

The Long View

July 2011

Expect the unexpected

So far, 2011 has been marked by a shocking and costly natural disaster in Japan, escalating unrest across the Middle East and North Africa, an oil price surge and Standard & Poor's sending shockwaves through Wall Street and Washington by lowering its outlook on U.S. federal debt to "negative."

Clearly, recent events have shown the world remains an uncertain place, says portfolio counselor Jim Rothenberg. But over his 40 years of investment experience, Jim says he's come to expect the unexpected.

"Those four decades of experience have led me to the conclusion that surprise and change and the unexpected are the norm, not the unusual," Jim says.

Standard & Poor's 500 Composite Index has also experienced its share of "shock events," but for many decades the market has demonstrated an ability to overcome adversity. The market's resilience has been particularly evident in its climb from the March 2009 low, an advance that is largely due to solid company earnings, says portfolio counselor Greg Johnson.

"Earnings have been one of the key determinants of the market's strength, and that's a testament to how well corporate America has done over the last couple of years," according to Greg. "Now I'm hearing people conclude that the market has come too far, too fast. We'll have to see if that's right, but I'm still reasonably constructive about the markets on a multi-year view."

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.

Johnson and other portfolio counselors attribute much of the strength of the U.S. market to opportunity abroad for U.S. companies. "The developing nations are fueling overall world growth," says portfolio counselor Claudia Huntington. "As the world becomes more integrated, where a company is headquartered isn't as important as where it does its business.

Well-managed companies in industries that have global characteristics expand to where they can find opportunities."

Although the economy and political events have commanded attention recently, the focus for investment professionals at American Funds remains on finding companies with sustainable growth prospects, strong cash flow and healthy

balance sheets. "Over time, if you invest in successful, leading companies, we believe that approach will be more consistently rewarding than basing investment decisions on some estimate of future macroeconomic developments," says portfolio counselor Brad Vogt.

Uncertainty is likely to always be a factor for investors, Rothenberg says. "I think a diversified portfolio is the best prescription, and that portfolio should explicitly address the realities of a much more global world," Jim says. "But don't forget to expect the unexpected, because next time will also be full of surprises."

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— Jim Rothenberg,
portfolio counselor

A bond investor on interest rates



David Hoag
Portfolio counselor
23 years of investment experience

People usually ask me two questions: Are interest rates too low? And, aren't interest rates going to go up?

Are rates too low? Given the environment, I would say the answer is generally no. That's because inflation has been well behaved. That certainly can change. We've seen components of inflation change recently, mostly food and energy, but the core Consumer Price Index remains very well behaved.

Inflation remains relatively low because there's a "wall of worry" that makes it difficult for the economy to expand, and you usually don't see inflation until the economy is at full capacity. The worries include: The financial system remains frail; state and local governments are not in great shape; the federal government's deficit; unrest in the Middle East; the disaster in Japan; debt in parts of Europe; high unemployment; and a severe downturn in the housing market.

Are rates going up? Absolutely. But I expect them to rise at a very measured pace, and the increases are likely still some time out. My assumption is that the Fed will be very clear and telegraph what it's planning to do. In that case, the bond market can anticipate the moves, and have the potential to price them into the market in a rational fashion.

After crises, the market has a history of regaining traction



- Seldom a year seems to go by without a crisis of some sort. This year already has had several shocking and surprising events, including the unrest in the Middle East and North Africa, and the earthquake and tsunami in Japan that has resulted in staggering loss of life and a crisis at a nuclear power plant.
- A look at about 50 years of the S&P 500's history shows that there's been no shortage of traumatic events. But decade after decade, the market has demonstrated its ability to climb a "wall of worry." Even since the market's low in March 2009, the S&P has demonstrated its strength in the face of issues ranging from the "flash crash" to high unemployment.
- Many of the events depicted on the chart have been traumatic and costly. The market, however, has not only survived, but thrived. For more than a century, the U.S. market has endured wars, recessions, assassinations, scandals and natural disasters. And each time it has come back. Through it all, the market has demonstrated a remarkable strength and resiliency in the face of challenges.

