

The Long View

October 2011

A macro-micro tug of war

The global economy and equity markets around the world have had plenty to worry about lately. At times, the litany of bad news can seem overwhelming: Fallout from Standard & Poor's downgrade of U.S. credit, sovereign debt problems in European Union countries, weak U.S. economic and employment data, a housing market still mired in a slump and the ongoing impact of Japan's disasters on global growth.

But there is good news that offers hope and, for long-term investors, an opportunity to pursue financial goals.

The earnings at many companies in the U.S. and abroad, for example, have recovered from recession lows, and reached near-record levels. In addition, many companies have fortified their balance sheets, built up cash, strengthened their competitive positions and have access to credit.

"I think we're in a tug of war right now between some very real concerns on a global level, and some good news about corporate profits," says portfolio counselor Paul White. "I think the good news right now in the U.S., at least in terms of the financial markets, is that corporate profits are very robust, and you're also seeing that in a number of other places in the world, particularly in emerging markets."

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— Paul White, *portfolio counselor*

White and other investment professionals at American Funds remain focused on individual companies and issuers with strong prospects for growth over time.

"It's important to remember that companies with strong balance sheets, smart management and innovative products can thrive in such uncertain environments, and I believe that there are a number of solid companies whose shares are attractively valued," portfolio counselor Steve Watson says.

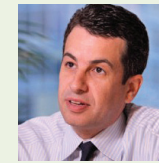
Steve and other portfolio counselors caution that the world remains an unpredictable place, and that uncertainty is likely to always be a factor for investors. The recent volatility in the world's equity markets has unnerved many investors, but portfolio counselor Tim Armour says the fact that many corporations continue to produce record earnings should be reassuring.

"When you get volatility like this, there is very little differentiation in the type of companies that get beaten up," Tim says. "I think it can be an opportunity to invest in well-run companies that have strong balance sheets, pay a good dividend and are attractively priced. Those are the companies that can be very good investments over time."

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.

The dividend culture abroad



Andrew Suzman

*Portfolio counselor
18 years of investment experience*

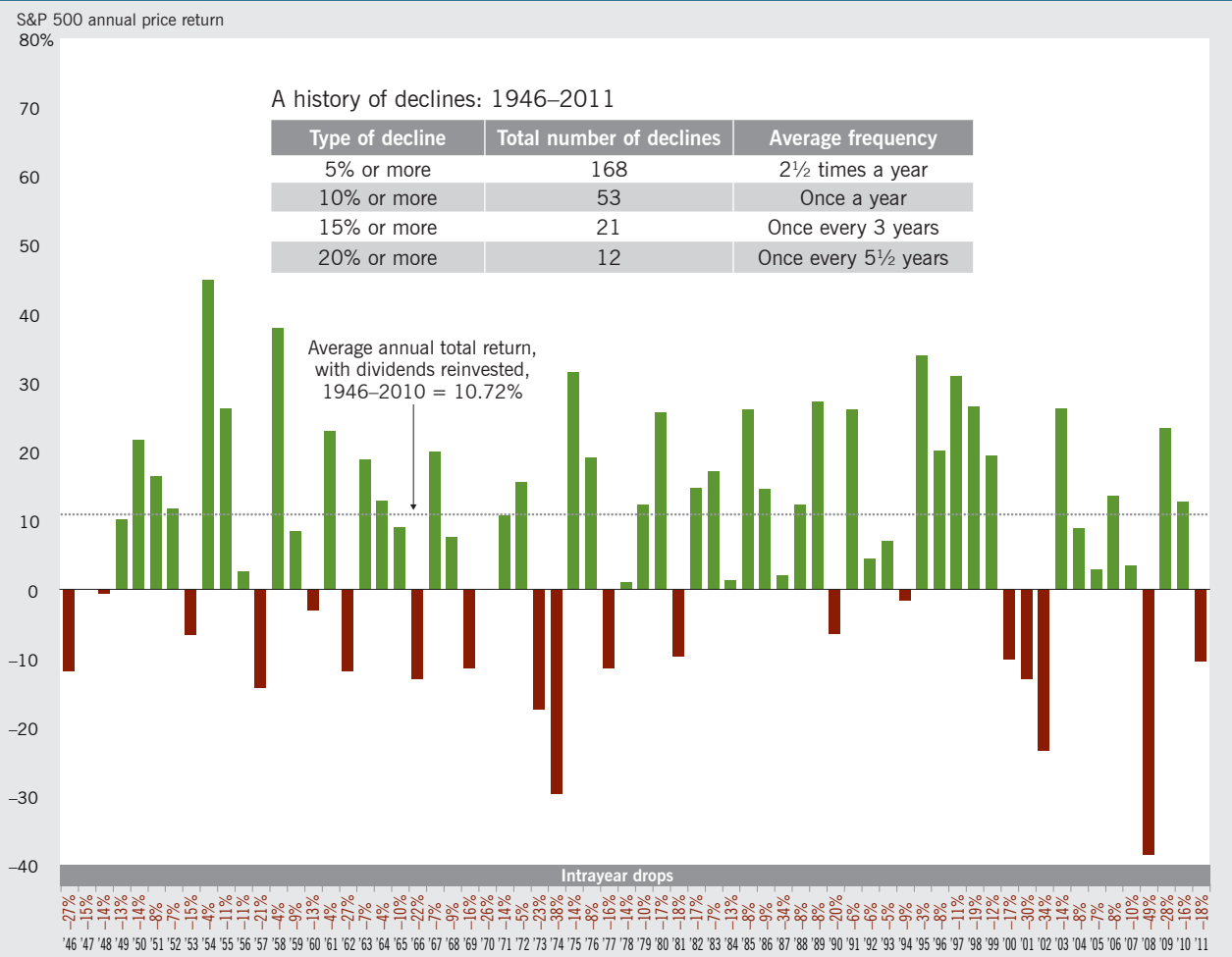
The benefits of international investing have been well-established in the minds of thoughtful, long-term investors for a number of years now. They know that companies outside the United States represent a significant opportunity for capital appreciation and diversification.

