LPL FINANCIAL RESEARCH

Mid-Year Outlook 2012

Campaign 2012: What the Elections Hold for Investors

Contents

LPL Financial

Campaign 2012 What the Elections Hold for Investors

We feature **"How to Invest"** discussions throughout this publication, indicated by this blue box.

In our *2012 Outlook*, we predicted that finding a middle ground, or Meeting in the Middle, was going to be key for growth in the markets and economy. In particular, we highlighted a key characteristic of this year: soft sentiment and hard data find middle ground, meaning that we see a convergence between facts and feelings. So far, this has been reflected in economic and market data. Notably, at this year's midpoint, the gap between consumer confidence and leading economic indicators has narrowed about halfway [Figure 1].

However, when divergent rational facts and emotional feelings attempt to converge, it usually comes with some ups and downs. We have experienced this in the first half of 2012 with large upswings and dramatic downdrafts in market performance. We do anticipate that this volatility will persist for the rest of 2012—though it hopefully mellows a bit as we get some clarity around the November elections.

We continue to believe that:

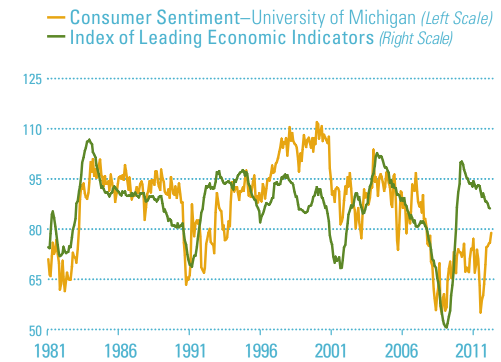
- The U.S. economy will grow about 2%, supported by soft sentiment and hard data continuing to converge,
- The U.S. stock market is likely to post an 8–12%* gain, backed by mid-to-high single-digit earnings growth,
- Corporate bonds will post modest single-digit gains and outperform government bonds.
- Policy-driven events will hold major consequences for investors.

In our *2012 Outlook*, we stated that the party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in the federal budget policy since World War II. During the next several months, the elections will likely become an increasingly potent driver of the overall markets and particular investments as well as determine whether our expectations for the year come to fruition. Therefore, we devote this publication to exploring the key issues surrounding these very consequential elections and what they mean for investors' portfolios.

In our *Mid-Year Outlook*, we explore the potential investment impacts of policy and legislative changes resulting from the elections. Our outlook over the second half of 2012 for the economy, the stock market, and the bond market are on track based on our *2012 Outlook*. However, financial markets will react in anticipation of potential election impacts and influence stock and bond market performance. In the stock market, we continue to focus on sectors that derive more of their growth from more rapidly growing emerging markets and business spending. In the bond market, we continue to focus on higher yielding sectors that may outperform in a low-yield environment resulting from political uncertainty, sluggish economic growth, and ongoing risks from Europe.

These elections can be broken down into many issues for analysis. We can think of these issues as campaign stops on our journey across the current political landscape. As we explore these issues, we will be making stops at the White House, Congress at the Capitol Building, the Federal Reserve, heading down Main Street to discuss the budget, moving on to talk taxes, and then making a pit stop to talk about the sector impacts of policy changes on Wall Street. Finally on to Europe for the impact of the numerous elections on the second half of 2012.

1 Meeting in the Middle: Gap Between Facts and Feelings Has Narrowed in 2012



Source: LPL Financial, Bloomberg 06/20/12

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

Past performance is no guarantee of future results.

*LPL Financial provided this range based on our earnings per share growth estimate for 2012, and a modest expansion in the price-to-earnings ratio. Additional explanation can be found throughout this publication.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

The White House

The presidential election results are intertwined with the markets and the economy. Surprisingly, it is not the stock market performance that can serve as a predictor of whether the incumbent president wins or loses the election—but is instead some economic data that plays this role. However, regardless of the winner, the markets and economy will be impacted by the outcome of the November 2012 elections.

We believe the impact of congressional elections may be more meaningful than the presidential one this year. However, we will cover Congress in the next section. At this campaign stop, we will focus on the presidential election's relationship to the performance of the markets and economy. Specifically, we will address the impact of:

- The market on the election,
- The election on the market,
- The economy on the election, and
- The election on the economy.

Market Impact on Election

Generally, the stock market does not predict the outcome of the election: a strong stock market does not appear to favor the incumbent nor does a weak stock market favor a challenger. For example:

1. Franklin D. Roosevelt was re-elected in a landslide victory in 1940, despite losses in the S&P 500 in the third and fourth years of his term. Harry Truman and Richard Nixon also were re-elected in the face of lackluster stock market results.
2. George H. W. Bush lost in 1992, even with a 57% gain in the stock market during his tenure. Al Gore was unable to secure the presidency in 2000, despite the powerful eight-year stock market gain while under his party's tenure in the White House.

History shows that voters are unwilling to attribute moves in the market directly to presidents, either positive or negative. Therefore, market returns do not predict an election winner or loser.

Election Impact on Market

Historically, the election outcome to the incumbent or challenger does appear to have a significant impact on the stock market. This is explained, in part, by the material impact on corporate profits that regulatory policy guided by the White House or legislation passed by Congress can have. Industries that are heavily regulated are the most affected; these include Health Care, Utilities, Telecommunications, Media, Energy, Materials, and Financials. This impact is felt both before and after the election itself.

Usually the market performs well in an election year. In fact, there have been only three election years that suffered losses since WWII. The market usually posts better-than-average gains—the 2008 plunge brought down the average, but the median return is above-average.

The four-year presidential cycle of stock market performance has been remarkably consistent over the years, with strong performances in years three and four of a presidential term, with weaker results in years one and two [Figure 2]. Interestingly, 16 of the 20 down years since 1940 came in the first or second year of a presidential term. A key reason for this historical pattern of stock market performance during a presidential term is the greater amount of economic stimulus, in the form of both monetary and fiscal policy, applied during year two and three, which then begins to fade in year four. Since this stimulus affects the economy with a lag of around a year, stock market performance tends to follow this pattern of stimulus, leaving years one and two paying the price for the better years three and four leading up to the election.

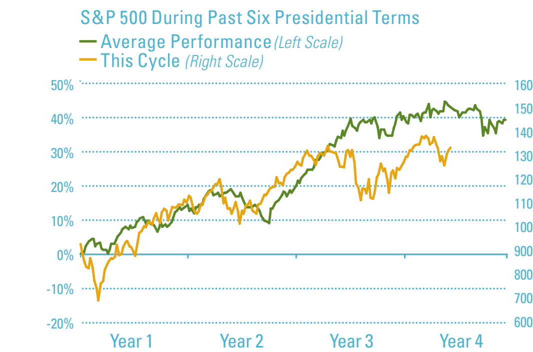
A relatively volatile and range-bound stock market leading up to a fourth quarter breakout—one direction or another—has been a common occurrence in more recent election years, taking place in 1992, 1996, 2000, 2004, and 2008 [Figure 3].

As we look out to 2013, there has been no consistent performance difference in the year after the presidential election based purely on which political party won the White House. Instead, the stock market has been more likely to respond to whether the incumbent political party won or lost. This is intuitive, since another term for the same party will likely result in a more consistent political, legislative, and regulatory environment than if the balance of power shifts to that of a new administration. However, consistent environments are not always viewed positively by investors. There are times when "more of the same" is positive and others where markets are looking for a change to a perceived better path.

