.S."

"Companies have had to get very lean in the last couple of years … I think one can be quite constructive on equities."
— Jody Jonsson, *portfolio counselor*

While our investment professionals take the economy into account, they focus on finding companies with sustainable growth prospects, strong balance sheets and cash flow, and dominant positions in the industry.

"Companies have had to get very lean in the last couple of years," says portfolio counselor Jody Jonsson. "We have seen some surprisingly strong earnings, and many companies are in great shape. I think one can be quite constructive on equities."

Jody says the history of the markets, and especially the past two years, has emphasized the importance of a long-term perspective and remaining optimistic.

"As dire as it looked in 2008, the world didn't end, and it isn't going to end now," Jody says. "There are companies that can thrive and do just fine."

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.

Investing in companies, not countries

Carl Kawaja
Portfolio counselor
23 years of investment experience

We have been through a volatile and, in some ways, a very surprising period. When we go through times like this, it's easy to respond by focusing on the short term. But I think the right thing to do in such an environment is to push your time horizon. You need to be thinking for the long run.

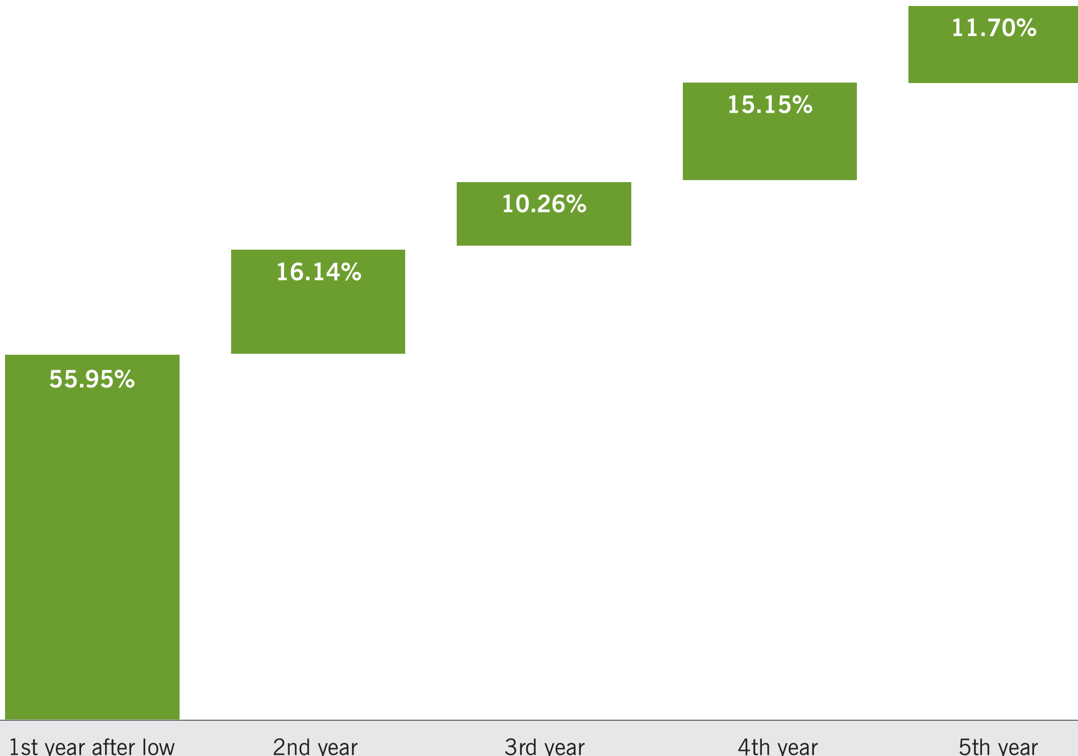
I say that because when things look dire, there may be a tendency to feel gloomy and worry about whether the economy or markets will ever get better. But what we've seen, over and over, is that good companies find ways to adjust and prosper.

All of it makes me fairly bullish on equities. I say that because we have been through a tremendous financial crisis, and we've also been through disruption in the markets around the world. But companies are still standing, and many of them are making more money than they were a year or two ago.

Valuations also seem to be relatively attractive in the U.S., and I'm very positive on some developing nations. But it bears repeating that we invest in companies, not countries, and when I look at what many companies around the world are doing, it reaffirms my belief in investing for the long run.