What may not be as well-known is that during the last decade the dividend culture abroad has expanded, and now represents an important element of international investing. Many international companies now believe that a percentage of earnings should be returned to shareholders each year.

In fact, we've seen a growing number of companies adopt a policy of returning value to shareholders through dividends, particularly in Europe and in Latin America, and we're also starting to see it in Japan. These days, in order to maximize income, you must be global.

We've also found that the dividends paid by companies outside the U.S. have been a sign of another important element of investing: companies with the highest dividend yields have often provided the best returns over time (see chart, page 5). Between the dividends and potential return, it appears clear that there's a significant investment opportunity abroad for long-term investors.

Despite average intrayear drops of 14.1%, annual price returns were positive in 46 of 65 calendar years



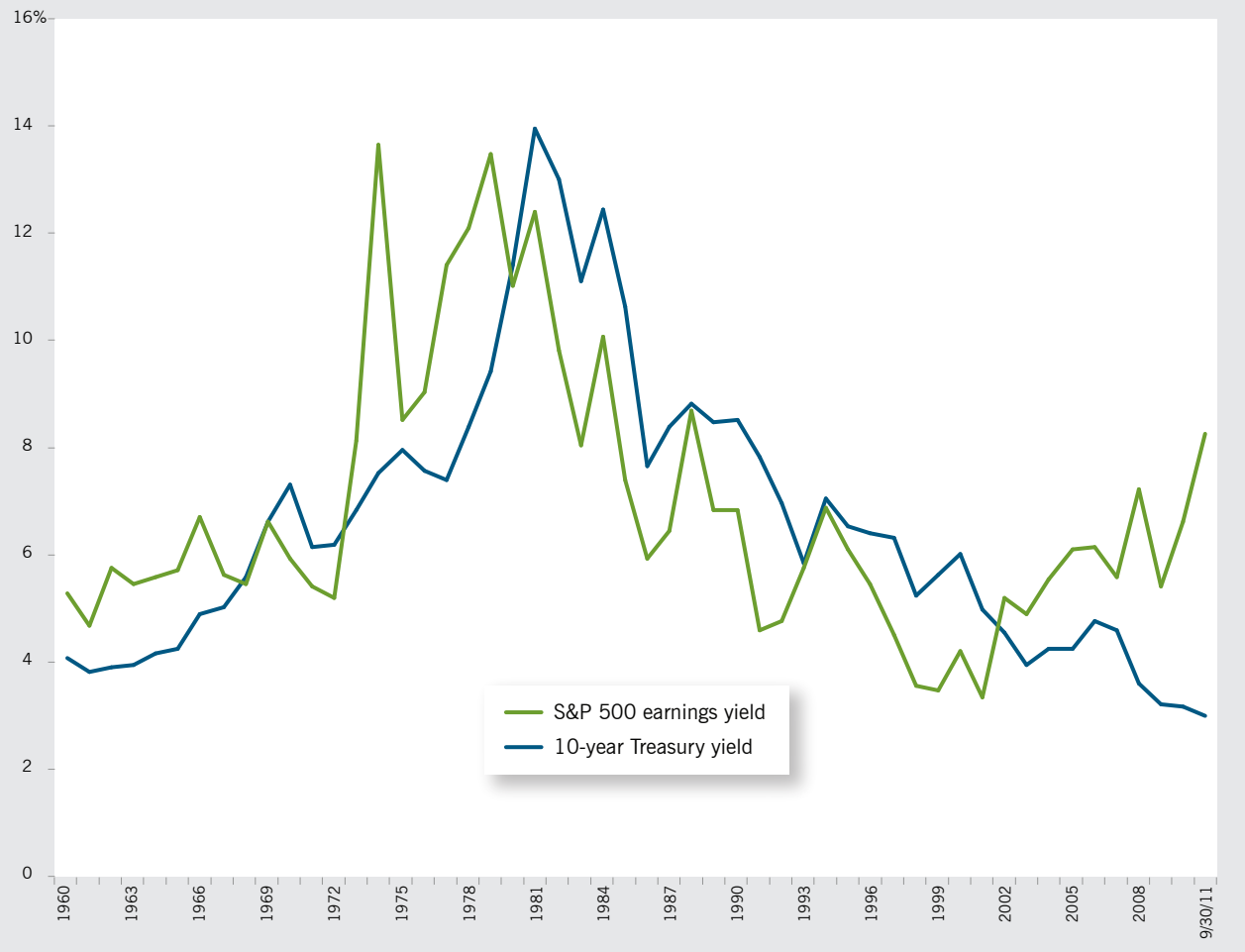
S&P 500 annual returns, as represented in the bar chart, are based on the price index only (and, therefore, do not include dividends). Intrayear drops refer to the largest drop for each calendar year. Total number of positive years and average intrayear drops are for the 65 years ended 12/31/10. Data for 2011 are based on the period 1/1/11-9/30/11. The index is unmanaged, and its results do not reflect the effect of sales charges, commissions, account fees, expenses or taxes. Average frequency of declines, as shown in the table, assumes 50% recovery of lost value, except for the most recent decline; the current market downturn may not be over.

- Sharp and sometimes steep, market declines can be unsettling for even the most experienced investors. Although they may be jarring, corrections are relatively routine in the long sweep of market history.
- The chart shows that there have been significant declines nearly every year during the 65-year post-War period beginning in 1946. Over the entire period, the average intrayear decline was 14.1%.
- Despite such a relatively severe setback every year, the S&P 500 has had a positive annual return in 46 of the 65 calendar years from 1946 through 2010, or 71% of the time.
- Market fluctuations can often be a source of concern and uncertainty. Bearish headlines, troubling events and disappointing economic news can create a sense of panic. That was especially true during the 2000s, when intrayear declines averaged 20.4%.
- Investors who found the courage and conviction to stay the course have been rewarded with relatively attractive results. The average annual return of the S&P 500 from 1946 through 2010 was 10.72%, with dividends reinvested.

“Over the years, I have learned that one of the best things any investor can do is step back and put the markets’ often chaotic behavior into a broader context. I know how hard that is, but I also know it’s crucial to long-term investing success.”