Are Markets Looking for Change or More of the Same?

Over the past 85 years, the stock market has had three distinct reactions to election outcomes [Figure 4].

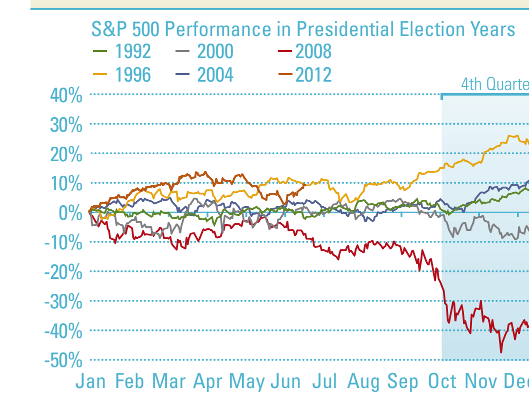
2 Presidential Pattern for Stocks



Source: LPL Financial, Bloomberg 06/20/12

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

3 Fourth Quarter Breakout: S&P 500 Election Year Pattern



Source: LPL Financial, Bloomberg 06/20/12

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

- **1928–1940:** During the turbulent period of the 1920s, 1930s, and early 1940s that included the stock market crash of 1929, the Great Depression, and WWII, the stock market favored challengers over incumbents — it sought change.
- **1944–1972:** From the mid-1940s until the early 1970s, the stock market reaction to the election outcome was mixed — neither favoring nor fretting over incumbents.
- **1976–2004:** Over the three decades from the mid-1970s to the mid-2000s, noted for above-average stock market returns and lengthy economic expansions, investors have displayed a strong preference for incumbents, as more of the same was viewed positively.
- **2008–?:** It may be that the cycle is repeating and the current turbulent period is prompting voters to once again favor challengers over incumbents.

Different from stocks, bond market performance—driven by yields that rose in the late 1960s and throughout the 1970s and fell steadily during the 1980s, 1990s and 2000s—seemed unaffected by changes in the White House and cared more about the Federal Reserve (Fed) policy. However, the election impact on taxes plays a role for municipal bonds, more details of which are in the Taxes section [Page 15].

4 Stock Market Election Reaction Has Had Four Different Periods

Market Performance Average Return	Election Year	S&P 500 Performance Year After Election (%)	Incumbent Party	Winning Party
Year After Favored Challengers Challenger= 46.6% Incumbents= -22.8%	1928	-11.9	R	R
	1932	**46.6**	R	D
	1936	-38.6	D	D
	1940	-17.9	D	D
Mixed Challenger= 1.7% Incumbents= 3.7%	1944	30.7	D	D
	1948	10.3	D	D
	1952	**-6.6**	D	R
	1956	-14.3	R	R
	1960	**23.1**	R	D
	1964	9.1	D	D
	1968	**-11.4**	D	R
	1972	-17.4	R	R
Year After Favored Incumbents Challenger= -6.8% Incumbents= 21.9%	**1976**	**-11.5**	R	D
	1980	**-9.7**	D	R
	1984	26.3	R	R
	1988	27.3	R	R
	1992	**7.1**	R	D
	1996	31.0	D	D
	2000	**-13.0**	D	R
	2004	3.0	R	R
Year After Favored Challengers?	**2008**	**23.5**	R	D
	2012		D	

Source: LPL Financial, Bloomberg 03/30/12

(Shaded Areas Represent Years When Incumbent Lost)

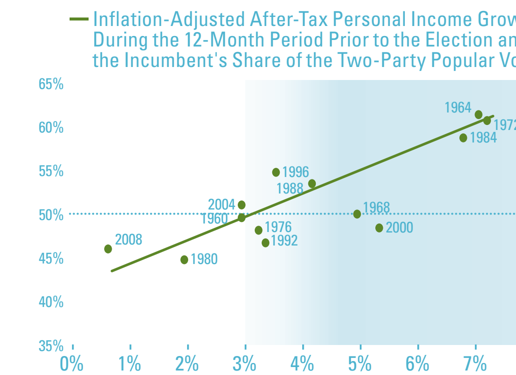
The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Economic Impact on Election

The impact of the economy on the election can best be grasped by viewing the income growth in the year leading up to the election and election results. Inflation-adjusted, after-tax income growth of about 3–4% appears to be the threshold for incumbents to get 50% of the popular vote [Figure 5]. This measure captures the impact of several key factors including the unemployment rate. As of June 2012, this measure of per capita income is currently only growing at 0.6%. This suggests the president faces an uphill re-election battle.

Clearly, factors other than taxes, inflation, and income have a bearing on the election. However, income growth and related job creation may be the key measures by which a presidency is judged, and they often determine the election outcome.

5 Income Growth Above 3–4% Is the Key to Getting Re-Elected



Source: LPL Financial, Bloomberg 04/02/12

In 1964, 1972, 1980, 1984, 1996, and 2004, an incumbent was running for a second term after a change in party in the previous election.

Election Impact on Economy

The economy is impacted by fiscal, monetary, and regulatory policy—all influenced by the election winner. The outcome of this year's election may be more consequential, as it will help to determine the path taken in 2013 to address the fiscal challenges in the United States including the debt ceiling and potential debt downgrades. In addition, the tax increases and spending cuts that have already been written into existing legislation to occur in 2013 need to be addressed. More than ever, this election will likely have a major impact on the economy.

In the months leading up to the election, markets are likely to be volatile since most presidential races are turbulent. Of the last nine presidential contests, the winner has consistently led in only two election years: 1984 and 1996. In the other seven elections, the loser of the election was ahead sometime in the summer—by an average of six points—and four of them were ahead in late October [Figure 6]. Market volatility may increase as the markets grapple with the changing expectations of who the president will be in 2013.

6 Poll Leader Switched Hands Ahead of Election Seven Out of Nine Times

Election Year	Winner	Loser	Loser's Widest Lead		Loser's Last Lead
			Margin	Month	
1976	Carter	Ford	1	October	October 30
1980	Reagan	Carter	8	May	October 26
1984	Reagan	Mondale	N/A	N/A	N/A
1988	H.W. Bush	Dukakis	17	July	August 7
1992	Clinton	H.W. Bush	10	May	July 8
1996	Clinton	Dole	N/A	N/A	N/A
2000	W. Bush	Gore	11	October	October 23
2004	W. Bush	Kerry	6	June	October 31
2008	Obama	McCain	6	May	September 15

