American Funds®

The Long View

2011 Review / 2012 Outlook

The year of living uncertainly

"Keep calm and carry on." Those words, printed on a poster by the British government in 1939 in an effort to boost morale among citizens at the beginning of World War II, have gained new currency during the past few years. It's good advice, but for many investors, it's not easy to follow, and it's not hard to understand why.

For more than a decade, investors have been dealing with the most volatile market environment since the 1930s. From the bursting of the Internet bubble to the financial crisis that brought on the Great Recession, investors have faced one challenge after another.

"We continue to take a long-term view in how we invest, which seems to contrast with what many others are doing."
— Don O'Neal, *portfolio counselor*

The past year offered little relief. In fact, for a good part of 2011, many argued that it was really 2008 and that the global economy and world's equity markets were poised at the edge of another precipice. From natural disasters to seemingly insurmountable sovereign debt issues, the world seemed to be a very uncertain place.

Those issues and others have led to increased volatility in the equity markets. Portfolio counselor Rob Lovelace is concerned that volatility could drive some investors out of the market or cause them to make emotional decisions that could have long-term consequences for their portfolios.

"In an environment in which investors should have a well-diversified portfolio, some investors are concentrating their portfolios," Rob says. "They're going to cash or bonds. That might seem like the right short-term decision, but at some point, their portfolio is going to be really badly positioned. Diversification matters now, perhaps more than ever."

The reasons for the increased market volatility are subject to debate, but one element may be that powerful computers now allow some investors to make short-term trades at exceptionally high speeds. And, in the past decade, there has been an increase in investment vehicles that have their values tied to indexes or bundles of stocks rather than individual companies, making their transactions more broadly felt than others.

"The volatility is unfortunate because of the negative impact on investor confidence and the faith in the market system," says portfolio counselor Don O'Neal. "We continue to take a long-term view in how we invest, which seems to contrast with what many others are doing. We believe this is a source of competitive advantage for our investors over time."

The volatile market conditions of the last few years have made some investors want to retreat to the sidelines. But history has shown that by staying the course, investors can achieve solid results in the years following significant downturns, even when those years are rife with geopolitical and economic challenges.

The case for better times ahead

Jim Dunton
Portfolio counselor
49 years of investment experience

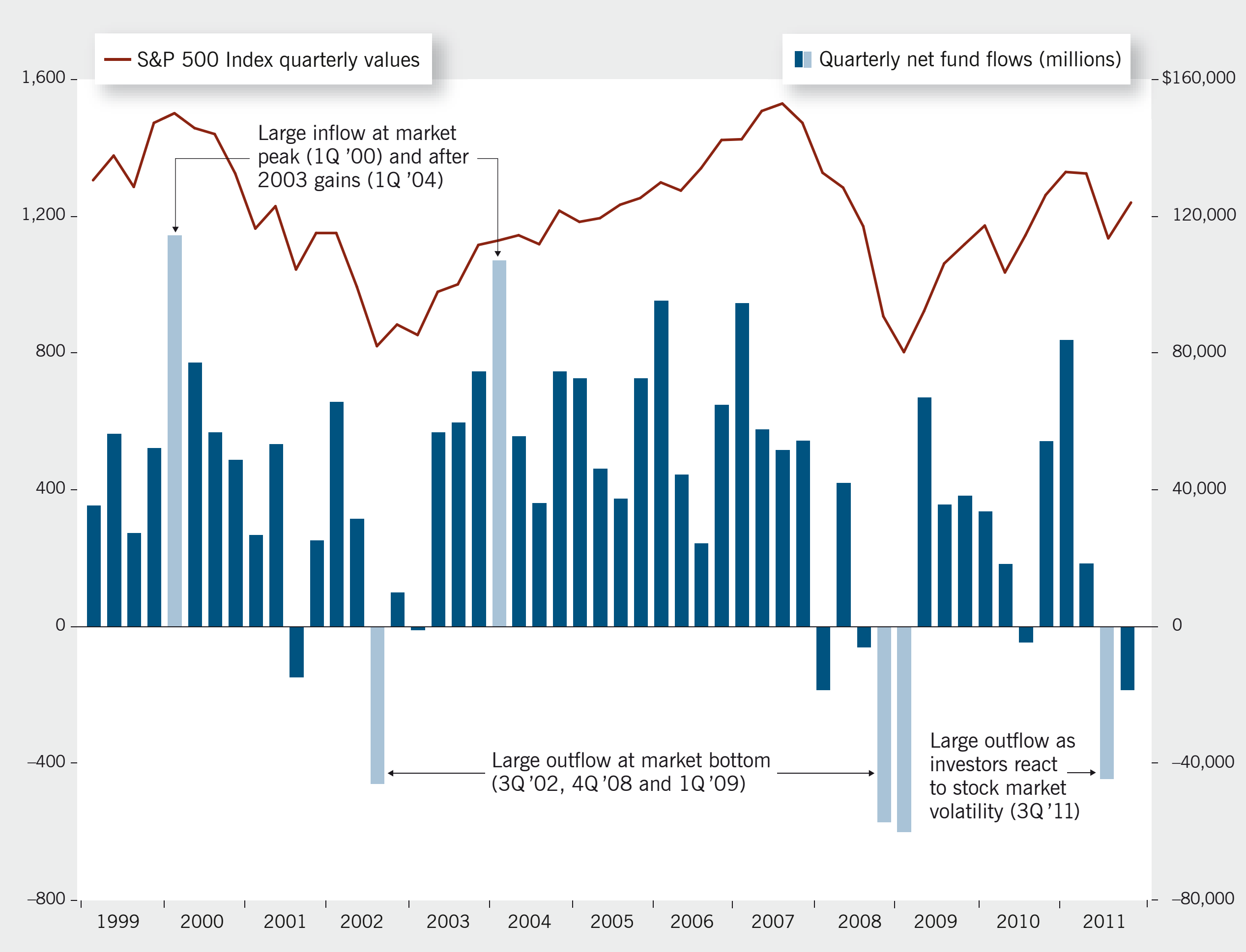
One of the things that's been so disturbing to me is the inordinate amount of handwringing about business and the domestic economy. The reports have been so down in the mouth that it just really scares everybody. But I think business is in much better shape than has been widely reported.