"We don't have a crystal ball, so we cannot forecast what's going to happen. As events this year show, you just never know. That's one reason why diversification is so important."

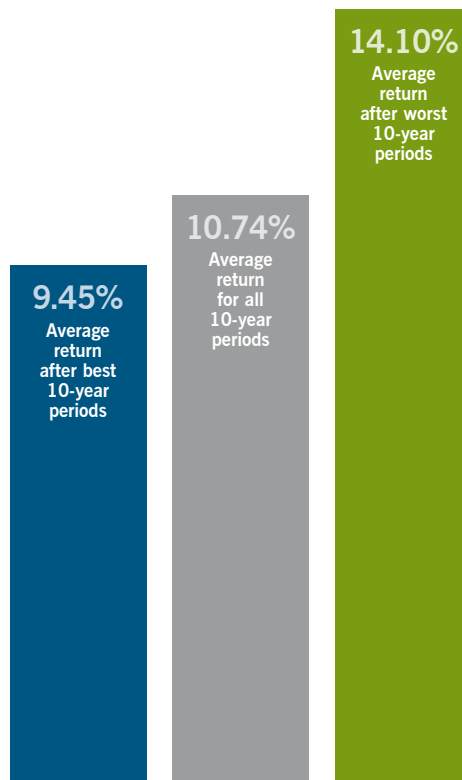
— David Riley, *portfolio counselor*

The specific periods depicted are as follows: 1/1/60–3/31/11 (top chart) and 3/9/09–3/31/11 (bottom chart). The S&P 500 Index is unmanaged.

After worst 10-year periods, returns have exceeded long-term average

S&P 500, rolling 10-year periods, 12/31/27–12/31/10

Best 10-year periods		Next 10 years	Worst 10-year periods		Next 10 years
10 years ended ...	Average annual total return	Average annual total return	10 years ended ...	Average annual total return	Average annual total return
1951	17.26%	16.42%	1937	0.00%	9.61%
1952	17.06	13.44	1938	-0.93	7.25
1954	17.09	12.82	1939	-0.08	9.15
1955	16.67	11.07	1940	1.78	13.36
1956	18.40	9.20	1941	6.44	17.26
1957	16.41	12.85	1946	4.41	18.40
1958	20.04	10.01	1973	6.00	10.66
1959	19.34	7.82	1974	1.23	14.81
1960	16.15	8.18	1975	3.27	14.34
1961	16.42	7.06	1976	6.64	13.84
1963	15.91	6.00	1977	3.60	15.28
1988	16.32	19.19	1978	3.17	16.32
1989	17.54	18.19	1979	5.88	17.54
1991	17.58	12.93	1981	6.49	17.58
1992	16.15	9.34	1982	6.72	16.15
1997	18.02	5.91	2007	5.91	N/A
1998	19.19	-1.38	2008	-1.38	N/A
1999	18.19	-0.95	2009	-0.95	N/A
2000	17.44	1.42	2010	1.42	N/A
Average	17.43	9.45	Average	3.14	14.10