Source: LPL Financial, Gallup 06/20/12

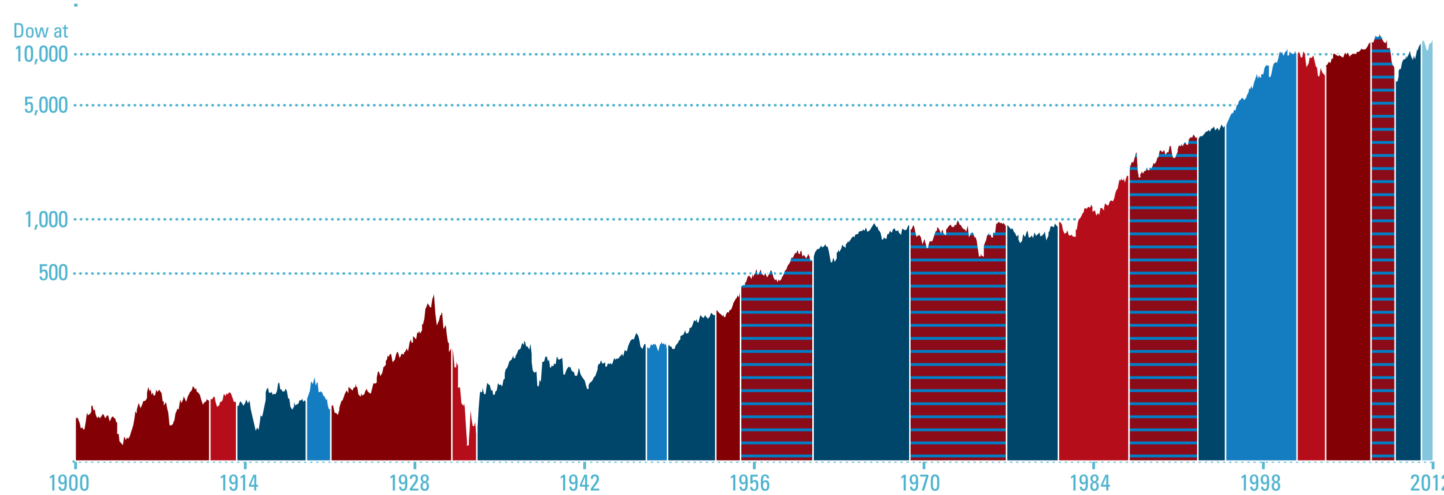
Congress

We believe the changes in Congress may have a dramatic impact on the second half of the year. The elections may result in both chambers being controlled by the same party. Given the fiscal challenges presented by 2013, markets may welcome the prospects for Congress moving from a state of gridlock to one where action is more likely.

It is often said that the markets like gridlock—meaning a divided Congress with one party in control of each chamber: the Senate and the House of Representatives. The theory is that during periods of gridlock investors assign a lower probability to the passage of new spending initiatives that would increase the debt supply and impact the bond market as well as fewer legislative changes to businesses that would cloud the visibility for stocks.

7 Dow Jones Industrial Average Performance by Political Regime

Political Regime	Annualized Performance	% of Time
Democratic President/Democratic Congress	7.3%	35.8%
Democratic President/Republican Congress	9.6%	9.0%
Democratic President/Split Congress	9.2%	1.2%
Republican President/Republican Congress	7.0%	23.4%
Republican President/Democratic Congress	2.2%	19.8%
Republican President/Congress Split	-4.0%	10.8%



Source: LPL Financial, Bloomberg, Ned Davis 06/20/12

(Logarithmic scale)

The Dow Jones Industrial Average Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

History, however, does not bear this out. Instead, the markets have tended to perform best when Congress was controlled by one party, as most of the time a split Congress resulted in losses for stock market investors.

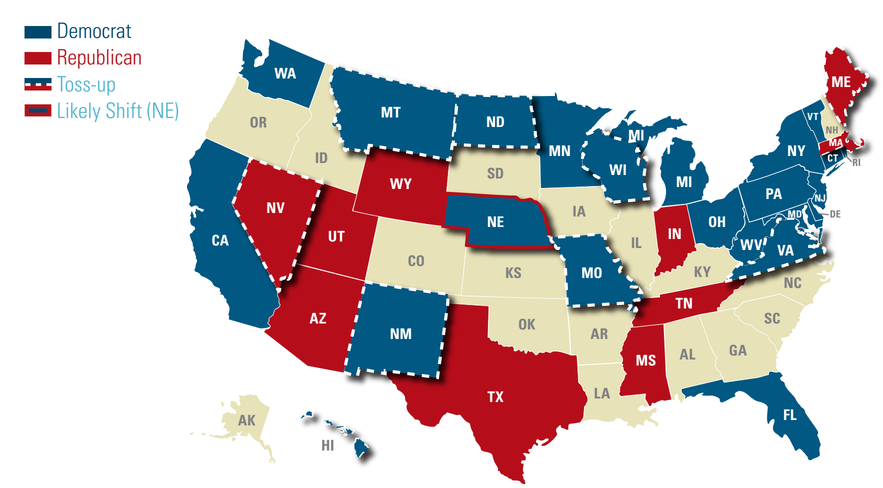
The periods when Republicans controlled Congress were some of the best, no matter which party controlled the White House [Figure 7]. We think the election odds favor an all Republican Congress next year and that markets may increasingly welcome this potential outcome leading to a late-year rally consistent with the historical pattern of performance in an election year.

While the Republicans may lose some seats in the House, they picked up a lot of seats in the 2010 elections and are likely to retain control by a wide margin. However, Republicans may take the Senate—though it will be by a slim margin. While all members of the House of Representatives are up for re-election every two years, Senators serve six-year terms with one-third of the Senate up for re-election every two-year period. This year, it ends up that of the 33 seats up for re-election, 23 are currently held by Democrats and only 10 by Republicans [Figure 8]. These numbers suggest it will be an uphill battle for the Democrats to retain their current slim three-seat majority.

We believe many of the seats will not change. Of the 33, 13 will likely stay in the hands of Democrats, nine states are likely to stay in the hands of the Republicans, and Nebraska will almost definitely go to the Republicans, leaving 10 up for grabs. While the polls have these states split evenly between Democrats and Republicans, the Democrats must win seven of the 10 toss-up states to retain the Senate. It is likely that as we move towards November, most states break to one party or the other rather than split down the middle.

Markets will likely welcome the prospect for one party being in control of Congress regardless of party affiliation. A Congress that can act promptly, bring proposals out of committees, put them to a vote, and bring them swiftly to the president's desk would be a dramatic change to the last year-and-a-half of gridlocked government. After all, Congress writes the laws. A Congress that is able to work together is critical after what happened with the 2011 debt ceiling debacle and downgrade. Congress has the potential to move from gridlocked to unlocked in 2013. This matters a lot to investors because of the need to avoid the budget bombshell that is about to hit our economy in 2013.

8 2012 Senate Races by Party of Current Seat Holder



Source: LPL Financial 06/20/12

How to Invest: Stock Market

Despite our outlook for sluggish U.S. economic growth of about 2% and a mild recession for Europe, we expect high-single to low double-digit returns for the S&P 500. We expect these gains to be driven by earnings growth in the high single digits and a modest rise in the price-to-earnings (PE) ratio from recession-like levels as sentiment begins to rebound.

We believe the PE ratio may rise slightly in the second half of 2012, as investors begin to price in the outlook for a shift to a one-party Congress, which would be more likely to take action on the U.S. fiscal imbalances that are weighing on stock market valuations versus the gridlock of the past two years of a split Congress.

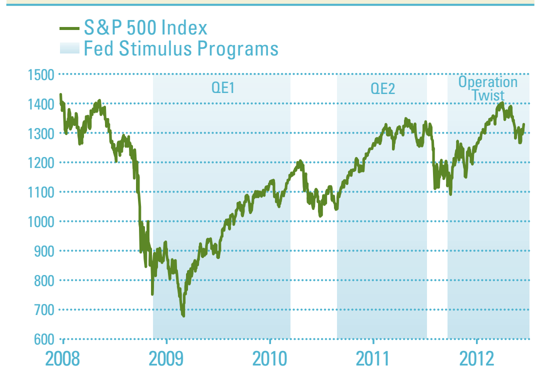
Domestically, we expect stocks to decouple from U.S. Gross Domestic Product (GDP) growth, as corporate profits are driven more by business spending and manufacturing than the more consumer spending-driven GDP. Overseas, while Europe is likely to experience a mild recession in 2012 and Japan struggles to rebound from recession, solid growth is expected in emerging economies benefitting a substantial 25% of U.S. corporate revenues. Slow growth is not bad for the stock market. In fact, over the past 40 years, the S&P 500 median return is 10% when real GDP grows less than 3%.