History shows market rallies have had staying power

S&P 500 returns after major market declines show rallies have been sustained



The return for the first year, which includes the most recent downturn, represents the average of the 12-month returns following 17 major market declines; returns for the years thereafter are based on 16 declines. Dates (from high to low) of the declines included in the illustration are as follows: 9/7/29–6/1/32, 9/7/32–2/27/33, 7/18/33–3/14/35, 3/6/37–4/28/42, 5/29/46–6/13/49, 1/5/53–9/14/53, 8/2/56–10/22/57, 12/12/61–6/26/62, 2/9/66–10/7/66, 11/29/68–5/26/70, 1/11/73–10/3/74, 9/21/76–3/6/78, 11/28/80–8/12/82, 8/25/87–12/4/87, 7/16/90–10/11/90, 3/24/00–10/9/02 and 10/9/07–3/9/09. Each market downturn reflects a period of more than 80 days and a decline of about 15% or more in the S&P 500's index value. The index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions or expenses.

- After Standard & Poor's 500 Composite Index lost much of its value in 2008 and early 2009, many investors fled the market, only to miss out on one of the most dramatic rebounds in the market's history. After hitting a low on March 9, 2009, the market advanced 72% during the following 12-month period.
- Some investors may now figure that after such a remarkable rally, the market can't possibly continue to advance. But a look back at stock market history reveals a common pattern, and suggests that investors could be well served by staying invested.
- An examination of the periods following 17 major declines shows how rapidly the market can turn after hitting bottom, rising an average of nearly 56% during the first year. But history also shows that while the gains might moderate over time, the market's momentum continued for at least four more years.
- A plan of regular investing can help take the emotion out of investing and reduce the temptation to time the market. This approach can help investors avoid locking in losses by selling when the market declines, and ensure that they participate in any eventual recovery.

> "The key element of successful investing is to follow a long-term approach. The 2008-2009 period was one of the most frightening periods that most of us have ever lived through. But it is during these periods of strife, uncertainty and trauma that the best long-term investment opportunities arise."
>
> — Tim Armour, *portfolio counselor*

