Standard Life
Investments

US Equities

4th Quarter 2009

Global Outlook Q4

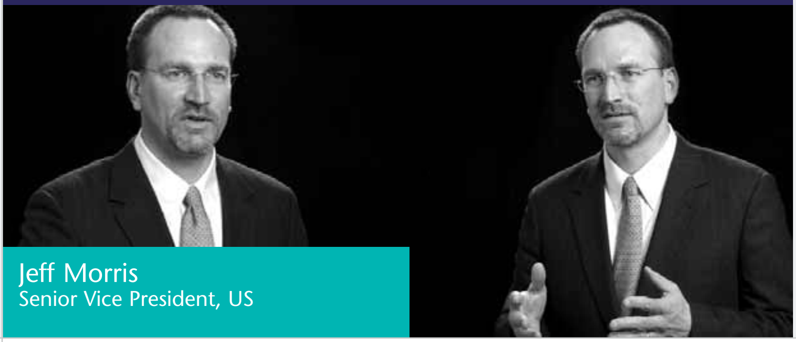
STANDARD LIFE INVESTMENTS

www.standardlifeinvestments.com

US Equities

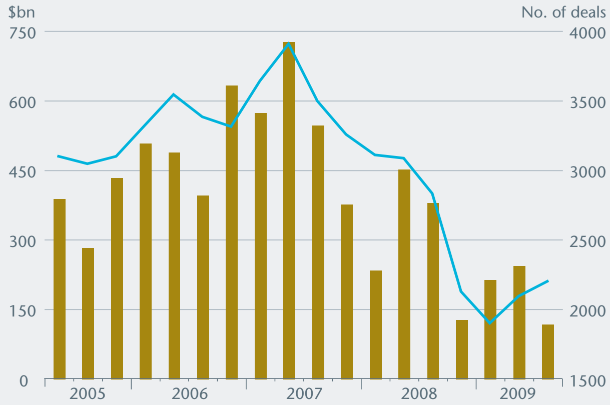
Steady uptick in activity

With the US economy stabilising, M&A activity has increased to the benefit of some financial advisers. Meanwhile, cable companies have shown resilience in a challenging consumer environment.



Jeff Morris
Senior Vice President, US

Chart 1
M&A cycle turns



US quarterly M&A activity

Deal volume ($bn) — No. of US deals (R.H. Scale)

Source: Bloomberg

M&A activity – good advice proves valuable

With the US economy in a stabilisation phase, M&A activity is showing signs of life. Running at around 5% of market capitalisation so far in 2009, M&A activity has declined around 68% from its peak (see chart). However, some recent high-profile deals, including Merck's acquisition of Schering-Plough and Pfizer's purchase of Wyeth, have reinvigorated the market.

We hold a number of stocks for their acquisition-driven growth potential. However, we are also indirectly benefiting from our holdings in investment banks and financial advisers such as Morgan Stanley, Bank of America and Goldman Sachs, which have been called in to advise on these deals. So far, competition for the advisory business of the large-scale healthcare tie-ups we mentioned earlier has been aggressive, resulting in reduced fees for the investment banks. However, profitability for the advisers should improve as the corporate deals broaden out to other sectors and industries. Indeed, this has already started to happen with Disney's planned bid for Marvel and Adobe's acquisition of Omniture, while hostile bids such as Kraft's for Cadbury also appear on the rise. M&A is a self-perpetuating phenomenon, as CEOs question whether an acquisition would improve their companies' competitiveness, and we expect to see the deal pipeline increase to the benefit of our holdings.

Interestingly, smaller firms, like our favoured stock Lazard, are increasingly being called in to broker deals, as they are seen to be more 'impartial' than the bigger players. Lazard has also successfully used the rise in corporate distress to its advantage; providing strategic restructuring assistance to businesses that have fallen into difficulty (including Lehman Brothers' bankruptcy). It has also successfully capitalised on the current flow of talent from larger financial institutions to augment its own workforce.

Cable can stand its ground

Within the portfolios, we currently favour cable TV companies over telecom providers, with Time Warner and Comcast our preferred holdings. As consumers look for ways to trim their budgets, many observers expected cuts in discretionary spending to undermine cable companies. In our view, consensus opinion is too pessimistic. The cable companies have not suffered these anticipated dramatic falls in revenues, even in the hardest-hit industrial markets of the Mid-Western states.

Both Comcast and Time Warner have been able to defend their base businesses fairly successfully in a tough economic climate. There is still a fair amount of inertia around cable subscriptions, so both have benefited from customers simply remaining with their current providers. Meanwhile, for those consumers who have shopped around for a good deal, Time Warner and Comcast have been able to offer discounted TV packages and also sell add-on services. This means monthly billing has stayed relatively stable. Finally, both companies are seizing growth opportunities by rolling out commercial telecom services to small and medium-sized businesses, which puts them in direct competition with traditional fixed-line telecom businesses such as AT&T and Verizon. Synergies from its acquisition of Adelphi are also proving fruitful for Time Warner, which has been able to increase both its cost savings and its penetration of services.