It's important to understand that we have come back fairly sharply from the very serious problems we experienced in the first quarter of 2011. You'll recall that the earthquake and tsunami in Japan affected industries around the world, and we had some of the worst floods and tornadoes that we've seen in the U.S. in some time. Also, oil prices jumped during the first part of the year, putting pressure on the consumer.

Since then, things have gotten steadily better. Our gross domestic product has increased every quarter since the third quarter of 2009. While overall unemployment remains a problem, private employment has been increasing smoothly and steadily for about two years, and I think you'll continue to see more of that in 2012. This recovery is a little over two years old, but recoveries over recent decades have lasted at least seven years. So I think there's good reason to be positive about the U.S. economy.

Volatility can lead to herd mentality and cause investors to rush for the exit

Buying high, selling low — fund flows have closely traced the highs and lows of the market



Sources: Standard & Poor's and Strategic Insight. Net fund flows represent domestic and international equity mutual funds and exchange-traded funds. The most recent data shown for S&P 500 Index values and net fund flows are through 11/30/11. Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the average weighted results of 500 widely held common stocks.

- Turmoil in the markets can inspire powerful emotions and lead to very human, but ultimately destructive, investment decisions. For investors confronted with confusion, uncertainty and financial pain, the natural temptation is to retreat.
- The chart shows how market cycles can exert a powerful pull on investors. The flows into domestic and international equity mutual funds and exchange-traded funds during the past decade display a striking correlation with the returns of the market. When financial markets have risen, money has flowed into the market. And when the market has faltered, many investors have left the market.
- What's behind this seemingly endless cycle of buying high and selling low? Research indicates that investment decisions can be affected by a variety of issues, including herd mentality, overconfidence, pride and regret. There is also a tendency to respond much more strongly to losses than to gains, a tendency that drives many investors out of the markets during acute declines.
- A consistent investment plan can help take the emotion out of investing and reduce the temptation to try to time the market. This approach can help steer investors away from their tendencies to lock in losses after market declines.

"This is not a time to panic and not a time to be selling. I look at this period as an opportunity to add to positions I already have or to start new positions in companies I have been waiting to buy when the price was right."

