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U.S. LARGE-CAP PORTFOLIO REVIEW & OUTLOOK
THIRD QUARTER, 2009

From: The Portfolio Management Team

Market Summary

The equity market rally continued during the third quarter of 2009, with the S&P 500 index returning 15.6%. Investors were encouraged by improving economic data and earnings news, as well as increased mergers and acquisitions activity. As investor appetite for risk started to return, credit spreads narrowed sharply for both investment grade and high yield bonds. Equity markets rose rapidly, led by the lowest-quality names, often the players that narrowly avoided bankruptcy. As the Financials sector (+25.5%) had several such players, it rebounded sharply for the quarter. With our quality orientation and measured exposure to Financials, our portfolios were up, but not as much as market benchmarks. (Additional details overleaf).

The quarter started with mixed economic news, as consumer confidence, personal income, and real consumption numbers remained low. Announcements indicated that the economy contracted by only 1% in the second quarter, and expectations solidified that it would emerge from recession in the third quarter. Consumer confidence improved despite rising unemployment, and corporate earnings came in ahead of expectations. The Federal Reserve left the Fed funds rate unchanged, and Fed Chairman Bernanke remarked that “prospects for a return to growth in the near term appear good.”

Economic Outlook

The recent Great Recession was triggered by the unavoidable bursting of the housing bubble, with its impact on the financial sector and household balance sheets. The securitization market had performed a quasi-banking role, funneling capital into housing and broader consumption-related borrowing. As mortgage default rates rose, the securitization market dried up. This exacerbated the house price collapse, further hurting bank balance sheets and prompting the Fed and government agencies to hold substantial amounts of securitized assets in an effort to keep mortgage costs low and prop up the housing market.

Although some market participants worry that excessively loose monetary and fiscal stimulus may lead to higher inflation and unsustainable budget deficits, we expect policymakers to err on the side of caution. High unemployment, overcapacity, and weak credit and money flows are likely to put downward pressures on prices. Fear of the “Japan” scenario of prolonged

Market Index Returns

	3rd Qtr. 2009	YTD 2009	Year 2008
Stocks			
<i>Large Cap:</i>			
S&P 500	15.6%	19.3%	-37.0%
S&P 500 Growth	13.6%	22.1%	-34.9%
S&P 500 Value	17.9%	16.3%	-39.2%
Russell 1000 Value	18.2%	14.8%	-36.9%
<i>Small Cap:</i>			
Russell 2000	19.3%	22.4%	-33.8%
<i>International:</i>			
EAFE	19.5%	29.0%	-43.4%
Fixed Income			
Barclays Govt/Corp.	4.2%	4.7%	5.7%
Barclays Municipal	7.1%	14.0%	-2.5%
Citigroup 3M T-Bill	0.0%	0.1%	1.8%

deflation with no growth should motivate policymakers to keep monetary and fiscal policy accommodative as banks work through balance sheet challenges.

The larger structural challenges on the horizon remain daunting: the potential for slower trend growth and higher natural unemployment, excessive dependence on leverage, new banking system regulation, a ravaged housing sector, limited access to credit, and the need to tackle our healthcare and climate change problems. However, the cyclical news continues to improve. Indications are that the economy experienced positive growth during the third quarter. The dollar has reversed its recent panic-induced rise, allowing U.S. companies to become more competitive globally. The non-financial corporate sector remains underleveraged, and corporate investments in productivity enhancement, coupled with improving net exports, could support U.S. economic growth. Despite positive cyclical trends, investors continue to worry about the sustainability of the recovery once the monetary and fiscal stimulus is withdrawn.

We expect that continued growth in the emerging markets, and in the resource economies that prosper alongside them, will raise global growth levels beyond current expectations. Weaker



consumer spending in the U.S. and higher commodity prices could pose challenges to corporate profits. Modest economic growth, low inflation, and supportive monetary and fiscal policies may provide a positive environment for risk assets, including equities.

Portfolio Strategy

In the wake of the dramatic stock market rally from March onwards, one may wonder whether stocks have risen too far, too fast. To address this concern, we looked at history, as well as current sources of risk and support for the equity markets.

There is historical precedent for broad market surges following sharp declines. In 1975 and 2003, these surges were also characterized by an initial, abrupt rally by lower quality names. The 2009 low-quality rally was more dramatic than those previous

examples. According to Morgan Stanley, stocks priced under \$5 rose 281% from March 9th through quarter-end, while those with prices above \$30 rose “only” 46%. The markets will need support from rising earnings. Corporations have been quick to cut costs to salvage profits in this sharp downturn, but investors will now need to see signs of revenue growth.

We expect this next phase to be rewarding for stock pickers, as sustainable growth and pricing power remain scarce. Our goal is to remain fully invested, but to pay particular attention to end-market growth, balance sheet quality, management execution, and diversification.

Even with a modest rate of economic growth, stock market returns could be sufficient to exceed returns from bonds and cash. We have raised our allocation to equities in balanced accounts. Within bond portfolios, we hold investment grade credit risk and some inflation protection.

What Worked & What Didn't

Industry Groups	What Worked	Examples*	What Didn't	Examples*
Interest Rate Sensitive	Large banks led the explosive rally	JPMorgan Chase	Uncorrelated holdings didn't participate	Gold, Cash
Cyclical	Profitable growth in the technology sector	Cisco Systems, Apple, NetApp	Renewable energy companies fell on oversupply concerns	First Solar
	Surprising strength in consumer spending	Kohls, TJX	Fears of adverse international regulation	Qualcomm
Defensive	Company-specific news, including swine flu vaccine approval	Novartis	Defensive healthcare names underperformed	Becton Dickinson, Quest Diagnostics, Johnson & Johnson

Current Portfolio Strategy

Industry Group	Strategy	Rationale	Examples*
Cyclical	Build global cyclical exposure	Favor players that dominate their niche within infrastructure spending.	Cummins, Tenaris
	Hold services players in Technology	Favor seasoned companies with good execution.	Hewlett Packard, IBM
Defensive	Underweight Consumer Staples	Retain exposure to strong global franchises.	Proctor & Gamble, Colgate-Palmolive
Interest Rate Sensitive	Cautiously rebuild broader exposure	Seek out exposure beyond largest banks, through well-run lenders, asset gatherers, and insurers.	BB&T, Chubb, Franklin Resources

* Company examples are drawn from model portfolios using Boston Common's comprehensive social screens. Holdings may vary by portfolio due to customized account features. 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.