Broad, vigorous market recoveries have often continued for years

Throughout the decades, S&P 500 recoveries have had the strength to carry on

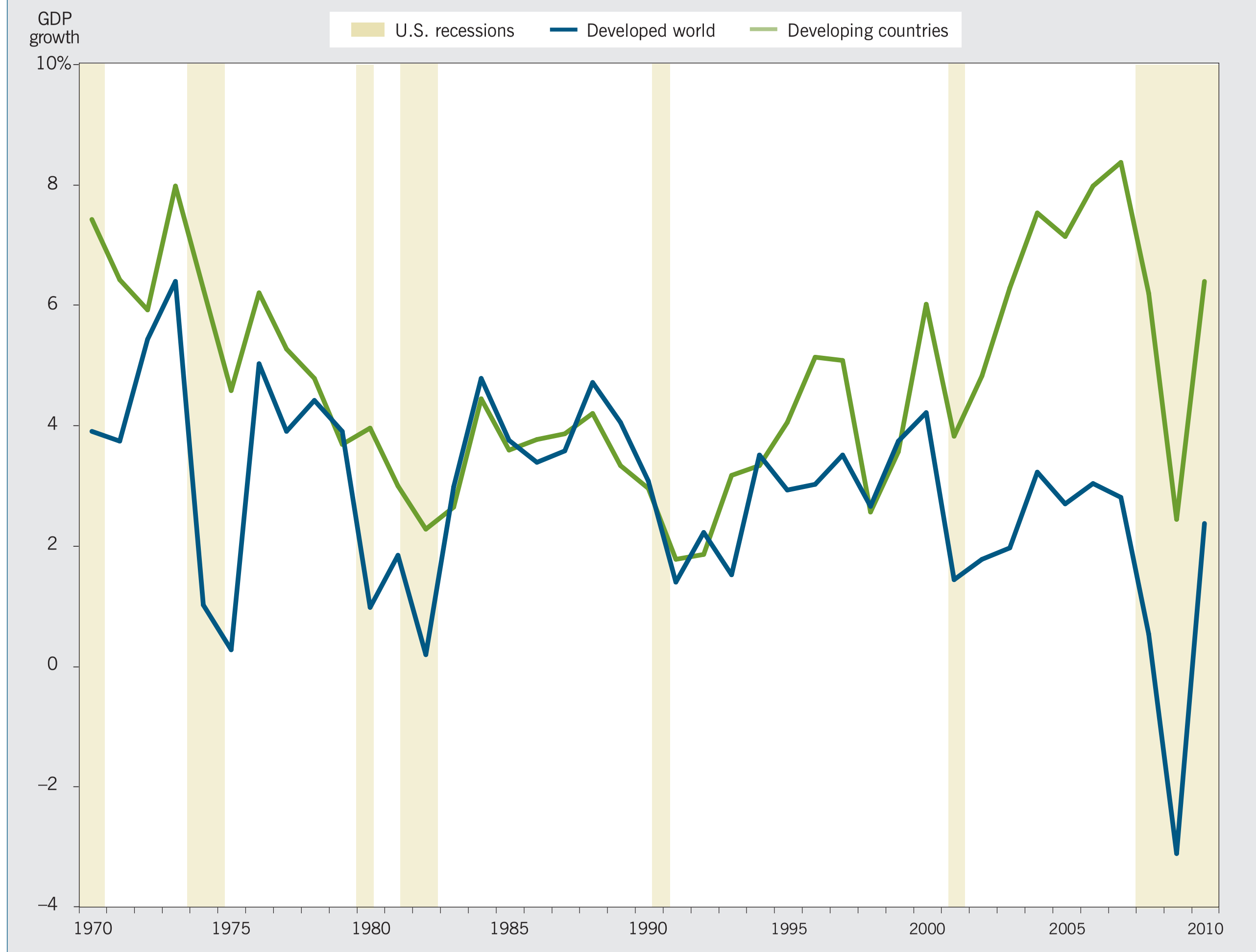
Market high	Market low	Percent decline	12-month returns (Positive periods (67), Negative periods (14)): 1st year after low	2nd year	3rd year	4th year	5th year	Avg. annual total returns for five years after low
9/7/29	6/1/32	–86.22%	137.60%	0.52%	6.42%	56.68%	16.52%	35.93%
9/7/32	2/27/33	–40.60	105.43	–14.77	74.12	29.05	–32.50	21.57
7/18/33	3/14/35	–33.93	88.37	30.91	–37.51	25.94	–0.65	14.03
3/6/37	4/28/42	–60.01	64.26	8.96	31.08	32.19	–19.89	19.96
5/29/46	6/13/49	–29.61	52.74	20.95	20.33	3.38	27.04	23.90
1/5/53	9/14/53	–14.82	45.46	50.22	9.19	–1.41	12.76	21.54
8/2/56	10/22/57	–21.63	36.30	13.23	–1.44	32.52	–17.10	10.82
12/12/61	6/26/62	–27.97	37.42	21.12	5.10	7.56	9.57	15.57
2/9/66	10/7/66	–22.18	37.34	10.04	–7.37	–3.08	18.89	10.04
11/29/68	5/26/70	–36.06	48.96	14.56	0.37	–15.06	7.28	9.31
1/11/73	10/3/74	–48.20	44.43	25.99	–2.86	11.79	12.82	17.39
9/21/76	3/6/78	–19.41	18.76	17.20	25.80	–11.19	48.59	18.24
11/28/80	8/12/82	–27.11	66.11	6.80	18.52	34.65	40.98	31.90
8/25/87	12/4/87	–33.51	25.92	33.76	–3.74	20.31	17.12	17.97
7/16/90	10/11/90	–19.92	33.55	8.82	17.71	3.93	27.75	17.83
3/24/00	10/9/02	–49.15	36.15	9.91	8.51	15.09	18.05	17.14
10/9/07	3/9/09	–56.78	72.28	N/A	N/A	N/A	N/A	N/A
Average of 12-month returns			**55.95**	**16.14**	**10.26**	**15.15**	**11.70**	**Avg.: 18.95**

The percent decline is based on the index value of the S&P 500 excluding dividends and/or distributions. Each market downturn reflects a period of more than 80 days and a decline of about 15% or more in the S&P 500's index value. The index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions or expenses.