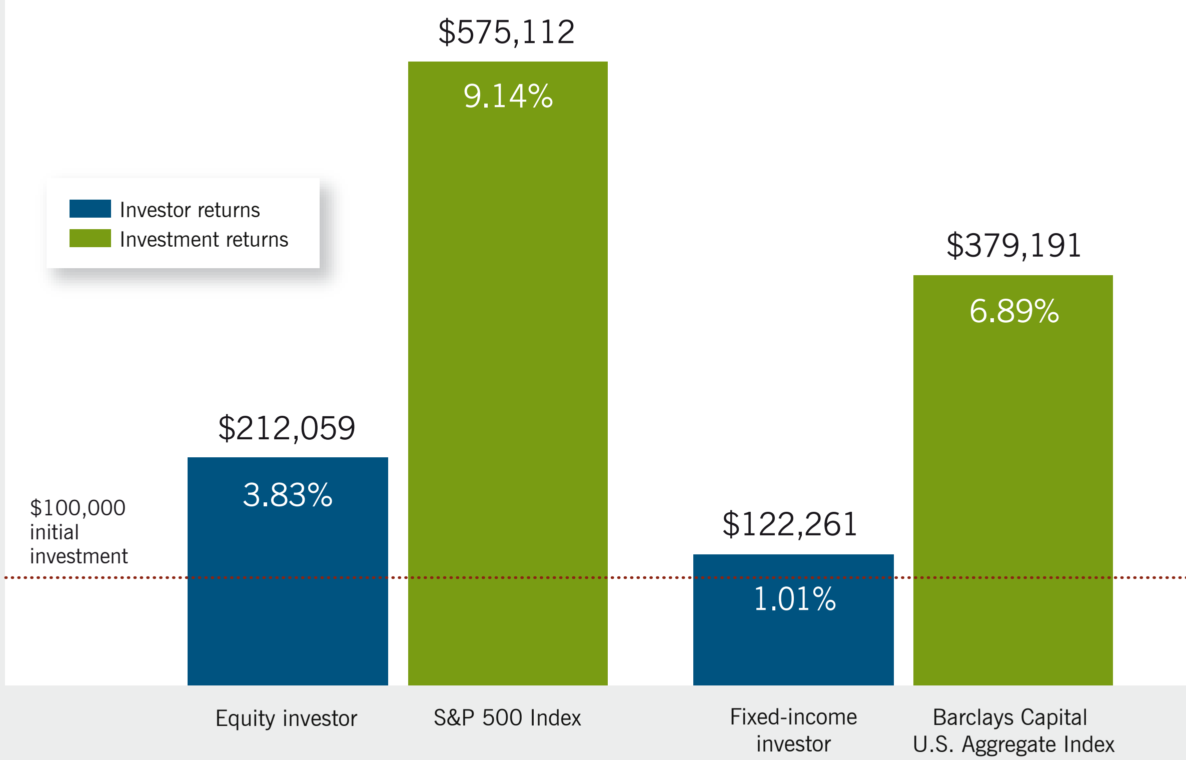
— Gregg Ireland, *portfolio counselor*

The result: A "behavior gap" between investor and investment returns

The return for the "average equity fund investor" has lagged the market

DALBAR Quantitative Analysis of Investor Behavior

Ending values and average annual total returns of hypothetical $100,000 initial investments for 20 years ended 12/31/10



Source: DALBAR (average equity and fixed-income investors data). DALBAR uses data from the Investment Company Institute, Standard & Poor's and Barclays Capital index products to compare mutual fund investor behavior with an appropriate set of benchmarks. These behaviors are then used to simulate the "average investor." Hypothetical investments for the equity and fixed-income investors are based on average annual total returns. Barclays Capital U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market. The indexes are unmanaged and, therefore, have no expenses.