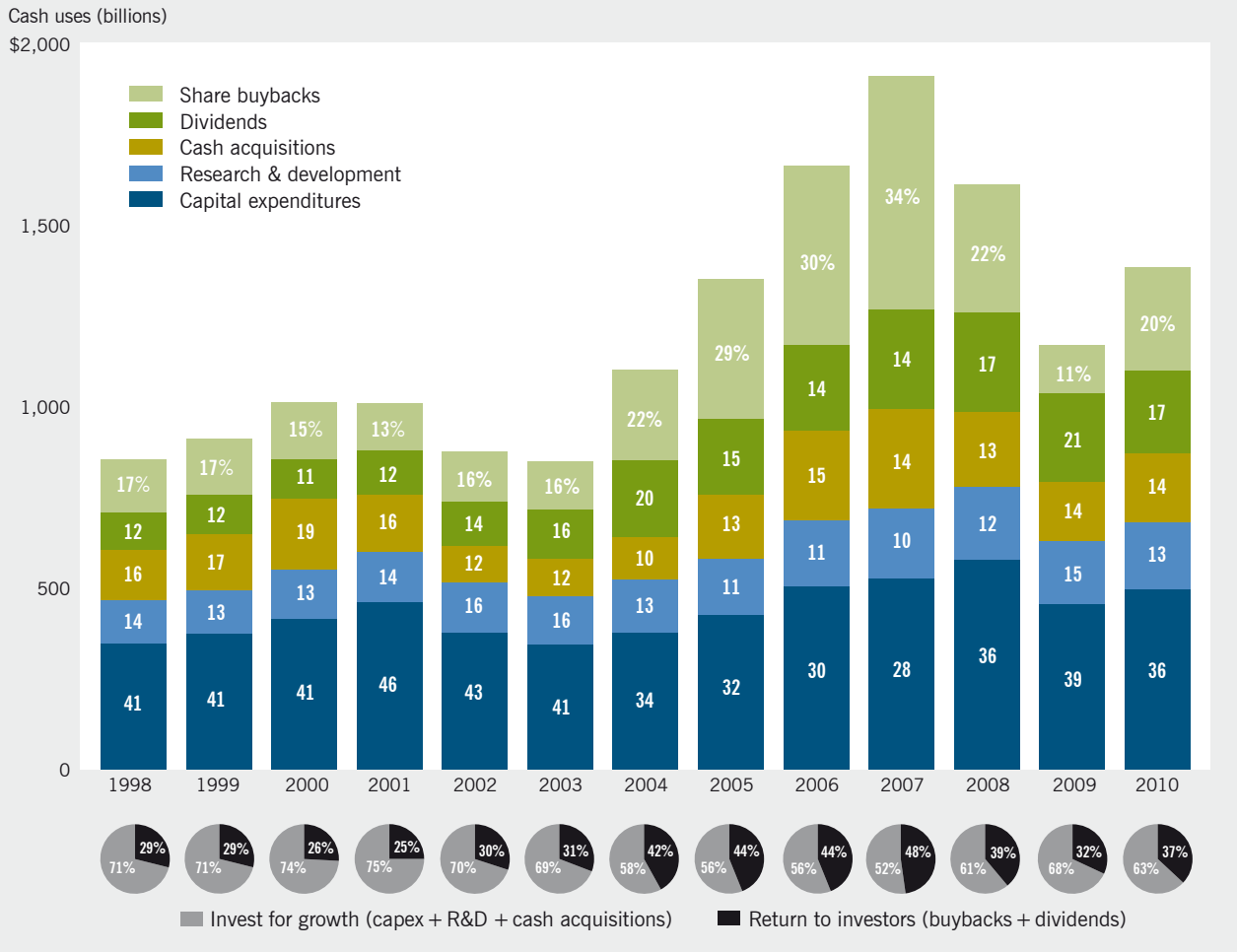
- A look back at the modern history of the S&P 500 reveals a common pattern: Over time, the market has demonstrated strength in the face of adversity and long-term investors have been rewarded.
- The chart depicts returns for 10-year periods that fall into the top quartile and the bottom quartile since December 31, 1927. A look at the 10-year periods can be instructive, given that the market recently recorded its worst decade, registering an average annual decline of 1.4% for the 10 years ended December 31, 2008. (The 10-year period ended December 31, 1958, had the highest average annual return, or 20%).
- The data for the worst 10-year periods show that the market has demonstrated the ability to recover and advance after extended periods of decline. For example, after a decade that fell into the bottom quartile, the subsequent decade provided returns that were not only higher and positive, but often higher than the 10.7% average return for all rolling 10-year periods since 1927. Past returns aren't predictive of future results, but history suggests that equity investing may still hold opportunity for long-term investors.

“Investors who stay the course will be better positioned to participate in the market’s eventual recovery. The key is to maintain a long-term view and a well-diversified portfolio.”