- Every market decline is different. A look back at stock market history shows that retreats have varied widely in intensity, length and frequency. But many of them share a common pattern. In numerous cases, market declines have been followed by at least five years of gains, interrupted by only the occasional down year.
- In fact, a look at all the one-year periods for the five years following these 17 significant declines, a total of 81 years, reveals that the S&P 500 advanced in 67 of those years, and declined in only 14.
- While the 2008–2009 decline ranks as one of the most severe on record, the chart shows that this isn't uncharted territory for the market. Of course, past results offer no guarantees of future results; however, from the 1930s into the 21st century, the market has exhibited a reassuring pattern of rewarding long-term investors.
- Market crises are traumatic and costly. But ultimately, the market has not only survived, but thrived. For more than a century, the U.S. market has endured wars, recessions, assassinations, bubbles and busts. And each time it has come back. Through it all, the market has demonstrated a remarkable strength and resiliency in the face of challenges.

> "I think we're setting up for a good period for the global economy and global stock markets over the next several years. You want to be careful, but it should be a healthy economy the next few years for the world."
>
> — Gordon Crawford, *portfolio counselor*

Global economy shows signs of recovery

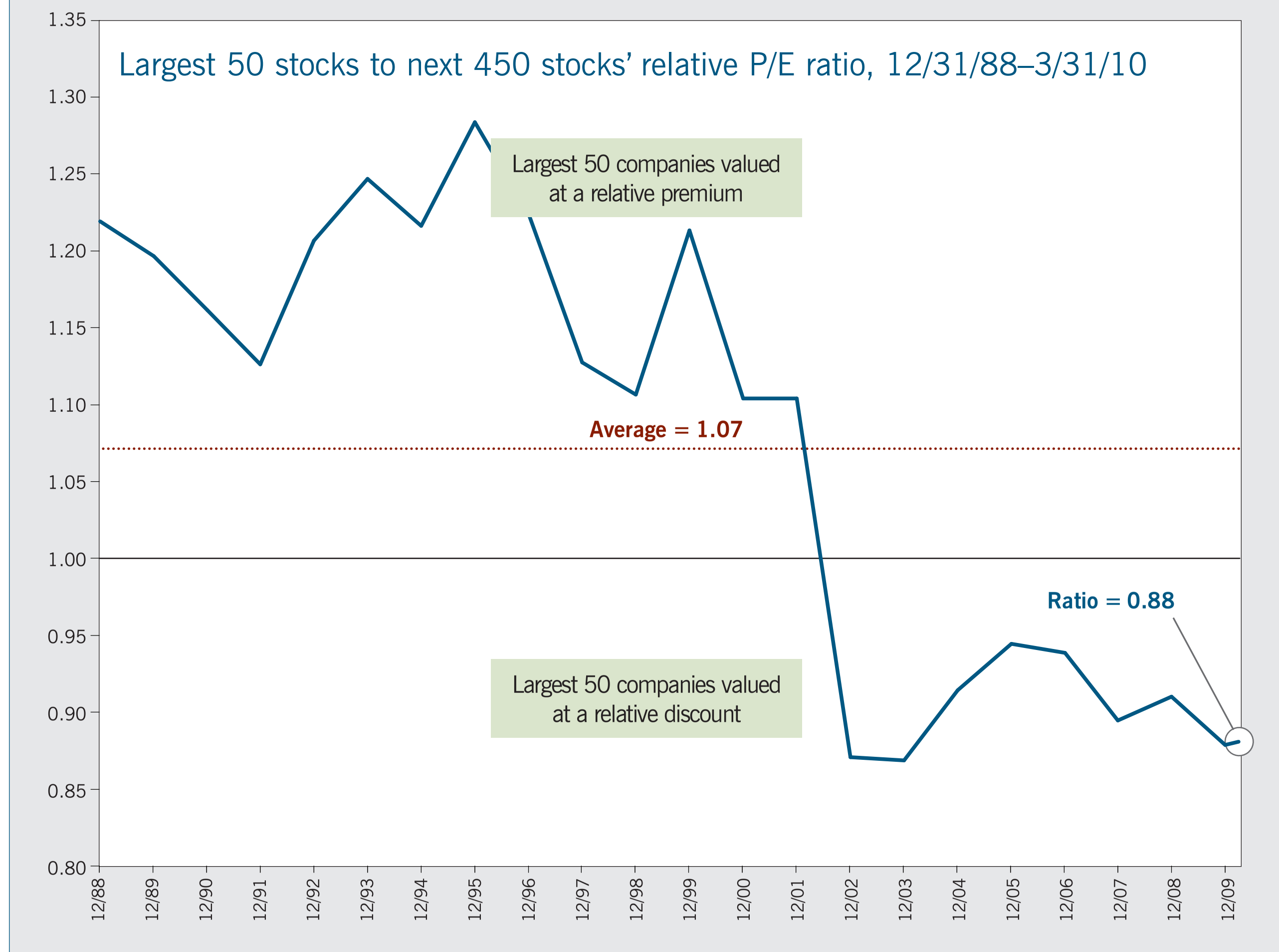


Sources: International Monetary Fund (IMF) and National Bureau of Economic Research (NBER). Developed world represents 33 countries comprising IMF's group of advanced economies, and developing countries represents 149 nations in the group of emerging and developing economies. Real gross domestic product (GDP) is the number reached by valuing all the productive activity within a country at a specific year's prices. When economic activity of two or more time periods is valued at the same year's prices, the resulting figure allows comparison of purchasing power over time, since the effects of inflation have been removed by maintaining constant prices. Real GDP figures for 2010 are estimates. A recession, as defined by NBER, reflects a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales.

- The pace may vary by country and region, but the recovery in the global economy continued to gain traction during the first half of 2010. Mounting concerns about the debt burdens of Greece and a few other European countries dampened expectations for a broad recovery. But in June the International Monetary Fund reaffirmed forecasts in its World Economic Outlook, issued in April, which projected global economic growth of 4.2% in 2010.