— Jim Rothenberg, *portfolio counselor*

The gap between the S&P 500 earnings yield and 10-year Treasury



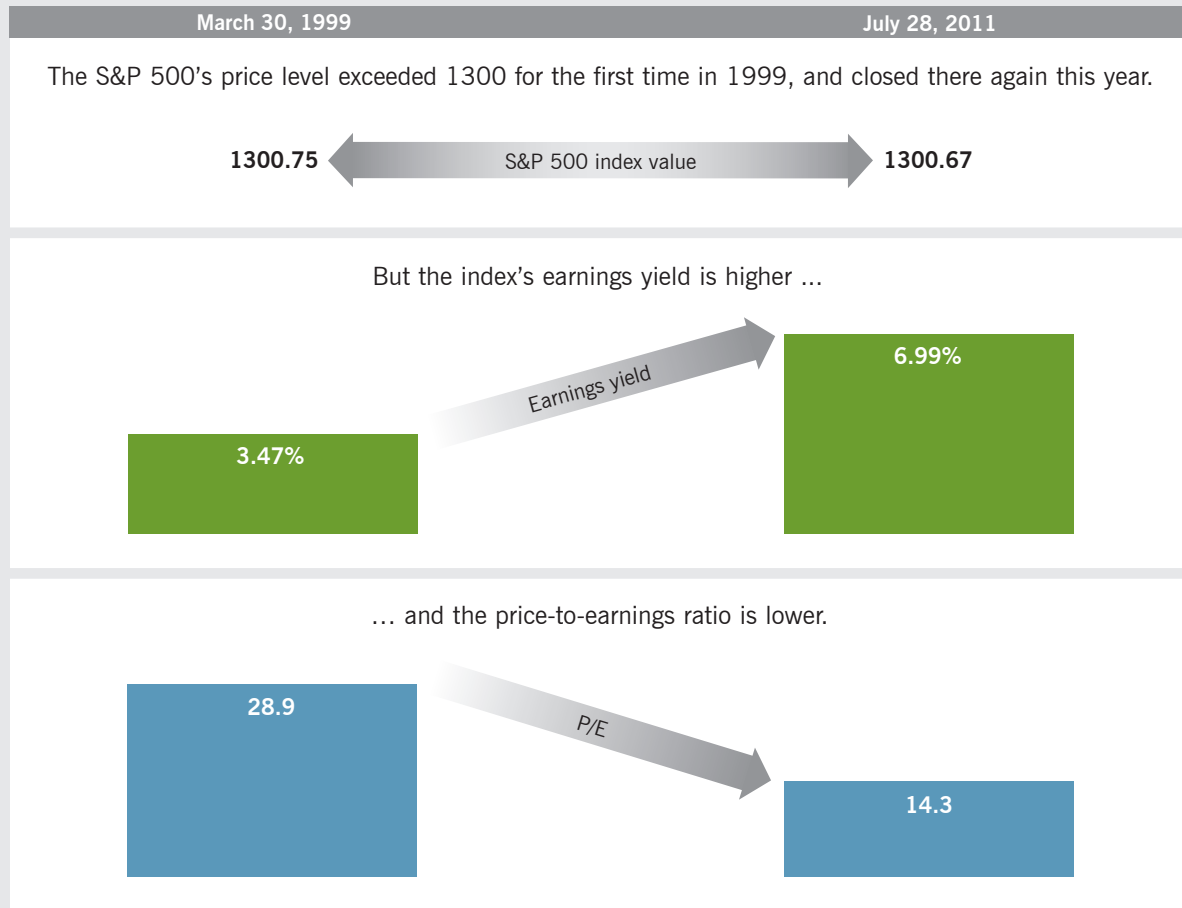
- The earnings yield of an index is one measure that can be used to assess the relative value of equities to other assets, including bonds.
- The earnings yield measures the earnings a company generates as a percentage of its price. As with bonds, higher yields represent lower prices.
- As of September 30, 2011, the earnings yield on the S&P 500 was 8.30%. The gap between that yield and the 3.03% yield on the 10-year Treasury was 527 basis points.
- By looking at valuations of companies from the perspective of the earnings yield, many seem to be at levels that may bode well for companies going forward and for investors seeking long-term equity investments.

“The spread between the earnings yield and the 10-year Treasury is about as wide a spread in favor of equities as you virtually will ever see in the stock market.”