— Jim Rothenberg, *portfolio counselor*

Based on average annual total returns of 74 rolling 10-year periods, divided into quartiles. The range of returns for each quartile is as follows: Quartile 1 (top/best quartile), 15.91% to 20.04%; Quartile 2, 11.06% to 15.28%; Quartile 3, 7.06% to 10.66%; and Quartile 4, -1.38% to 6.72%. The average return for the years after the best and worst periods is the average of the average annual total return of the periods following each period in the top and bottom quartile, respectively. Data are not available for future 10-year periods; therefore, the last return for the “next 10 years” is for the period 12/31/00–12/31/10. The S&P 500 Index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

Some S&P 500 companies have begun to increase dividends as corporate spending recovers

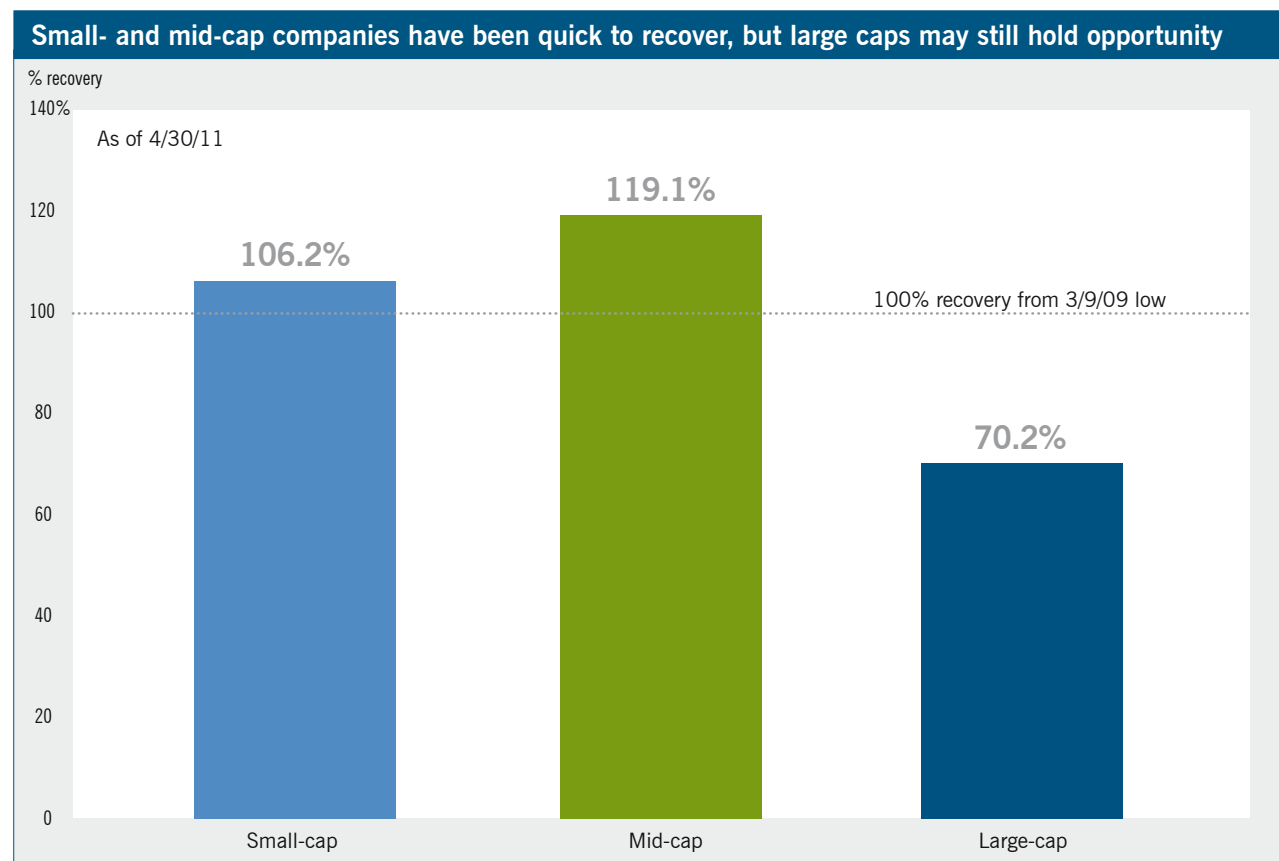


Sources: Computstat and Goldman Sachs Global ECS Research. Data represent S&P 500 non-financial firms. Sum of percentages in bars may not equal 100% due to rounding.