- While Europe's credit crisis has roiled markets, there are signs of steady growth in many countries around the world. Developing countries, especially those in Asia, have played a major role in leading the global economy out of decline. Growth among the advanced economies has been mixed, with the United States off to a better start than Europe and Japan.
- While signs of recovery are heartening, the global economy remains fragile. Clearly, some of the recovery is attributable to governments swiftly and aggressively injecting unprecedented cash into their economies to shore up growth and add to stability. As the stimulus is withdrawn, recovery will be tested.

> "The U.S. economy may have a slower projected growth rate currently, but it appears to be on a faster path toward recovery than many of the other developed nations, and productivity is rising."
>
> — Will Robbins, *portfolio counselor*

Slow to rise, large companies may represent opportunity for investors



Source: Vestek. The price/earnings ratio (P/E) is the price of a stock divided by its earnings per share. The P/E ratio gives investors an idea of how much they are paying for a company's earning power.

- The size and quality of a company can be a factor in how its share price is affected by economic and market cycles. In many instances, smaller companies are the most severely impacted by an economic downturn or market decline. Conversely, if they survive, they are also likely to register the most dramatic increases.
- The value of larger companies, however, tends to be recognized later in a recovery. Every recovery is different, but by the second year of many recoveries, as the economy and the market have gathered steam, so have larger companies.
- The chart shows that the valuation among companies in the S&P 500 during the 2009 rebound has been mostly consistent with that pattern. Shares in the smaller 450 companies in the index have surged since the market's bottom, while the largest 50 companies haven't fully participated in the rally.
- As a result, the price/earnings ratio of larger companies, relative to the P/E ratio of the rest, is below the long-term average. The measurement indicates large companies, despite the rally, may be undervalued by the market.

> "It's very common in an economic or stock market recovery for quality companies to lag the more leveraged companies. It's like the tortoise and the hare, and in the long run, the tortoise is not a bad place to be."
>
> — Brad Vogt, *investment professional*

Currency's impact on international investing

Even when the dollar is rising, overseas investments have benefited U.S. investors

Strengthening dollar (highlighted years marked *)