Specifically, mid and small capitalization companies tend to perform better after the economy emerges from mid-cycle soft spots and credit markets improve.

Federal Reserve

In a presidential election year, politics often plays an even bigger role in policy—even when it comes to the Fed, which has been viewed in recent decades as a nonpolitical and independent organization. However, the Fed has either raised or lowered its short-term policy rate—and in some cases done both—in every presidential election year since 1968. In general, the Fed claims it wants to avoid mingling in politics. However, in the past 40 years, the Fed acted to change policy as needed and is likely to do so again over the second half of this year if conditions warrant.

9 Another Fed Stimulus Program Looming



Source: LPL Financial, Bloomberg 06/19/12

(Shaded Area Represents Fed Programs From the Date of Announcement Until Termination.)

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

The Fed Always Acts in Presidential Election Years

In each of the past two years, Federal Reserve (Fed) stimulus programs, known as QE1 and QE2, came to an end in the spring and summer, and stocks began to slide until the next program was announced. The current program, Operation Twist, was announced on September 12, 2011 and was scheduled to conclude at the end of June 2012. In late June 2012, the Fed extended Operation Twist through the end of 2012, and said it is "prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions." [Figure 9]

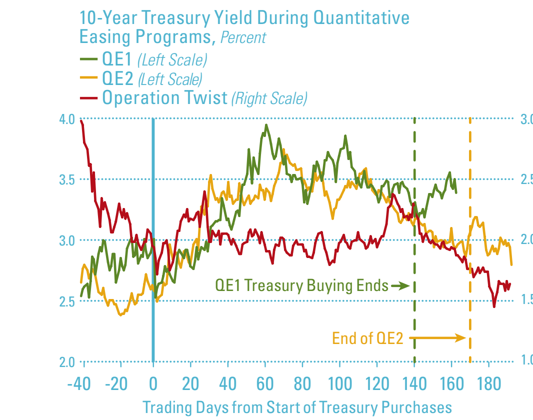
Fed policymakers would likely prefer not to begin a new round of QE in the weeks and months leading up to the November 6 election, leaving the Fed only a narrow window between now (late June 2012) and the onset of the fall presidential campaigns, which traditionally swing into high gear after Labor Day. With Operation Twist now extended to the end of 2012, the question markets will ask is: what would prompt the Fed to do QE3?

QE3 Still on the Table

The Fed has a dual mandate to promote low and stable prices and to foster conditions that lead to full employment. Recent data points on employment, the overall economy, and inflation suggest the following.

- **Softening Labor Market.** The labor market is softening again, with the unemployment rate at 8.2% in June 2012, and is in danger of rising further over the remainder of this year. The unemployment rate may not fall to the Fed's forecast of 8.1% by the fourth quarter of 2012. In comments made just after the June 20, 2012 Federal Open Market Committee (FOMC) meeting, Fed Chairman Ben Bernanke stated, "if we are not seeing sustained improvement in the labor market, that would require additional action."
- **Slowing Economy.** The overall economy remains near stall speed and below the Fed's forecast (2.2% for real GDP growth in 2012 and 2.5% in 2013). The economy grew at just 1.9% in the first quarter of 2012, and thus far in the second quarter of 2012 is on track to post growth closer to 1.5% than 2.0%. Bernanke cited the following drags on growth: Europe and the looming fiscal cliff in the United States, sluggish housing market, and ongoing fiscal stress at the state and local level. Our forecast remains that the economy will grow at 2.0% in 2012, and if this forecast is achieved, the Fed will likely act.
- **Stabilizing Core Inflation.** Deflation, a prolonged period of falling prices and wages, is not likely. Both headline and core (excluding food and energy) inflation remain above the FOMC's forecast range for 2012. However, headline inflation has decelerated sharply this year, and core inflation has stabilized. With plenty of slack in the labor market, wage gains are nearly nonexistent. Since labor costs account for roughly two-thirds of business' costs, there is little ability to pass through price increases. In addition, inflation expectations (of consumers, businesses, and professional forecasters), a key input to the Fed's process on monetary policy, have barely budged in recent years and suggest inflation expectations remain well contained.
- **Considering More Stimulus.** The potential for much more restrictive fiscal policy in 2013, as tax hikes and spending cuts go into effect, may prompt the Fed to provide more stimulus. Indeed, financial conditions have already worsened (including measures like interbank lending rates, yield curves, credit spreads, price-to-earnings ratios, and the value of the US dollar). Although conditions have not deteriorated as much as they did prior to the start of QE2 in fall 2010 or summer 2011, prior to the announcement of Operation Twist, financial conditions have deteriorated rapidly since the start of the second quarter of 2012.

10 Treasury Yields Increased at the Start of Prior Bond Purchase Programs



Source: LPL Financial, Bloomberg 06/15/12

Repeat Performance?

A look back at prior rounds of Fed bond purchases shows that Treasury yields actually increased following the start of bond purchases. In each of the three prior bond purchase programs—QE1, QE2, and Operation Twist—the yield on the 10-year Treasury increased almost immediately [Figure 10]. Treasury market response seems contradictory or ironic given the size of Fed purchases. But remember that markets are forward-looking. Investors quickly anticipated the beneficial impacts of the Fed's bond buying on the economy and pushed up stock prices as well as prices of more economically sensitive fixed income sectors such as high-yield bonds. Even if the Fed's bond buying did not materially lower interest rates, it could help restrict any potential rise in bond yields and provide key support to segments of the economy, and therefore financial markets, that benefit from lower interest rates.

How to Invest: High-Yield Bonds

The extension of the Fed's Operation Twist into the second half of 2012 may help high-yield bonds outperform. High-yield bonds did not initially benefit following the start of two of the three Fed bond purchase programs. Instead, high-yield bond spreads over Treasury yields actually increased following QE2 and Operation Twist. However, in all three cases, high-yield bonds did improve relative to Treasuries over the intermediate to longer term as evidenced by narrower yield spreads.

This outcome was intended by the Fed. Lower risk premiums on the bonds issued by lower-rated companies translated into lower borrowing costs, helping to boost the economy—a goal of the Fed.

The Budget Bombshell

The 2013 budget changes, primarily consisting of tax increases, are already in the law and would need to be changed or restructured to mitigate their economic drag. If this is not mitigated, a return to recession may be looming in 2013.

The 2013 budget is going to have the biggest impact of any budget in decades even if no action is taken in Washington. The fiscal headwind composed of both tax increases and spending cuts under current policy totals over $500 billion or 3.5% of Gross Domestic Product (GDP) [Figure 11].