- The level of spending among U.S. companies began to rebound in 2010, a change that may signal increasing confidence among executives and potential benefits for investors. After peaking at nearly \$1.9 trillion in 2007, spending dropped to about \$1.1 trillion in 2009. Spending rebounded to nearly \$1.4 trillion in 2010.
- The increase in spending may be due to the relatively strong profits many companies have recorded during the past two years. There may also be growing confidence in the sustainability of profits and potential for growth as the economic recovery, although still fragile, gains traction. Capital spending, for example, increased to \$486 billion in 2010, up from \$446 billion in 2009 but still substantially below the \$566 billion in 2008.
- There are also signs that some companies have increased dividend payments to shareholders. Year-to-date ended May 3, 2011, S&P 500 companies increased or initiated dividends 156 times (144 increases, 12 initiations), compared with only two decreases. That represents an increase of about \$22.3 billion in announced dividend payments through the same date. In all of 2010, the announced increase in dividend payments totaled \$20.7 billion.

“In our experience, companies that pay a meaningful dividend often take a more disciplined approach to allocating capital. Historically, this dividend discipline has served companies well operationally, which often translates into solid gains in their stock prices.”

— Hilda Applbaum, *portfolio counselor*



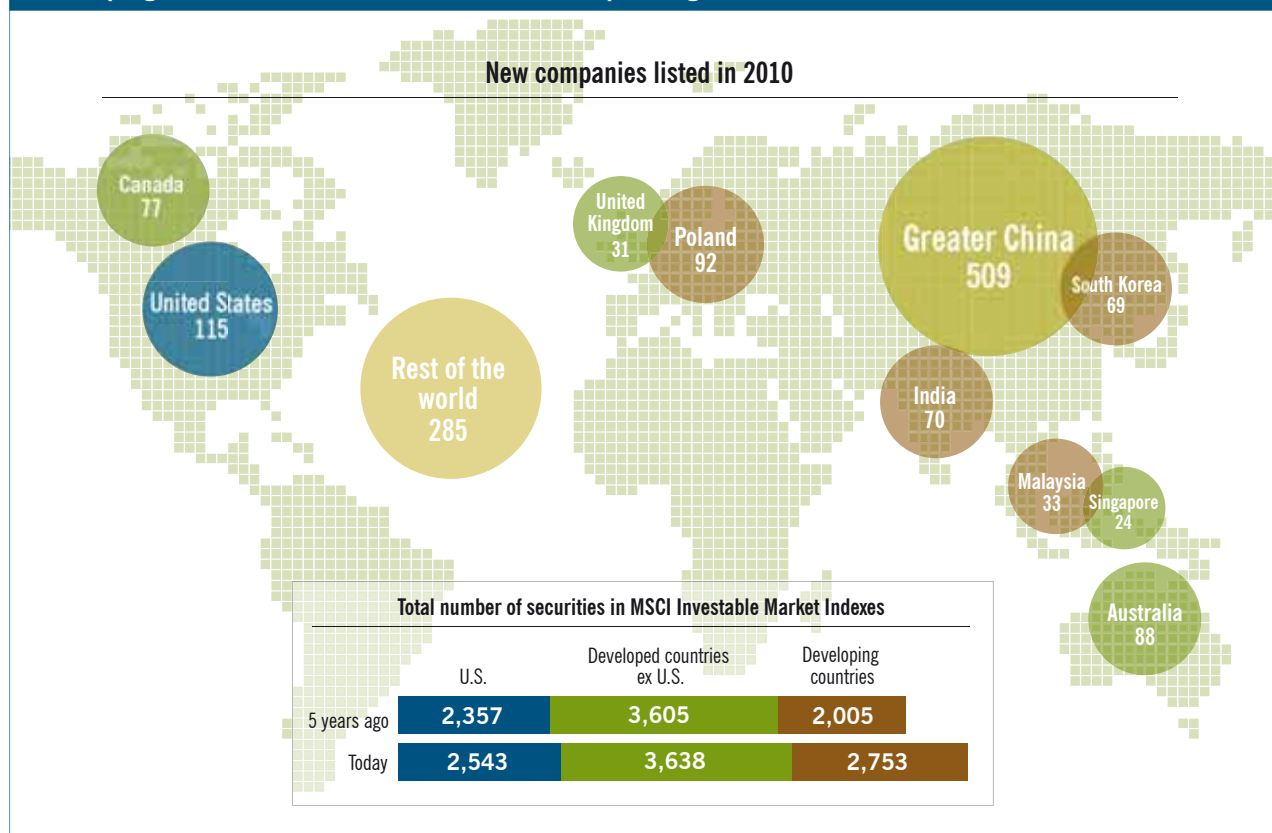
Sources: RIMES. Small-, mid- and large-cap companies are represented, respectively, by the following indexes: S&P SmallCap 600, S&P MidCap 400 and S&P 100. The indexes are unmanaged. The indexes achieved a 100% recovery by advancing from the low on 3/9/09 to the previous high on 10/9/07. Major stock market declines are defined as a decline in price of 15% or more, without dividends reinvested, based on 100% recovery after a decline.