	Index results		Best results	
Year-end	S&P 500	MSCI ACWI ex USA	U.S.	Outside U.S.
2009	26.47%	42.14%		✔
2008*	–36.99	–45.24	✔	
2007	5.49	17.12		✔
2006	15.78	27.16		✔
2005*	4.91	17.11		✔
2004	10.87	21.36		✔
2003	28.67	41.41		✔
2002	–22.09	–14.67		✔
2001*	–11.88	–19.50	✔	
2000*	–9.10	–15.09	✔	
1999*	21.04	30.91		✔
1998	28.58	14.46	✔	
1997*	33.35	2.04	✔	
1996*	22.95	6.68	✔	
1995*	37.53	9.94	✔	
1994	1.32	6.63		✔
1993	10.06	34.90		✔
1992*	7.61	–10.97	✔	
1991	30.40	13.95	✔	
1990	–3.11	–22.74	✔	
1989*	31.63	12.03	✔	
1988*	16.56	27.90		✔

Source: Index Database Information. Highlighted areas represent years when the U.S. dollar generally appreciated against the yen, pound and euro, since 1999. Before 1999, the dollar was measured only against the yen and the pound. The indexes are unmanaged, and their results assume reinvested dividends and/or distributions. Standard & Poor's 500 Composite Index is a broad measure of the U.S. stock market. The MSCI ACWI ex USA is designed to measure the equity markets of developed and emerging markets, not including the U.S.

■ The recent decline in the value of the euro relative to the dollar may have raised some questions regarding the impact of currency on international investing. During much of the past decade, a weakening dollar has aided returns in overseas market. But a strengthening dollar doesn't necessarily mean it's time to move away from international investing. That's because currency is only one factor in market returns. So are economic conditions, market valuations, trade patterns, company growth and a range of other drivers. A strengthening dollar doesn't mean one can't do well investing abroad.

What the data say:

- Eleven of 22 years had a strengthening dollar.
- Seven of 11 dollar-strengthening periods saw positive returns overseas.
- Three of the 11 strengthening periods saw the MSCI All Country World Index (ACWI) ex USA outpace Standard & Poor's 500 Composite Index.

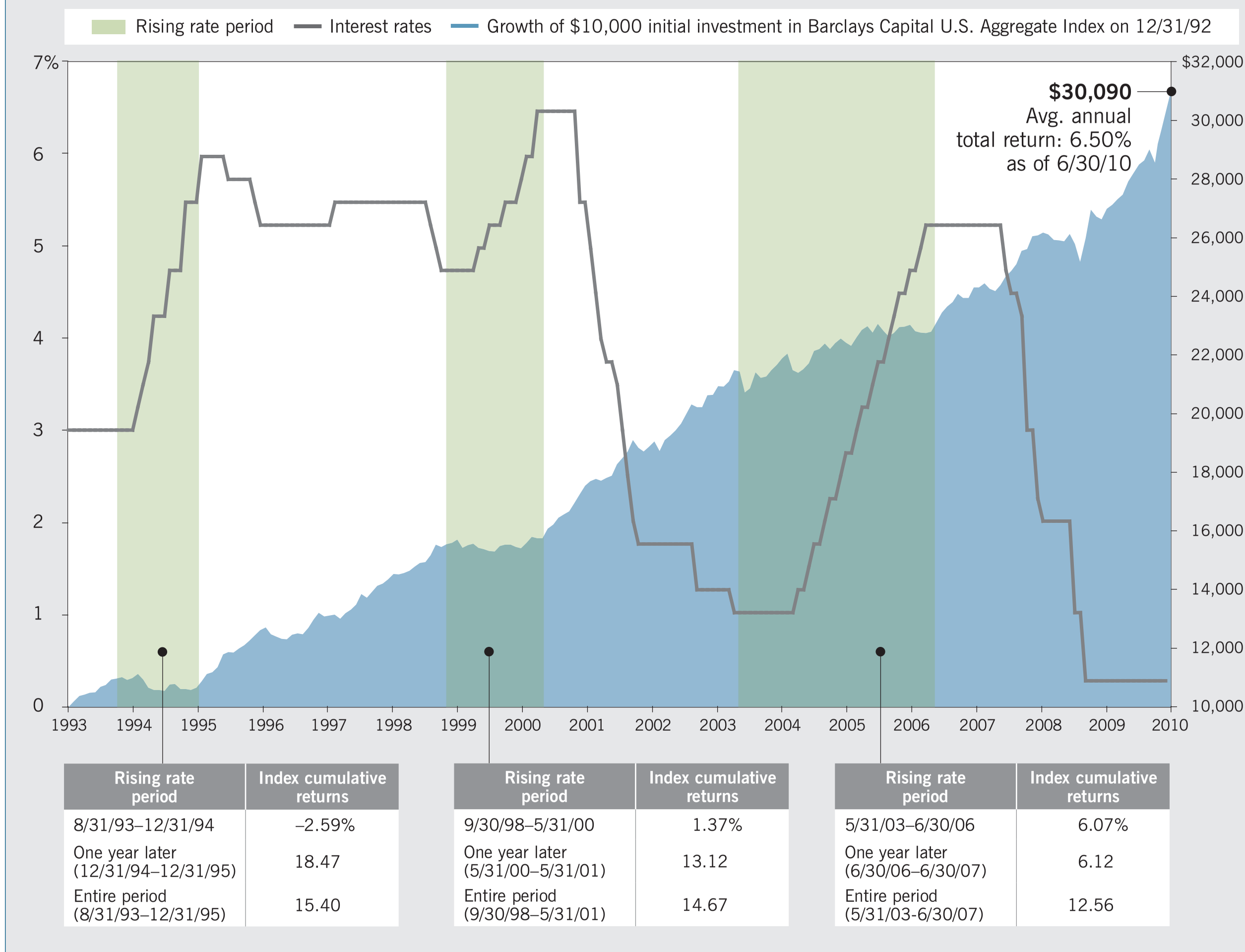
What it means:

