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US LARGE-CAP PORTFOLIO REVIEW & OUTLOOK
FOURTH QUARTER, 2010

From: The Portfolio Management Team

Market Summary

US equities finished the year on a strong note with the S&P 500 up 10.8% for the fourth quarter. This rally brought the market to levels last seen in August 2008, though still below the October 2007 peak. Although the recovery is still weaker than in past economic cycles, it is gaining traction. Several economic indicators point to stronger growth ahead. At year end, new fiscal stimulus from tax cuts coming on top of the monetary stimulus of quantitative easing (QE-2) created hope for sustained economic momentum.

All sectors were up this quarter, with the cyclical sectors doing particularly well amid growing optimism regarding economic recovery. Energy (+21.5%) and Materials (+19.2%) had exceptional returns, while the Consumer Discretionary (+12.8%), Industrials (11.8%), and Technology (+11.6%) sectors all finished ahead of the market. Utilities (+1.1%), Health Care (+3.6%), Consumer Staples (+6.1%) and Telecommunications (+7.3%) underperformed as defensive sectors were out of favor.

Economic Outlook

What a difference a quarter makes! All talk of double-dip recessions is now off the table, and the debate among forecasters is focused on the size and longevity of the recovery. Some forecasters have aggressively raised growth expectations while others are worried about higher inflation and rising interest rates. We expect this to be a period of interesting checks and balances – a cyclically improving economy, buoyed by stimulus but tempered by structural challenges, avoiding deflation but also staying well below runaway inflation.

In 2011, we believe it will be critical for the US economy to begin weaning itself off stimulus, and transition toward a state of self-sustaining expansion. Only then can policy makers start unwinding the extraordinary monetary and fiscal supports put in place following the Great Recession. An aspirational goal would be for these same policy makers to tackle the daunting structural imbalances that remain: debt, unemployment, and inequality, to name but a few.

Helped by additional monetary and fiscal stimulus, we expect the economy will achieve a reasonable growth rate of over 3%

Market Index Returns			
	4thQtr. 2010	Year 2010	Year 2009
Stocks			
<i>Large Cap:</i>			
S&P 500	10.8%	15.1%	26.5%
S&P 500 Growth	11.0%	15.1%	31.6%
S&P 500 Value	10.5%	15.1%	21.2%
Russell 1000 Value	10.5%	15.5%	19.7%
<i>Small Cap:</i>			
Russell 2000	16.3%	26.9%	27.2%
<i>International:</i>			
EAFE	6.6%	7.8%	31.8%
Fixed Income			
Barclays Govt/Corp.	-2.2%	6.6%	4.5%
Barclays Municipal	-4.2%	2.4%	12.9%
Citigroup 3M T-Bill	0.0%	0.1%	0.2%

in 2011 – not vigorous enough to address the unemployment challenge, but sufficient to stave off deflation. Positive economic news should continue to support modest improvements in consumer confidence and credit. Housing remains a weak spot in the economy. Sales of both new and existing homes have improved in recent months, but only from historically depressed levels. The overhang of unsold houses and foreclosure inventory continues to cast a pall over the real estate market. This weakness is geographically varied and not enough to derail the recovery, but could still delay a new credit-driven growth cycle.

Policymakers have applied fiscal stimulus regularly, at the rate of 2.8% of GDP in 2008, 3.3% in 2009, with more to come from the year-end 2010 tax deal. Beyond the extension of Bush-era tax cuts, the tax deal creates new sources of support to the recovery. Temporary payroll tax cuts benefit the employed, an extension of unemployment benefits help those who are not



working, and provisions for 100% expensing of investments are intended to accelerate capital spending by businesses.

On the monetary side, the Federal Reserve has already stepped in with quantitative easing for the second time, committing to a steady purchase of financial assets. Policy stances worldwide are still directed at reflatting demand. Real interest rates are negative even in emerging markets that are trying to contain inflation. Because of controversy surrounding QE-2 among inflation hawks and foreign governments, going forward, the Fed may have less room to be expansive. In the background, the Fed faces the challenge of returning policy settings to pre-crisis levels, but that seems to be a concern for the second half of 2011.

The next set of policy actions ideally should trend toward fiscal responsibility, but this move awaits more proof that the recovery has turned into a durable expansion. Ideally, lenders and capital markets will be reassured by America's economic growth, as debt and deficit numbers decline as a percent of GDP. The Fed is unlikely to raise rates precipitously unless inflation convincingly exceeds the targeted two-to-three percent level.

We expect global demand for oil to remain high, as US growth picks up and emerging market demand remains strong. However, the price impact of this demand could be mitigated in the near term by increases in the value of the dollar. In another balancing act, sovereign debt challenges in Europe and the improving growth picture in the US could drive the dollar up for short periods of time even as long-term Fed policy pushes down the value of the currency.

Portfolio Strategy

Equity markets and interest rates are up strongly in anticipation of better growth, with large capitalization US stocks rising 22% in the last four months. We remain fully invested, but expect the recovery to remain uneven as it becomes more sustainable. The seemingly unsteady recovery will keep markets volatile, as investors react anxiously to new economic data. Investor appetite for risk has been severely damaged through the decade-long drought in equity markets, and the sharp, correlated declines following the credit-crunch. The traumas of the past decade could limit multiple expansion for some time.

Corporate profitability has remained surprisingly strong despite the challenging growth environment. Further margin expansion may prove difficult, now that initial savings have been realized. We do not expect much margin expansion in aggregate, but have sought out companies with the ability to grow earnings in line with sales growth despite rising input costs and hiring needs. In sum, we expect small but positive market returns, in line with profit growth.

We continue to invest in diversified portfolios of high quality names with cyclical as well as defensive exposures. We see opportunity in global consumption of technology, including medical technology. We continue to seek US companies that benefit from demand in emerging economies, as we expect responsible monetary policy in these countries will address inflation without choking off growth. And, in the aftermath of a long period of rising and volatile commodity prices, we favor industrial companies that can improve efficiency and conservation in the areas of agriculture and energy.

What Worked & What Didn't

Industry Groups*	What Worked	What Didn't
Interest Rate Sensitive	Asset management and exchanges benefited from market rally	Regulatory changes created uncertainty for consumer finance companies
Cyclical	Agriculture and energy sectors fared well globally	Overcapacity weighed on renewable energy stocks
	Auto, truck and parts companies benefited from new vehicle buying cycle	Weaker forecasts from large technology companies
Defensive	Some equipment and niche product suppliers did well	Healthcare and utility stocks lagged in strong cyclical rally

*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.