— Jim Dunton, *portfolio counselor*

Sources: Federal Reserve Board, New York University, Stern School of Business, and Standard & Poor’s. The yields as of 9/30/11 represent the average of yields for nine months ended 9/30/11 for the 10-year Treasury and four quarters ended 9/30/11 (estimated) for the S&P 500.

Then and now: S&P 500 companies have higher earnings yields, lower P/E ratios



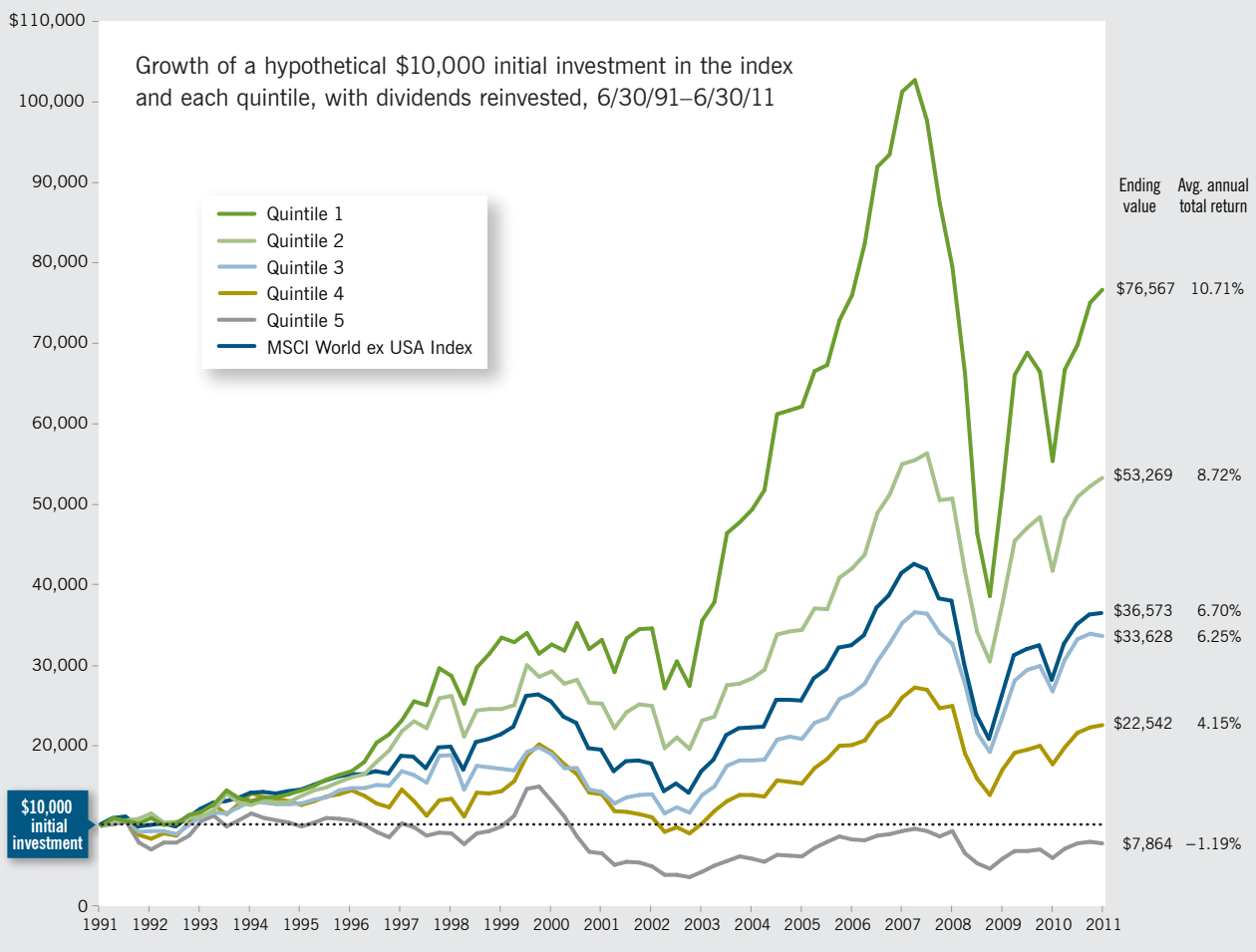
Sources: Standard & Poor's and FactSet. Data are based on 12-month operating earnings per share.