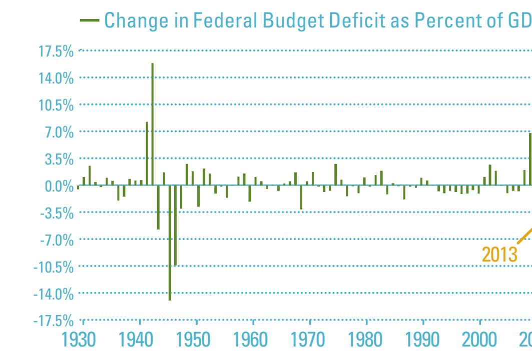
11 2013 Fiscal Headwinds ($ billions)

Expiration of Bush tax cuts for middle income earners	205
Expiration of Bush tax cuts for high earners	50
Payroll tax cut for workers	112
Debt ceiling annual spending sequester for defense	55
Debt ceiling annual spending sequester for non-defense	55
Alternative minimum tax annual "patch"	38
Medicare tax of 3.8% on investment income from 2009 Obama health care plan	21
Total	536
Total as % of estimated 2013 GDP	3.5%

Source: LPL Financial, Congressional Budget Office, Office of Management and Budget 02/06/12

While the U.S. economy is not likely to see the big declines in government spending that came after WWI and WWII, the United States has never experienced a deficit cut of more than 2% of GDP that did not end in a sharp decline in GDP. The last time the budget deficit was cut by a similar amount to the 3.5% on tap for 2013 was 1969. In 1969, the deficit was cut by 3.1% during the year [Figure 12]. GDP ended up shrinking 1.9% in the fourth quarter of 1969 (and -0.6% in the first quarter of 1970) as the United States entered a recession. Despite the recession, the efforts to narrow the deficit in 1969 had one pleasant outcome: they balanced the budget. Unfortunately, the budget changes on tap for 2013 will still leave the federal budget far from balanced.

12 Budget Change on Tap for 2013 Largest Since End of WWII



Source: LPL Financial, U.S. Census Bureau, U.S. Treasury 02/06/12

Most Likely Budget Impact

The most likely outcome is a fiscal tightening of more than 1% of GDP in 2013. A fiscal tightening of over $200 billion (with about half from tax increases) totaling about 1.3–1.5% of GDP is likely in 2013 and will be composed of:

- The likely expiration of the payroll tax cut ($112 billion),
- A reduction in discretionary spending (about $80–90 billion), and
- The imposition of the 3.8% Medicare tax on investment income ($21 billion).

As for some of the items under consideration, here are our predictions:

- Payroll Tax Cut: The 2% payroll tax cut is unlikely to get extended even under a Republican sweep of the White House and Congress. The Republicans do not like short-term stimulus, so it is highly unlikely to be extended if Mitt Romney wins. Even though it is a tax cut, fiscal conservatives see it as stimulus that helps the economy one year and hurts it the next while increasing the debt.
- Sequesters: Congress is highly likely to live by the sequesters, or spending caps, agreed to as part of last year's deal to raise the debt ceiling. Along with the drawdown in troop levels overseas and a little bit more of an unwinding of stimulus spending, federal discretionary spending is set to drop by about $80–90 billion.
- Investment Income Tax: The 3.8% tax on investment income for upper income individuals has little chance of being repealed by Congress before 2013. Even if Republicans sweep the election, the tax will likely remain in effect in 2013.

This combination of about $100 billion in tax increases and $100 billion in spending cuts may be the sweet spot for markets: it is significant but not enough (by itself) to cause a recession, it may allay the immediate concerns of the rating agencies and avert a downgrade of our debt, and it may boost confidence that we can address our long-term fiscal imbalances and return to the path of fiscal sustainability. This is why the makeup of Congress is especially important as Washington attempts to avert the budget bombshell from going off and taking the economy and markets with it.

The combination of about $100 billion in tax increases and $100 billion in spending cuts may be the sweet spot for markets: it is significant but not enough (by itself) to cause a recession.

The year-end "lame duck" session will have a full agenda. What is likely to get addressed is the Alternative Minimum Tax (AMT) patch, physician Medicare reimbursement, and prevention of the sequester from taking effect for very long (if at all). A temporary expiration of the Bush tax cuts is more than a 50/50 proposition (especially with a Republican win of the Senate).

The markets may begin to price in a major budget deal taking place in early 2013 for several reasons:

- The economic impact of the many scheduled tax increases and spending cuts,

- The debt ceiling will be hit again in early 2013 and require legislative action to approve an increase,
- The rating agencies have warned that they will be watching in 2013 for the United States to take actions to return to a path of fiscal sustainability, and
- The president and a newly elected Congress will have maximum political capital to make it happen in early 2013.

But, the risk that a budget deal does not eventually happen will likely keep markets in check and prevent them from posting exceptional gains in 2012.

How to Invest:
The Budget Bombshell and the Bond Market

We maintain our forecast of mid-single-digit returns for the bond market in 2012, as even modest fiscal tightening will help support high-quality bond prices through late 2012. Economic growth, one of the key drivers of interest rates, will likely be restrained due to our expectation of fiscal tightening. The prospect of a slower growth environment, coupled with investor uncertainty over just how much of an impact reduced government spending and higher taxes will have on the economy in 2013, is likely to keep demand for bonds elevated despite high valuations and very low yields. Furthermore, the Fed indicated it will refrain from raising interest rates until late 2014, removing another source of risk for bondholders. Add in continued European uncertainty, and bond prices are likely to be range-bound, and yields low, and this all would support a low return environment for bonds.

In this range-bound, low-yield bond market environment, we believe yield will play an even more dominant role in bond total returns. Therefore, we focus on higher yielding segments of the bond market supported by solid fundamentals. Currently, among high-quality bonds, Mortgage-Backed Securities (MBS) provide more than 1% in extra yield versus comparable Treasuries, and limited new issuance provides a favorable supply-demand backdrop. Corporate bond credit quality metrics remain very strong. Although defaults are expected to increase modestly over the remainder of 2012, current high-yield bond valuations, with a yield spread of over 7% to comparable Treasuries, more than compensate for the increase. A slow-growth environment has historically been good to corporate bond investors as the yield advantage to comparable Treasuries has proved to be a valuable performance driver.

Taxes

The 2012 elections hold major consequences, and one of the most important outcomes focused on by all of us who are taxpayers is tax policy. We discuss how tax changes may directly affect investors in the stock and bond markets.

Already written into law for 2013 are big tax policy changes including the expiration of the Bush tax cuts, the payroll tax cut, and the new Medicare tax on investment income—not to mention the impact of the increasingly costly annual fix to the AMT. However, these may be replaced by proposals from President Obama centered around the so-called "Buffett Rule", or from the Republican House tax cuts supported by Mitt Romney [Figure 13].

13 Investor Tax Changes: Interest, Dividend, and Capital Gains Taxes

	Pre-Bush Tax Cut Rates	2012	Current Law 2013*	Obama Proposal 2013**	Romney supported House Republicans Proposal 2013
Top Rate on Interest	39.6%	35%	43.4%	43.4%	25%
Top Rate on Dividends	39.6%	15%	43.4%	43.4%	15%
Top Rate on Capital Gains	20%	15%	23.8%	30%	15%

Source: LPL Financial 06/20/12

* Includes the new 3.8% tax on interest, dividends and capital gains.

