



**BOSTON COMMON**  
ASSET MANAGEMENT, LLC

84 State Street, Suite 940 • Boston, MA 02109 • Tel: (617) 720-5557 • Fax: (617) 720-5665 • www.bostoncommonasset.com

**US LARGE-CAP PORTFOLIO REVIEW & OUTLOOK**  
SECOND QUARTER, 2011

From: The Portfolio Management Team

Market Summary

US equity markets were essentially flat (+ 0.1%) for the second quarter. However, this tepid result masks tremendous volatility. The markets had a strong showing in April, as healthy earnings results helped them rebound from the prior quarter’s Middle East geopolitical uncertainties and Japanese tragedy. The markets then declined sharply through May and for most of June on troubling macroeconomic indicators. High energy prices and disaster-related supply chain dislocations disrupted previously strengthening consumption trends. European sovereign debt questions, the US debt ceiling, and the impending end of the Federal Reserve’s quantitative easing program further heightened investor concerns.

Nevertheless, by quarter end, there were positive developments on a number of fronts. The International Energy Agency announced that its members would sell oil from strategic reserves; the decline in oil prices would help consumers and the global economy in the near term. The Greek Prime Minister survived a no-confidence vote, leading investors to expect progress on Greece’s debt crisis. Despite incompatible positions, US Congressional leaders reached the negotiating table to find a way to address the budget and debt ceiling. The Federal Reserve Bank’s QE2 officially expired at the end of the quarter, but the Fed will continue to reinvest proceeds from mortgage-backed securities and agency debt. The last few days of June brought a rally in global markets that reversed earlier declines, resulting in an eventful yet flattish quarterly return for the major indices.

In the quarter’s tumultuous markets, defensive sectors fared significantly better than cyclical ones. Our core portfolios lagged the markets this quarter, while our value portfolios outperformed. More detail on what worked and what didn’t is on the following page.

Economic Outlook

As we begin the new quarter, many opposing trends are at work, creating a confusing near-term picture. On balance, and with a longer term perspective, we continue to expect modest economic recovery in the US as well as a return to modest inflation. The battle in Congress to raise the legal borrowing limit in order to avoid a technical default by the US Treasury is making

Market Index Returns

	2 <sup>nd</sup> Qtr. 2011	YTD 2011	Year 2010
<b>Stocks</b>			
<i>Large Cap:</i>			
S&P 500	0.1%	6.0%	15.1%
S&P 500 Growth	1.6%	6.8%	15.1%
S&P 500 Value	-1.5%	5.2%	15.1%
Russell 1000 Value	-0.5%	5.9%	15.5%
<i>Small Cap:</i>			
Russell 2000	-1.6%	6.2%	26.9%
<b>Fixed Income</b>			
Barclays Govt/Corp.	2.3%	2.6%	6.6%
Barclays Municipal	3.9%	4.4%	2.4%
Citigroup 3M T-Bill	0.0%	0.1%	0.1%

headlines every day. Even with an August deadline looming, Congressional leaders are not showing any signs of compromise. This sort of standoff has become a ritual, with politicians posturing for their electoral base, while rating agencies threaten downgrades. In reality, a country like the US that issues debt in its own currency can service its debt, if nothing else by printing more money. Nevertheless, in normal times, doubts about debt levels and the capacity to service the debt would lead investors to demand higher interest rates from the US Treasury to compensate for inflationary risk. These aren’t normal times. A large and growing global pool of savings, stimulative monetary policy, and risk-averse investors seeking the safety of the US Treasury have combined to keep interest rates low in absolute terms, even though the yield curve is steep. Fed Chairman Ben Bernanke, speaking at the post-FOMC press conference, affirmed that the Fed would continue its accommodative stance by setting interest rates low for an “extended period.” There seems little risk of rates being raised by policy action, and eco-



nommic growth doesn't appear resilient enough yet to force interest rates higher.

At the end of the quarter, the Fed again downgraded its growth forecast and nudged up its outlook for the unemployment rate. We view this as a reflection of a weak recovery, not the beginning of a renewed cyclical downturn. We anticipate that interest rates will remain subdued, allowing consumers to continue to re-liquify their balance sheets and allowing corporations, flush with cash, to continue to find profitable investment opportunities. The former will help shore up the underpinnings for consumption growth, while the latter will create a healthy capital expenditure environment. Both should help to support eventual employment growth.

A more complex picture is emerging on global inflation. Concerns about inflationary pressures resulting from rising commodity prices have led emerging markets, notably China, to raise interest rates, thereby slowing their economies down. A slower growth rate could moderate emerging market demand for commodities, which could in turn allow prices to come down, helping corporate profits as well as economic growth in commodity-importing nations, both developed and emerging.

### Portfolio Strategy

Corporate earnings continue to come in strong, with company managements indicating optimism about global demand. There are growing pressures on companies to take shareholder-friendly steps with the cash on their balance sheets: reinvest in business growth, pay dividends, and buy back stock. In this low interest rate environment, we continue to favor stocks over fixed income investments, given what we see as attractive yields in stocks and meaningful growth prospects.

At this point in the business cycle, we expect the rate of growth of corporate profits to begin to slow. Even without multiple expansion, equity investors can expect reasonable market returns, in line with profit growth and dividends. We expect multiple expansion to accrue to quality companies that consistently generate free cash flow. We are finding many such ideas in the technology and healthcare sectors, both of which we believe have substantial growth opportunities and are attractively valued. Investors continue to be nervous, and have reacted with speed and vigor to every piece of positive or negative global news, making market conditions volatile. Therefore, our portfolios maintain a balanced profile with cyclical as well as defensive exposure. More details about our portfolio choices are in the tables below.

### What Worked & What Didn't

Industry Groups*	What Worked	What Didn't
Interest Rate Sensitive	Select consumer discretionary stocks in media and global brands had strong, profitable growth	Banks did not participate in economic growth
Cyclical	Niche technology companies and energy services companies were strong this quarter	Investors fled semiconductor and large technology names amid fears of cyclical slowdown and weaker profitability
Defensive	Investors sought the relative safety of consumer and healthcare stocks	Company-specific news affected the performance of some stocks

*\*Industry Groups: Cyclical (Energy, Industrials, Materials, & Technology); Defensive (Consumer Staples, Health Care, Telecom, & Utilities); Interest Rate Sensitive (Financials & Consumer Discretionary). The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that the securities discussed herein will remain in the account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. As with any investment, there is a risk of profit or loss.*