- Sometimes, it can seem as if the more things change, the more they stay the same. The price level of the S&P 500, for example, first reached 1300 in March 1999. Since then, the index has swung from a low of about 677 to a high of about 1565, only to close recently at 1300.
- But several important measures of the market's value may be telling investors that some things have changed. The earnings yield of S&P 500 companies is twice the 1999 level, and the price-to-earnings ratio is about half the level.
- There are a number of ways for determining the value of a company, and many techniques to assess whether the price is attractive relative to other assets. For equities, a look at a company's earnings yield and the P/E ratio can provide insight into whether valuation is attractive.
- The P/E ratio is one way to measure a company's prospects. It represents the current price of a stock divided by its earnings per share. The ratio reflects the cost of a given stock per dollar of current annual earnings and is the most common measure of a stock's expense. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

"U.S. large-cap stocks in particular appear to be relatively attractively valued. There are a number of companies that have great market positions, very low valuations and reasonable growth prospects."

— Chris Buchbinder, *portfolio counselor*

Companies with the highest dividend yields have provided the greatest returns



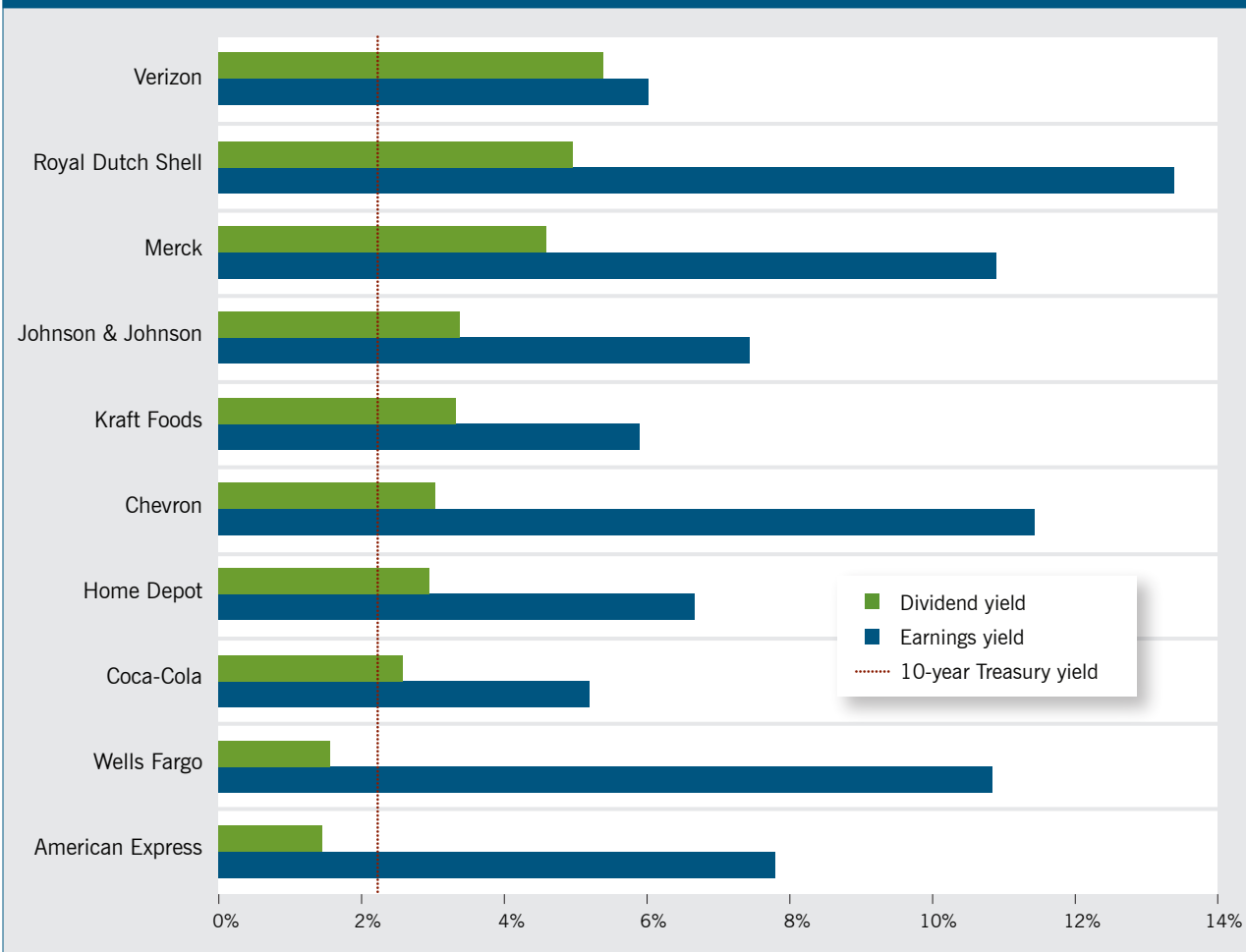
Source: FactSet. Represents American Funds analysis of companies, which constitute the MSCI World ex USA Index, on the basis of dividend yield. The companies were divided into quintiles that were reconstituted quarterly throughout the 20-year period. The number of companies varied each quarter; as of 6/30/11, there were 1,045 companies in the index. Companies with a dividend yield of 4.691% or greater as of that date represented Quintile 1. The dividend yield range was as follows for the other quintiles: 3.565%–4.689% for Quintile 2, 2.364%–3.563% for Quintile 3, 1.380%–2.363% for Quintile 4 and 0%–1.379% for Quintile 5. The index is unmanaged, and its results do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