Our strategy within US equities

We continue to focus on bottom-up stock selection and have a number of exciting product stories within our portfolios. In the biotechnology and pharmaceutical sectors, we hold Medivation, AMAG Pharmaceuticals and Vertex Pharmaceuticals. These stocks have significant upside potential because of their novel or revolutionary product offerings. For example, Medivation has developed an Alzheimer drug that claims to not only halt the disease but also improve cognitive activity in patients. Meanwhile, AMAG is a leader in iron-replacement therapy, and Vertex has developed a treatment for Hepatitis C, which has a significantly higher cure rate than existing drugs. We also hold several stocks that are benefitting from the shortening of the replacement cycle in their own specific sectors. The delay on any kind of residential spending has been unhelpful for air-conditioning specialist Ingersoll-Rand. However, consumers are now replacing their aged air-con units, while the drive for energy efficiency is boosting Ingersoll's industrial refrigeration business. Elsewhere, casinos are starting to replace machinery, to the benefit of slot-machine manufacturer Bally Technology. There are also opportunities for the company to make market-share gains through new product innovation.

Oct 09

House View

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK-based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

	Positive	Negative	Our View
US Equities	• The recession is ending in response to major policy measures, such as fiscal packages and quantitative easing • Valuations are attractive, especially as more companies return to profitability	• Squeeze on corporate margins is forcing major cuts in employment and investment • Continued uncertainty about extent of downturn in the housing sector	Market supported by favourable long-term valuations and easier monetary and fiscal policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management responding to pressures on margins through cost cutting and more M&A activity • Parts of the region did not experience as large a credit boom as other countries	• Exports remain under pressure due to euro appreciation and sharp slowdown in global trade • Continued concerns about efficacy of policy response in Europe	The region remains vulnerable to the strength of the euro currency impacting on company margins STAY LIGHT
UK Equities	• More aggressive monetary and fiscal support than in many other countries • Valuations such as dividend yields provide underpinning for the market	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about extent of consumer and housing bad debts as unemployment rises	Despite concerns about the valuation of a number of cyclical sectors, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Japan's financial sector is in a stronger position than in some other countries • Increasing dividends plus share buybacks are helpful for investors	• Companies facing much weaker export demand from the US and Europe • Domestic data suggests economy is suffering a severe recession	Growing concerns about the impact of deflation on profit margins while the policy response is more limited than elsewhere STAY VERY LIGHT
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • Some governments have taken strong action to support domestic activity	• Earnings at risk from the length of the slowdown in OECD demand • Concerns growing about eventual policy tightening in China to cap inflation risks	Long term valuations remain a concern but governments are taking strong action to support domestic activity STAY LIGHT
Global Emerging Market Equities	• Strong commodity demand is supporting some economies • Current account surpluses protect some countries from credit concerns	• Certain economies still require significant support from international bodies • Some central banks are becoming concerned about inflation risks	Some economies are supported by strong China trade links but others remain vulnerable to capital constraints STAY LIGHT
International Bonds			
US	• Quantitative easing by the US authorities should cap Treasury yields	• Vulnerable to increased supply as the fiscal position deteriorates rapidly	STAY HEAVY within international bonds as Treasuries benefit from quantitative easing
Euro-zone	• Slow response by the monetary authorities to the financial and economic crisis	• Extent of likely debt issuance from easier fiscal policy	STAY HEAVY within international bonds on expectations of further ECB quantitative easing
Japan	• Return of deflation and the lack of policy levers to stimulate economic growth	• Valuations starting to look stretched	MOVED TO VERY LIGHT within international bonds on a comparison of international bond yields
UK Bonds			Within UK bonds:
Gilts	• Interest rates are close to zero, anchoring short-dated gilt yields while the authorities are continuing quantitative easing to affect longer dated yields • Defensive characteristics increasingly recognised	• Continued concerns about the extent of the rise in the public sector deficit • Uncertainty about an exit strategy from quantitative easing is worrying some investors	Stay Heavy in conventional gilts Stay Neutral in index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield	• Downturn in corporate cash flows will lead to higher corporate bond defaults	Stay Very Heavy corporate bonds Corporate bond valuations remain attractive although individual issues require careful examination
Property			
UK	• Property income yields relative to gilt yields have risen to highs last seen in the 1930s. Evidence of price improvement in 'prime' assets as newly raised capital is invested.	• Rental values are falling in line with a weak economic recovery, especially continuing pressures on the retail sector	We favour well located properties with tenants of good financial strength, plus a sector bias towards core London markets, where future supply is limited, and dominant retail locations MOVED TO NEUTRAL
Global	• Lack of overbuilding in this cycle should support growth in rents as economies emerge from recession. • Infrastructure investment underpins opportunities in emerging markets.	• Credit conditions remain very mixed with commercial bank holdings of property overhanging some markets	We prefer selective high yielding logistics markets in Asia & Central Europe, and office locations with low future supply such as Paris and Sydney.
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under pressure	• Cash yields close to zero are encouraging more investors to seek higher-yielding assets	Official interest rates in major economies are expected to remain low well into 2010 STAY VERY LIGHT

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.