- Currency cycles are hard to predict or time.
- Even when the dollar is rising, overseas investments can pay off for U.S. dollar-based investors.
- Investments in markets outside of the United States have outpaced domestic ones in a rising-dollar environment.

> "Fundamentally, if we invest in good companies with good management teams that handle their businesses well, over time the currency issues become far less important."
>
> — Julian Abdey, *investment analyst*

Bond investing in a rising interest rate environment

Staying invested over the long term can help absorb the effects of rising interest rates



Rising rate period	Index cumulative returns
8/31/93–12/31/94	–2.59%
One year later (12/31/94–12/31/95)	18.47
Entire period (8/31/93–12/31/95)	15.40

Rising rate period	Index cumulative returns
9/30/98–5/31/00	1.37%
One year later (5/31/00–5/31/01)	13.12
Entire period (9/30/98–5/31/01)	14.67

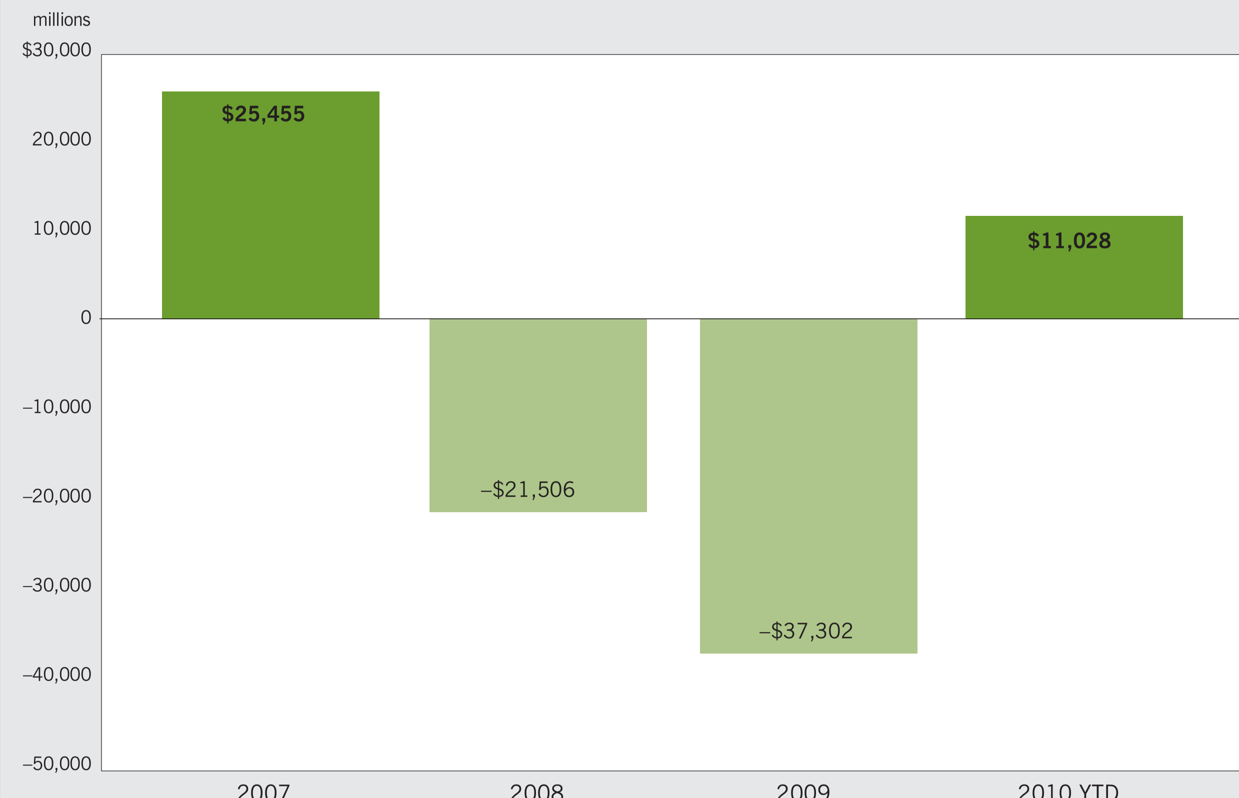
Rising rate period	Index cumulative returns
5/31/03–6/30/06	6.07%
One year later (6/30/06–6/30/07)	6.12
Entire period (5/31/03-6/30/07)	12.56