- With nearly 60% of the world's equity market capitalization coming from securities outside the United States, international investing provides an opportunity for diversification, capital appreciation and, increasingly, income.
- International equities aren't always associated with dividends, but a growing number of companies from Asia to Europe have increasingly initiated or raised dividend payments in recent years. Many of the companies that pay the highest dividends have also been among those with the highest returns.
- The chart shows that Quintile 1, which represents the highest-yield securities, provided an average annual return of 401 basis points more than the index. Quintile 1's return also exceeded every other quintile. Indeed, each quintile rank in the growth of \$10,000 corresponded with the level of its dividend yield.
- While the ending value of the lowest-yield quintile ultimately fell below \$10,000, the same investment in Quintile 1 amassed more than seven times the initial investment, a testament to the potential returns from companies that pay relatively high dividends.

"Dividends can be an important indicator of investment value in the stock market. We think that is the case today — that there are very attractive dividend yields in Europe, for example, despite the problems there, as well as other places in the world."

— Steve Watson, *portfolio counselor*

10 companies with dividend yields that rival the 10-year Treasury



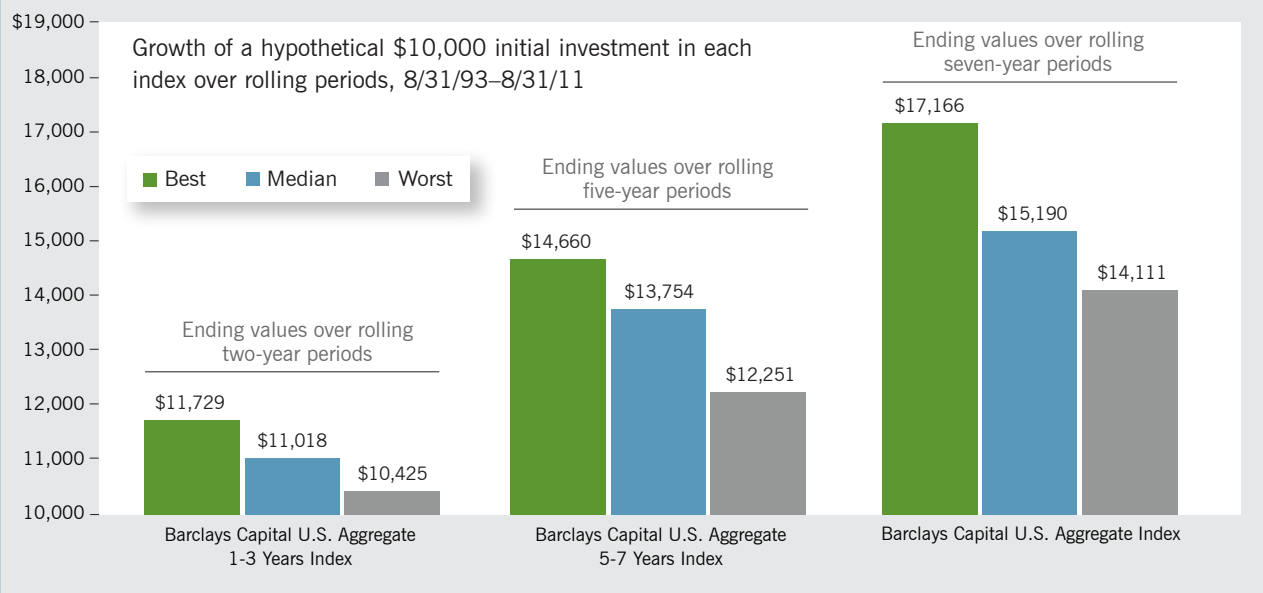
Sources: Bloomberg and Compustat. List of companies are based on the top 10 equity holdings of Washington Mutual InvestorsSM; holdings change. The percentage of the fund's net assets for each company are as follows: 3.7% for Verizon, 4.1% for Royal Dutch Shell, 3.9% for Merck, 2.8% for Johnson & Johnson, 2.3% for Kraft Foods, 6.3% for Chevron, 2.3% for Home Depot, 2.3% for Coca-Cola, 2.2% for Wells Fargo and 2.2% for American Express. All data are as of 8/31/11.