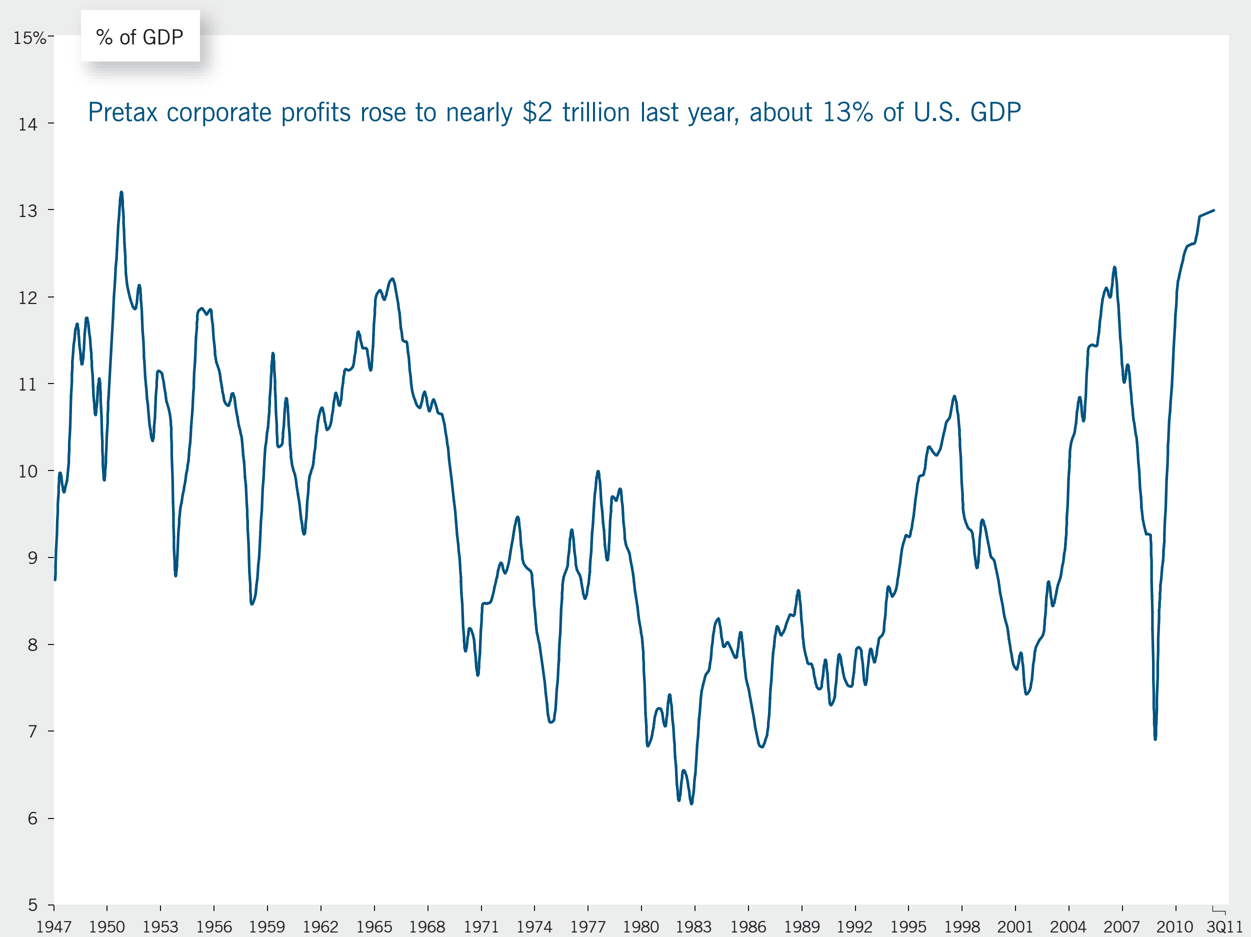
- For many investors, maintaining a consistent investment plan can prove difficult. DALBAR, a research firm, provides evidence every year of the gap between investor returns and investment returns in its Quantitative Analysis of Investor Behavior.
- The latest study shows that from 1991 through 2010, the "average equity fund investor" realized an average annual total return of 3.8%, while Standard & Poor's 500 Composite Index provided an average annual total return of 9.1%. A $100,000 hypothetical investment in the index would have grown to about $575,000 during that time, while this same investment would have grown to about $212,000 for the investor.
- The goal is to close the gap between investor and investment returns. The difference in returns is largely attributable to investors getting in when times are good — essentially buying high and selling low. Some have dubbed this the "behavior gap," and it seems clear that investors need a consistent approach that can help them overcome the tendency to respond emotionally to market volatility and to stay on track with long-term goals.

"The volatility in markets obviously scares investors. The biggest risk is that volatility causes investors to get out of the market. A point-to-point return doesn't matter if the investor isn't there at the end point."

— Rob Lovelace, *portfolio counselor*

Corporate America's vital signs have been strong

Earnings at U.S. companies have continued to rebound



Source: Bureau of Economic Analysis. Corporate profits before tax with inventory valuation and capital consumption adjustments reflect quarterly data expressed at seasonally adjusted annual rates.