** Includes "Buffett Rule" tax

The outcome is likely to be somewhere in the middle of the wide range between the two proposals from President Obama and House Republicans. Given the scale of the tax changes, it may be surprising that we do not expect major direct impacts on the stock or bond market. The far bigger impact is an indirect one determined by the magnitude and direction of

14 Closing the Loopholes

Top-10 Individual Tax Expenditures For Fiscal Years 2011 – 2015 (5-Year Estimate in Billions)	
Exclusion of employer contributions for health care	$725.0
Mortgage interest deduction	$464.1
Lower rate on cap gains, dividends	$456.6
Defined contribution pension plans	$375.9
Earned income credit	$294.1
Defined benefit pension plans	$263.7
Exclusion of capital gains at death	$230.8
Deduction of state and local government income, sales, and property taxes	$230.3
Exclusion of untaxed Social Security and railroad retirement benefits	$188.8
Charitable contributions deduction	$186.1

Source: LPL Financial, Thomson Financial, Center for Tax Policy 04/16/12

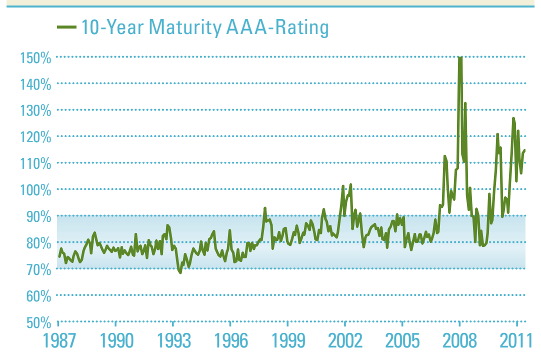
The tax information contained herein is for educational purposes only. Please contact your Financial or Tax Advisor for more information on your specific situation.

How to Invest: Municipal Bonds

We find municipal bonds attractive and believe there will likely be no changes to the municipal tax exemption. According to the Joint Committee on Taxation (January 2012), the cost of the municipal tax exemption totals $177 billion over fiscal years 2011–2015, which does not crack the top-10 tax expenditures and provides less bang-for-the-buck as a deficit reduction measure.

If Democrats raise tax rates, the tax-exemption of municipal bonds will become more valuable and municipal bond prices may benefit. Alternatively, Democrats may seek to cap the tax exemption at 30%, for example, reducing the benefit to higher tax bracket investors. However, the law may be applied only to newly issued bonds. Under such a scenario, municipal bond prices may still benefit as the supply of tax-exempt municipals becomes constrained and a scarcity premium develops. Attractive valuations relative to Treasuries are likely to offset the impact of the potential for lower tax rates under a Republican sweep.

15 Municipal Bond Yields as % of Treasury Yields



Source: LPL Financial, Bloomberg 06/20/12

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Past performance is no guarantee of future results.

overall fiscal policy taken (or not taken) in 2013 to put the United States back on a path to financial stability.

While the changes to existing policy will likely be dramatic, we do not expect a sweeping re-write of the tax code in 2013 for a few reasons.

1. Under a divided government there is unlikely to be enough common ground upon which to base a new code.
2. Republican priorities will be to simply retain as much of the Bush tax cuts as possible, repeal provisions of Obama's Affordable Care Act (ACA), and reduce the deficit. There will not be the political bandwidth to tackle comprehensive tax reform.
3. It is not politically easy to reduce tax rates while raising the same amount of revenue, which the House Republican budget pledges to do. Closing enough "loopholes" to raise sufficient revenue to offset the reduced rates would mean eliminating popular deductions such as mortgage interest, the exclusion of employer contributions for health care, and deferred taxation of retirement plans [Figure 14].

This does not mean there will not be any significant tax changes. But, we believe the idea of a major rewrite of the tax code early next year that involves rate cuts is highly unlikely. That probably means pass-through vehicles such as master limited partnerships (MLPs) and real estate investment trusts (REITs) may be safe from any tax changes in 2013 and may benefit from demand from yield-hungry investors.

Bond Market Tax Rate Impacts

Historically, changes in income tax rates that apply to interest income appear to have had little, if any, direct impact on government bond yields. Yields rose with inflation in the 1970s and fell as inflation fears receded over the vast majority of the last 30 years, regardless of tax code changes or their impact on the deficit.

Generally, over the past 30 years, municipal bond yields traditionally traded at a discount to taxable bond yields. However, in recent years credit fears driven by macroeconomic events have resulted in a breakdown of the historic spread between taxable and non-taxable municipal bonds. Municipal bonds usually trade at 70%–90% of taxable bond yields. But lately muni yields have soared above Treasury yields—partly due to credit fears in the muni bond market, but mostly due to the global flight to Treasuries pushing taxable yields lower [Figure 15].

Stock Market Tax Rate Impacts

In the past, tax changes have had minimal effects on stock market performance. To illustrate, we can look at the two most important drivers of stock market return: earnings growth and valuations.

While earnings growth is cyclical, falling sharply during recessions and rebounding early in expansions, it has had a consistent average over historical cycles of about 7% growth rate over the full cycle. This has been consistent regardless of the prevailing tax rates. In fact, the growth rate of earnings from the peak of one business cycle to the next has consistently been about 7% over the six major earnings cycles spanning the past 50 years, despite average top marginal income tax rates that ranged from about 80% at the beginning of the period to the current 35% and corporate tax rates that ranged from about 50% to 35% [Figure 16].

With no discernible effect on earnings growth, what about the impact of tax rates on valuations? Certainly, tax rates have the ability to directly impact the value investors place on stock market investing. For example, if dividend and capital gains taxes were each set at 100%, stocks would have little value to a taxable investor, as all dividends and capital appreciation earnings would be consumed for taxes. It is reasonable to believe that the lower the tax rate, the more a taxable investor would value stocks. However, over the past 30 years, higher effective federal income tax rates for the top 20% of earners (who tend to make up the majority of individual investors) have not resulted in lower stock market valuations, measured by the price-to-earnings ratio for the S&P 500 index. Counter-intuitively, periods of higher valuations occurred during periods of higher effective tax rates, and lower valuations occurred when tax rates were lower. For example, in the late 1990s, stock market valuations rose to record highs despite relatively high marginal and effective tax rates.

Another reason the direct impact of tax rate changes may be muted is that it appears that stocks may already have priced in the return of higher tax rates. Indeed, current valuations are at or below the levels experienced during periods when tax rates were as high as we expect they may go in 2013.

Short-Term Impacts of Tax Rate Changes

It seems that the bond and stock markets have adjusted to different tax rates without any apparent long-term direct effects on performance. But what about during short-term periods when those rates were changed? Did markets have abrupt adjustments to the changes in rates? The answer is no; history shows that the markets took the changes in stride.

For example, the capital gains tax rate went from 20% to 28% in 1987, when the 1986 tax reform act was passed, and that did not stop a rally in stocks beginning as the act was passed that lasted for most of 1987 (until the unrelated October 1987 crash).

Alternatively, the market impact of the investor tax cuts in 2003 that lowered dividend and capital gains tax rates to 15% was difficult to discern, given the geopolitical and economic environment at the time. The impact of the reversal of these provisions may be equally difficult to discern separately from their macroeconomic context. We can see this difficulty by looking back at the stock market's reactions to the news of the proposed investor tax cut and then the passage of those cuts.

- Initial details of the 2003 investor tax cuts began to appear in early December 2002, with more insight in January 2003. Stocks slumped in December and January—even around the days details came to light—as investors were focused on the impending invasion of Iraq. The performance of both non-dividend and dividend-paying stocks was similar, despite the prospects for a cut in the dividend tax rate.
- Attention returned to the tax cuts in April 2003, as bills were introduced. The tax bill narrowly passed in mid-May and was signed by the president on May 28, 2003. Beginning in April, the stocks of low or no dividend-paying companies outperformed high dividend payers as stocks rallied powerfully and the invasion of Iraq got underway [Figure 17].