- For long-term investors, there may be an opportunity to invest in companies that provide a relatively high yield, and have the potential for capital appreciation.
- A number of well-established, large companies with strong dividend records and stable, long-term earnings potential have recently registered dividend yields that are near or above the yield on the 10-year Treasury. Equity holders of these companies can potentially benefit from a bond-type yield, in addition to possible capital appreciation.
- Although dividends paid by S&P 500 companies declined by a record amount in 2009, they have made a steady climb since then. Year-to-date ended September 30, 2011, S&P 500 companies increased or initiated dividends 259 times (242 increases, 17 initiations), compared with only four decreases. That represents an increase of \$32.5 billion in announced dividend payments through the same date. In all of 2010, the announced increase in dividend payments totaled \$20.7 billion.

“I believe dividends don’t lie. Dividends are the true measure of a company’s growth. I’m hopeful that we’re going to continue to see pretty robust dividend growth.”

— Greg Wendt, *portfolio counselor*

Short, intermediate or long, bonds can be aligned with future liabilities



Based on data rolling annually, every August. Illustration period begins in 1993, the inception year of the Barclays Capital U.S. Aggregate 1-3 Years and Barclays Capital U.S. Aggregate 5-7 Years indexes, which are also components of the Barclays Capital U.S. Aggregate Index. The indexes are unmanaged, and their results do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

Investors should carefully consider the investment objectives, risks, charges and expenses of the American Funds. This and other important information is contained in each fund's prospectus and summary prospectus, which can be obtained from a financial professional and should be read carefully before investing. Investments outside the United States involve 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. The statements in *The Long View* are the opinions and beliefs of the speaker expressed when the commentary was made and are not intended to represent that person's opinions and beliefs at any other time.

- Investing in bonds can sometimes be akin to selecting the right tool for the right job. One way to decide which bond funds may be appropriate is to determine which bond investment has the most potential to help cover a liability when it's incurred. That may be a matter of years, or decades.
- The chart shows the results of a hypothetical \$10,000 investment in three indexes that represent a variety of short, intermediate or long-term bonds. In each case, regardless of when the money was needed, the bonds preserved the investor's hypothetical \$10,000 initial investment. In fact, the ending value exceeded the initial investment in every rolling period.
- The key may be to align the investment with future liabilities. For short-term needs, it may be appropriate to seek out opportunities through the short-duration market, focusing on Treasuries and other government-backed securities, as well as high-quality corporate offerings.
- In any portfolio, there can be a place for a fund that strives to limit volatility, preserve capital and supply the investor with either current income, or a relatively certain amount at some point in the future. Those are the hallmarks of high-quality bond investing.

"More than ever, people need some peace of mind in their portfolios. It makes a big difference to have a portion of your portfolio invested in something with a history of low volatility and low worry."

— David Hoag, *portfolio counselor*