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From: The Portfolio Management Team

Market Summary

The S&P 500 followed the 10.8% rally of the fourth quarter with increases of 2.4% in January and another 3.4% in February. Despite unsettling political events here and abroad, compounded by natural and nuclear disasters in Japan, the US stock market closed the first quarter of 2011 with a total return of 5.9%.

As February drew to a close, all eyes were on the politically unstable Middle East, and the rising price of oil. On March 11th, an earthquake and tsunami in Japan followed by damage to nuclear facilities raised anxiety in world markets. US investors overlooked these worrisome developments, and focused instead on improving corporate earnings and employment news.

All sectors posted positive returns, but Energy (+16.8) dominated the market. Other strong performers included Industrials (+8.7%), Health Care (+5.6%), and Telecom Services (+4.9%). Defensive sectors Consumer Staples (+2.5%) and Utilities (+2.8%) lagged the group, as did Financials (+3.0%) and Information Technology (+3.5%).

Economic Outlook

The US economy continues to grow at a modest pace, up 2.8% year-on-year in the fourth quarter. But the composition of growth is uneven. The manufacturing sector has realized a strong recovery, while consumption and service sectors have seen relatively soft growth, and housing remains depressed. The economy has adjusted impressively to create growth without housing and credit, two significant drivers of past recoveries. Against this backdrop of steady if slow improvement, global transitions are underway in monetary policy, the geopolitics of energy, inflation trends, and government debt arrangements. We believe each of these contributes to near-term instability, but could lead to a more balanced and sustainable economy.

Although central banks in Europe and Asia have tightened monetary policy, we expect US central bank policy to remain stimulative until economic growth is on more solid footing or inflation becomes a bigger threat. However, discussions at the Federal Reserve reveal a growing focus on inflation concerns, making another round of quantitative easing unlikely. The end of quantitative easing in June is widely anticipated, so we do not expect major dislocations to result from this event.

Market Index Returns			
	1 st Qtr. 2011	Year 2010	Year 2009
Stocks			
<i>Large Cap:</i>			
S&P 500	5.9%	15.1%	26.5%
S&P 500 Growth	5.1%	15.1%	31.6%
S&P 500 Value	6.8%	15.1%	21.2%
Russell 1000 Value	6.5%	15.5%	19.7%
<i>Small Cap:</i>			
Russell 2000	7.9%	26.9%	27.2%
Fixed Income			
Barclays Govt/Corp.	0.3%	6.6%	4.5%
Barclays Municipal	0.5%	2.4%	12.9%
Citigroup 3M T-Bill	0.0%	0.1%	0.2%

Risks to the economic expansion come from its uneven nature. Unemployment could be very slow to decline after initial gains, as job creation in some sectors is offset by losses elsewhere. Public sector job cuts are unavoidable, and construction, housing, and the financial sector may be slow to recover. Weakness in these major sectors shifts the odds of monetary tightening out to next year, as the Federal Reserve, though vigilant to inflation indicators, will likely err on the side of caution before changing policy direction.

Oil prices have risen sharply in response to firming demand and political turmoil in the Middle East. Market analysts have been concerned that as in prior decades, higher oil prices would stoke inflation and/or dampen US growth. We think this concern is misplaced. In the US, the oil price's link to inflation and economic growth has become tenuous: the economy is less oil intensive than in the 1970s, because of greater energy efficiency and structural changes in GDP composition away from manu-



facturing towards services. The US appears to have a cheap and plentiful supply of natural gas, which can substitute for oil in some applications. In the previous oil shocks of 1972-73 and 1979-80, the global economy used 75% more petroleum to produce a dollar of GDP than it does today. Petroleum also comprised a bigger portion of price indices, and wage contracts often had escalator clauses linked to prices.

Recent political events do highlight the risks related to US dependence on imported oil. Conservation, development of natural gas, and other domestic alternative energy sources should all benefit from high oil prices. However, one potential non-oil energy source, nuclear energy, also suffered a setback last month as the tragic earthquake and tsunami in Japan led to a major accident at a nuclear power facility. We have long believed nuclear power does not represent a sustainable energy source given the tremendous risks inherent in operating such plants and disposing of their waste. Recent events should strengthen the case against its use.

The era of easy cost cutting and associated disinflation appears to waning. In the last two decades, corporations saw steady benefits from outsourcing manufacturing to Asia, carrying leaner inventories, and centralizing to a small number of suppliers with scale economies. Now, wages are rising quickly in Asia, inventories are already lean, and supply chain diversification is looking more attractive given component shortages precipitated by the Japanese disaster.

Despite rising commodity prices and distribution inefficiencies, inflation is likely to remain modest in the near term. High unemployment is likely to keep wages low, making it difficult for businesses to raise prices. Policy makers and analysts alike seem aware that continuing stimulative monetary policies for an extended period will mean greater risks of high inflation and higher interest rates in the medium to long term. We expect to see structural reform on the federal deficit in the next few years. Interest costs could become intolerably high if the national debt continues on the current trajectory. Meaningful action may only be forthcoming after the Presidential elections next year, and escalating political rhetoric may prevent constructive progress this year.

Portfolio Strategy

We are cautiously optimistic on stocks relative to bonds and cash, despite the outlook for continued macroeconomic volatility. Equity valuations are still reasonable, particularly in relation to government bond yields. Corporate earnings growth has been impressive, but further gains are likely to be smaller. Within stocks, we own a diversified portfolio of quality companies. The table below summarizes some of our investment themes.

What Worked & What Didn't

Industry Groups*	What Worked	What Didn't
Interest Rate Sensitive	Asset managers benefited from market rally	Banks did not participate in economic growth
Cyclical	Investors bid up energy names amid demand growth and Mideast turmoil	Concerns about rising gas prices hurt retail and discretionary stocks
	Agriculture and energy services sectors were strong this quarter	Weaker forecasts from large technology companies caused pullback in stock prices
Defensive	Consolidation through M&A activity	Consumer stocks faced growth and margin pressures

**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.*