- Every recovery is different, but there is evidence that the size of a company can be a factor in how its share price is affected by economic and market cycles. Historically, smaller companies have been the most severely impacted by an economic downturn or market decline. If they survived, smaller companies have also been most likely to experience the most dramatic increases. Conversely, the value of large companies has been slower to rise.
- The chart shows that since the low on March 9, 2009, through April 30, 2011, the advance among small- and mid-cap companies has outpaced larger companies.
- Large companies have fared relatively well, but they haven't experienced the same surge since the market's bottom. Despite their gains from the low, large companies may be undervalued by the market.

“You can invest in a number of large-cap stocks with great balance sheets, cash flow, earnings outside the U.S., that are reasonably managed, for about 80% of what the market multiple is for small- and mid-cap stocks.”

— Greg Johnson, *portfolio counselor*

Developing countries account for much of the expanding investment universe



Source: Ernst & Young, *Global IPO Trends, 2011*; FactSet; and MSCI USA, MSCI World ex USA and MSCI Emerging Markets Investable Market Indexes. The MSCI Investable Market Indexes represent approximately 99% of the equity investment opportunity set. For the U.S. and other developed countries, the minimum market capitalization is \$342 million; for developing countries, it is \$171 million. The number of new companies shown for each country on the map represents initial public offerings (IPOs) attributed to the domicile nation of the company undertaking an IPO, as of December 2010. Greater China includes China, Hong Kong and Taiwan. The rest of the world constitutes 64 countries with 1% or less IPO activity by number of listings or capital raised. The total number of securities shown in the bar chart for each country/country group labeled “5 years ago” and “Today” is as of May 2006 and May 2011, respectively.

- Around the world, the number of listings for new companies regained traction in 2010, with 1,393 initial public offerings (IPOs) raising a total of \$285 billion in capital, according to a report on the global IPO market published by Ernst & Young, a worldwide accounting and financial services firm. The capital raised in 2010 was double the amount raised in either 2008 or 2009.
- The bulk of the action occurred in greater China, where 509 new listings raised nearly \$132 billion in capital, or about 46% of the funds raised globally during 2010. About \$22 billion of the capital was raised from the offering of state-owned Agricultural Bank of China.
- The new listings in 2010 provide a snapshot of the change occurring in the investment universe, but the evolution of the equity markets has been under way for several years, led by developing countries. During the five years ended May 2011, the number of securities in the MSCI Emerging Markets IMI increased from 2,005 to 2,753, and represented about 31% of the 8,934 securities that make up the indexes highlighted in the chart. (There were about 49,000 listed companies worldwide in 2009, but many did not meet the criteria for inclusion in MSCI indexes.)

“The brisk growth in China, India and much of the emerging world has opened up new markets and business opportunities.”

— Carl Kawaja, *portfolio counselor*

Shanghai grows up in a hurry, going from a big but sleepy city to a thriving metropolis in 20 years



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