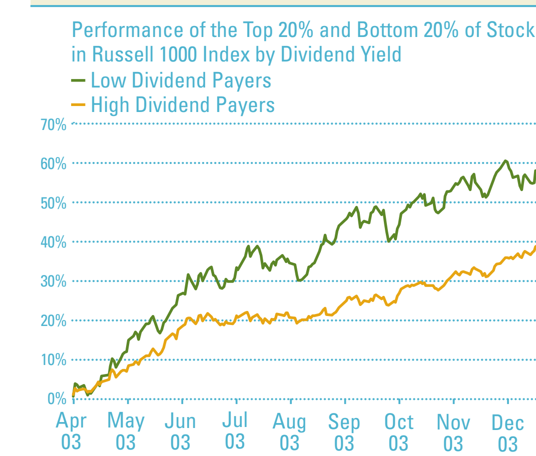
16 Earnings and Taxes: Tax Rates and Earnings Cycles for S&P 500 Companies

Earnings Cycle Peak	Annualized Earnings Growth From Prior Cycle Peak	Cycle Average	
		Top Marginal Income Tax Rate	Top Marginal Corporate Tax Rate
September 1969	5.4%	80%	50%
September 1974	9.1%	70%	49%
December 1981	7.5%	70%	47%
June 1989	7.4%	48%	43%
September 2000	7.2%	36%	35%
June 2007	7.2%	36%	35%

Source: LPL Financial, Thomson Financial, Center for Tax Policy 04/16/12

Past performance is no guarantee of future results.

17 High Dividend Paying Stocks Underperformed When Dividend Tax Cut Passed



Source: LPL Financial, FactSet 04/16/12

Dividend paying stock payments are not guaranteed. The amount of a dividend payment, if any, can vary over time and issuers may reduce dividends paid on securities in the event of a recession or adverse event affecting a specific industry or issuer.

Past performance is no guarantee of future results.

The direction of the markets is dependent upon substantive action taken to address the debt ceiling, potential debt downgrades, and fiscal stability. Any change in tax rates is likely to be secondary in its impact to how successfully the challenges are addressed.

During both of the previously referenced periods, U.S. and non-U.S. stocks also performed very similarly, with the world focused on Iraq. The impact of the investor tax cuts in the United States did not result in U.S. stock market outperformance. Also, low and non-dividend paying stocks outperformed the high-dividend payers that would benefit most from the lower dividend tax rate.

It appears that the tax rate changes have played little or no direct role in broadly viewed stock or bond market performance. Possible reasons may be that investors discounted the effect since changes were not made permanent or, more likely, that the effects on after-tax returns were deemed negligible relative to the macroeconomic and geopolitical concerns. However, certain segments of each market will be positively impacted by the changes, or lack thereof, and present strong investment opportunities.

Now, to be clear, we do not believe taxes do not matter. In fact, we believe the heightened attention on taxes and the deficit is more of a concern this year than in prior episodes of tax rate change. The direction of the markets is dependent upon substantive action taken to address the debt ceiling, potential debt downgrades, and fiscal stability. Any change in tax rates is, however, likely to be secondary in its impact to how successfully the challenges are addressed.

Year-End Effects

While history suggests otherwise, as investors may perceive a lame duck session after the election unlikely to result in enough time or cohesion to adjust tax rates before they change, investors might take action around year-end to take advantage of expiring low tax rates. As the year-end expiration of the 15% capital gains tax rate looms, investors might be prompted to sell stocks to lock in that rate. Also, a potential outcome of the year-end dividend rate tax hike could be a large number of public companies with a high concentration of family and closely held shares declaring and making a one-time, special dividend payment in the fourth quarter to be sure to take advantage of the 15% tax rate before it goes away.

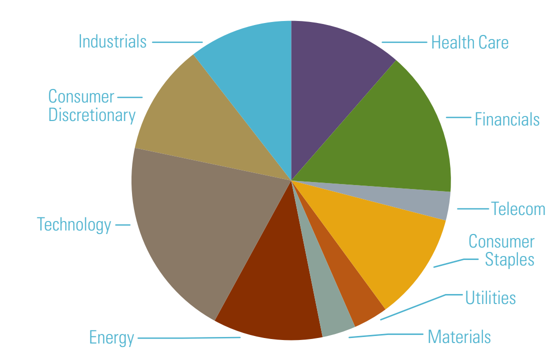
Wall Street Sectors

The outcome of the elections will define the political context and leadership for policies that address the looming fiscal imbalances coming to a head in early 2013. We have explored the budget bombshell and what it could mean for the markets and economy. In this section we will take a deeper look at what the elections mean for the markets.

The components of the 10 stock market sectors are impacted differently by election outcomes.

- Health Care is the biggest driver of the long-term budget problems at the Federal level. On their own, Medicare and Medicaid are expensive entitlements. When combined with the costs of the ACA, health care expenses are very large. States are already cutting Medicaid to balance their budgets. A sweeping win for Republicans holds the most promise for Managed Care providers as risks decline, and it increases the odds for a repeal of all or part of the ACA. Diagnostic labs, generic drug makers, hospitals, and nursing homes may benefit if the act is upheld and from Democratic leadership, given that they bring expanded health care coverage and an emphasis on preventative care and legislation to speed up the introduction of generic drugs to market.
- We may see a relief rally among the banks in the legislation-sensitive Financial sector. If the Republicans take the Senate it will result in the change of chairmanships of key committees. While major changes to the financial reform law, Dodd-Frank, are unlikely, a Republican Congress might influence the regulations used to implement the law. On the other hand, Republicans would likely look to address Fannie Mae and Freddie Mac, which were conspicuously left out of the Democrat-led financial reform law and could have negative ramifications on home loan originators. Democrats may also provide more housing support programs benefitting home builders and construction material providers.
- The potential extension of Bush tax cuts would mean the dividend tax rate may remain closer to 15% instead of going to 43.4%, a plus for companies with lots of cash to distribute. High dividend-paying sectors such as Telecommunications, Consumer Staples, and Utilities may benefit. Cash-rich companies in other sectors may also benefit as they introduce or substantially increase their dividend payout as they look to attract a new class of investor seeking yield. Alternatively, some food and

18 All Sectors Impacted by the Election—Shows Percent of S&P 500 Market Cap in Each Sector



Source: LPL Financial 06/20/12

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

staples retailers may benefit from the potential for a further extension of unemployment benefits under the Democrats.

- Companies in the Energy sector may be impacted by a strong election for the Republicans in a couple of ways. First, regulations on drilling would be more favorable as would Environmental Protection Agency (EPA) regulations. Second, we could see lower costs for producers in the Materials sector and users of coal such as Utilities. On the other hand, gas may benefit from stricter coal regulations under the Democrats. Alternative energy companies would face a less supportive outlook for subsidies under a Republican outcome.
- Sectors highly sensitive to international trade, including Technology, may benefit from a strong showing by the Republicans. The Consumer Discretionary sector could also benefit from the diminished risk of China trade protectionism—a plus for retailers dependent on low-cost imports and U.S. exporters of capital equipment fearing Chinese retaliation.
- The election could hold positives and negatives for companies in the Industrials sector. At 20% of the budget, defense will likely see cuts next year, but would likely see a more shallow trimming under the Republicans than Democrats. On the other hand, transportation funding will likely be smaller under Republican leadership, resulting in fewer government dollars for engineering and construction companies.

Attempting to draw simple conclusions about what the market is saying about the elections is fraught with the potential for misinterpretation. Instead, analyzing the market by the industries most impacted one way or another by the elections' outcome can help us evaluate potential investment opportunities.