Interest rates are based on the federal funds target rate. Dates for the three rising rate periods were determined using Barclays Capital U.S. Aggregate Index yields. In each case, yields rose more than two percentage points (low to high) over a period lasting more than 12 months. The index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions or expenses. Figures shown are past results and are not predictive of results in future periods.

- After a period during which interest rates have been at or near historic lows, an eventual increase in rates seems likely. As a result, some bond fund holders may be concerned about the potential for rising rates to negatively impact their fixed-income investments. That's because when rates rise, prices fall for the bonds the fund already owns.
- But price changes are only part of bond fund returns. Income is the other critical component, and when interest rates rise, the portfolio's income can increase. In short, price declines can be moderated by interest income. Moreover, as lower yielding bonds in the fund mature, investment professionals can take advantage of higher rates when redeploying the proceeds by investing in bonds with a higher yield.
- The chart shows the benefits that can accrue for those who reinvest income and stay invested for the long term. During the first period, index returns dropped in response to sudden, unexpected rate increases. During the latter two periods, however, the index recorded positive results, reflecting the market's anticipation of higher rates. Importantly, all three periods of rising rates were followed by rallies. Those who remained invested were rewarded for their patience.

> "As bonds in the portfolio mature, we have an opportunity to purchase newer, higher yielding securities when rates do trend upward. So over the long term, we can add bonds that generate more income for our shareholders."
>
> — Thomas Hogh, *portfolio counselor*

After a record decline, S&P 500 dividends begin to come back



Year-to-date data as of 6/30/10. The index is unmanaged.

- In 2009, some of the biggest names in U.S. business cut or eliminated dividends. For investors who depend on dividend income, or who expected the cash would cushion the bear market's blows, the setback has been sobering. The cuts have been particularly unkind to shareholders of funds focused on dividends.
- The damage from the record dividend cuts during the past two years won't be repaired quickly or easily. After all, in 2009 alone, the amount of net dividends paid by S&P companies declined a record $37 billion.
- But there are signs that companies are beginning to reconsider dividend payments to shareholders, thanks to improved market conditions, and reduced economic pressure. During the first half of 2010, many companies in the S&P 500 increased or initiated dividends. The list included some of the biggest names among U.S. companies, including Johnson & Johnson, Procter & Gamble and IBM.
- While the environment for dividends has not been favorable recently, over time they have played a significant role in total return. From 1926 through 2009, reinvested dividends accounted for 44% of the average annual total return of the S&P 500.

> "When a company is willing to share the fruits of its labor in the form of cash, that's an enormously positive signal. Dividends can be a big piece of the return, and it also serves as a vote of confidence by management in the future of their company."
>
> — Steve Watson, *portfolio counselor*

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