How to Invest:
Focus on Less "Election-Sensitive" Sectors

Our favorite sectors remain Technology and Industrials. These sectors may experience a neutral to modestly positive impact from election results. We are less favorable on sectors where election results could lead to disparate outcomes, and therefore potentially more volatile performance, such as Health Care and Financials.

The Technology sector has exhibited the strongest earnings growth among S&P sectors in 2012 and a good showing by the Republicans would be an added positive. We believe Technology stocks are still attractively valued based upon historical price-to-earnings ratio comparisons and that underlying earnings strength will remain intact. Furthermore, in a slow-growth economy we believe business spending on technology will remain elevated as companies strive to maintain peak productivity.

Election impacts to the Industrials sector may be mixed, but underlying themes outlined from our *2012 Outlook* remain intact. We continue to believe emerging market economies will lead global growth and Industrial stocks are most likely to benefit as they maintain greater exposure to emerging markets. In addition, we expect emerging market countries, including China, to stimulate their economies by cutting interest rates—a positive catalyst that is being dismissed by the market in our view. We continue to expect the U.S. economy to expand modestly and avoid a recession, which further supports our preference for more cyclical sectors such as Industrials.

Europe

This has been a major period of global political change. As we assess the outlook for the financial markets, it is important to look at the impact the elections in Europe are having on shaping the future of the Eurozone.

A wave of change is sweeping the continent; 12 out of the 17 Eurozone governments have collapsed or been voted out over the last two years, with many of the elections taking place in the past nine months and more on the way in Germany and Italy in 2013. Most recently, Nicolas Sarkozy was France's first president to be voted out of office in 30 years.

The turnover is related to the combined sovereign debt problems, austerity measures, and recession taking place in the Eurozone. Trying to balance the right mix of austerity and economic performance, collective obligations and independence, community, and national pride are not a simple matter. We will likely witness another step in the evolution of the European economy that began a little over 20 years ago with the reunification of Germany and the signing of the Maastricht Treaty.

In the immediate future, the second half of 2012 will be focused on austerity commitments and bailouts and whether any country will leave the 17-member Eurozone. No one really knows what the consequences of a country—Greece, Portugal, or any other—leaving the Eurozone would be given the complexity and interdependencies involved. But, beyond the financial adjustments of exiting a common currency and reintroducing a national one, the question for the economies of Europe is: where does withdrawal end? To what extent do those countries that desire their own unique monetary and fiscal (and defense) policies also want their own trade policy? One reason the Germans are not excited to see the Greeks leave is that, perhaps in addition to withdrawing from the euro, they might consider trade controls to protect their economy. As the world's second-largest exporter, Germany must maintain the free trade zone of Europe or suffer a painful economic adjustment. If expelling Greece led to a fundamental reconsideration of unlimited free trade in Europe, Germany would face serious risks to its own economy.

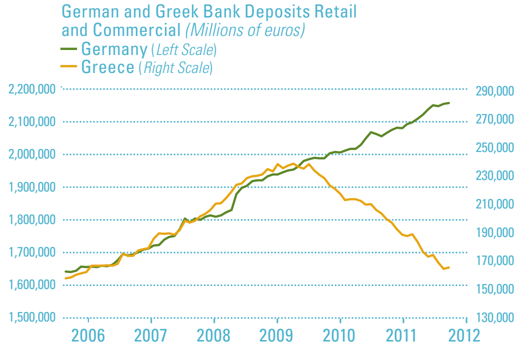
The decision to be made in Europe, by default or by intent, is either increased integration in the form of Eurobonds, which would make each Eurozone member liable for the debts of the other member countries, or the fear that a wave of nationalism could threaten the foundation and security of Europe. If the decision is deferred in a series of endless summits, a wave of bank failures may be the outcome.

No one really knows what the consequences of a country leaving the Eurozone would be given the complexity and interdependencies involved. But, beyond the financial adjustments of exiting a common currency and reintroducing a national one, the question for the economies of Europe is: where does withdrawal end?

How to Invest:

Geographically, we favor the U.S. markets and, to a lesser extent, the emerging markets over the foreign developed markets such as Europe. These markets are likely to produce better growth and more flexible policies to promote continued growth. For example, the United States sells three times as much to the emerging markets—which have slowed but are still growing fairly rapidly—as to Europe.

19 Bank Deposits Leaving Greece for Germany



Source: LPL Financial, Bloomberg 05/29/12

Nearly one-third of deposits have already left Greek banks over the past three years as the risk has risen. Interestingly, the Greeks voted against German influence for their economy, but want German protection for their money as Greek bank deposits flee to German banks. Greek banks have seen outflows of 70 billion euros. At the same time, German banks have seen deposits grow by 200 billion euros as depositors around the Eurozone seek safety [Figure 19]. This flow is already accelerating, but it could become a flood.

Next in line may be banks in other southern European countries. If the precedent is set that countries could leave the euro at the behest of Germany, deposits may leave Spanish and Italian banks, which so far have only seen a small move. This could then be followed by panic with banks closing their doors for "bank holidays" to halt the runs. The European Central Bank would likely have to inject massive amounts of capital to keep the banks from collapsing. What would likely follow is that the banks in Spain and Italy would be forced to sell their holdings of government bonds to meet the outflow of deposits. This could result in losses on these bonds and push yields up even further than the 6% they were hovering around at the start of June 2012. If these yields go high enough, other countries, such as Spain, may be in danger of default with devastating consequences.

This potential series of events leading to a crisis can be avoided, but it increasingly cannot be simply deferred. Europe has been circling around the potential for crisis for three years, sometimes drawing closer, sometimes moving further away, but unable to break free from its pull. Despite the changes in government, the parties in power are broadly in favor of maintaining membership in the Eurozone, yet at the fringes anti-European sentiment is brewing. The next group of leaders in Europe will set the path for a deeper common bond or a return to nationalism with both economic and market consequences.

Postscript:
Putting it in Perspective

In the second half of 2012, the issues facing policymakers are daunting. However, the issues facing investors may not be so dramatic or as prone to disappointment as they may at first seem.

Recall that in the first half of 2012: Greece defaulted, Spain needed a bailout, Iran thwarted deadlines on its nuclear program, and China's economy slowed to the weakest pace since the global recovery began in mid-2009. Yet the world did not end, a crisis did not erupt, and U.S. stocks and bonds actually posted gains.

Throughout history, we can see the ability of individuals and businesses to create value despite political or financial obstacles. A recent example is the series of events beginning in Asia in 1997, spreading around the world, and culminating in the 1998 financial crisis that was hailed at the time as the worst financial crisis in the post-war period by the head of the New York Federal Reserve. Yet, U.S. GDP growth remained above average, unemployment fell, and stocks posted powerful gains in both years. In another example of global economic resiliency, global GDP growth since 2007 has been about 3% per year even though Europe has contributed nothing to that growth.

We remain committed to our forecasts for gains this year, given our assessment of the developments and their likely impact in the second half of 2012.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market Bass-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

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Dividend paying stock payments are not guaranteed. The amount of a dividend payment, if any, can vary over time and issuers may reduce dividends paid on securities in the event of a recession or adverse event affecting a specific industry or issuer.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Health Care Sector: Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials Sector: Companies, whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Manufacturing Sector: Companies engaged in chemical, mechanical, or physical transformation of materials, substances, or components into consumer or industrial goods.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Information Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.