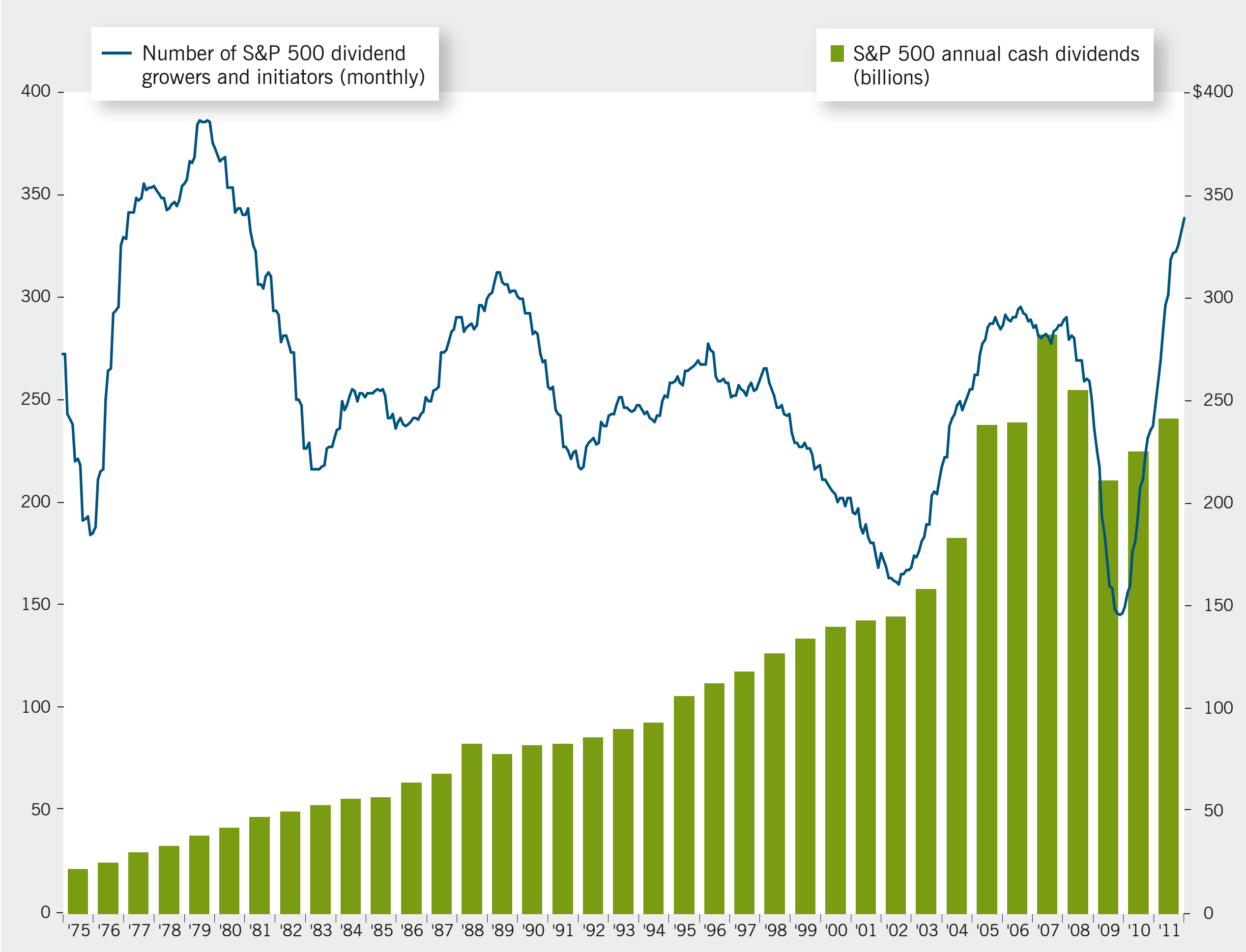
- One way to measure corporate profits is to look at earnings as a percentage of the economy. By that measure, corporate profits accounted for 13% of gross domestic product at the end of the third quarter of 2011, the largest percentage since 1950.
- Some of the increase in profits can be attributed to cost cutting at corporations and increased productivity. In short, many companies are doing more with less. The resulting efficiencies have led to higher profits.
- Why are corporate profits so high when GDP is relatively anemic? Partly because U.S. companies are increasingly able to boost their revenues and earnings by doing business in many countries. The chart shows data for nearly all U.S. companies, but a look at a smaller group provides evidence of the trend. According to Standard & Poor's, in 2010 about 46% of all S&P 500 sales originated outside the U.S., partly because of demand for goods in developing countries.
- S&P 500 companies registered record earnings during 2011, continuing their rebound from the financial crisis in 2008. With 479 of the S&P 500 companies reporting, earnings increased an average 21.9% year over year during the third quarter of 2011. Revenue rose an average 11.9%.

"Right now, corporate profits in the U.S. are at record highs by some measures. Margins are extremely high; corporate profits, as a share of national income, are extremely high. And that's in an environment where the economy hasn't been that robust."

— Eric Richter, *portfolio counselor*

In a volatile environment, dividends can be a stabilizing force

Many S&P 500 companies have been increasing dividend payments



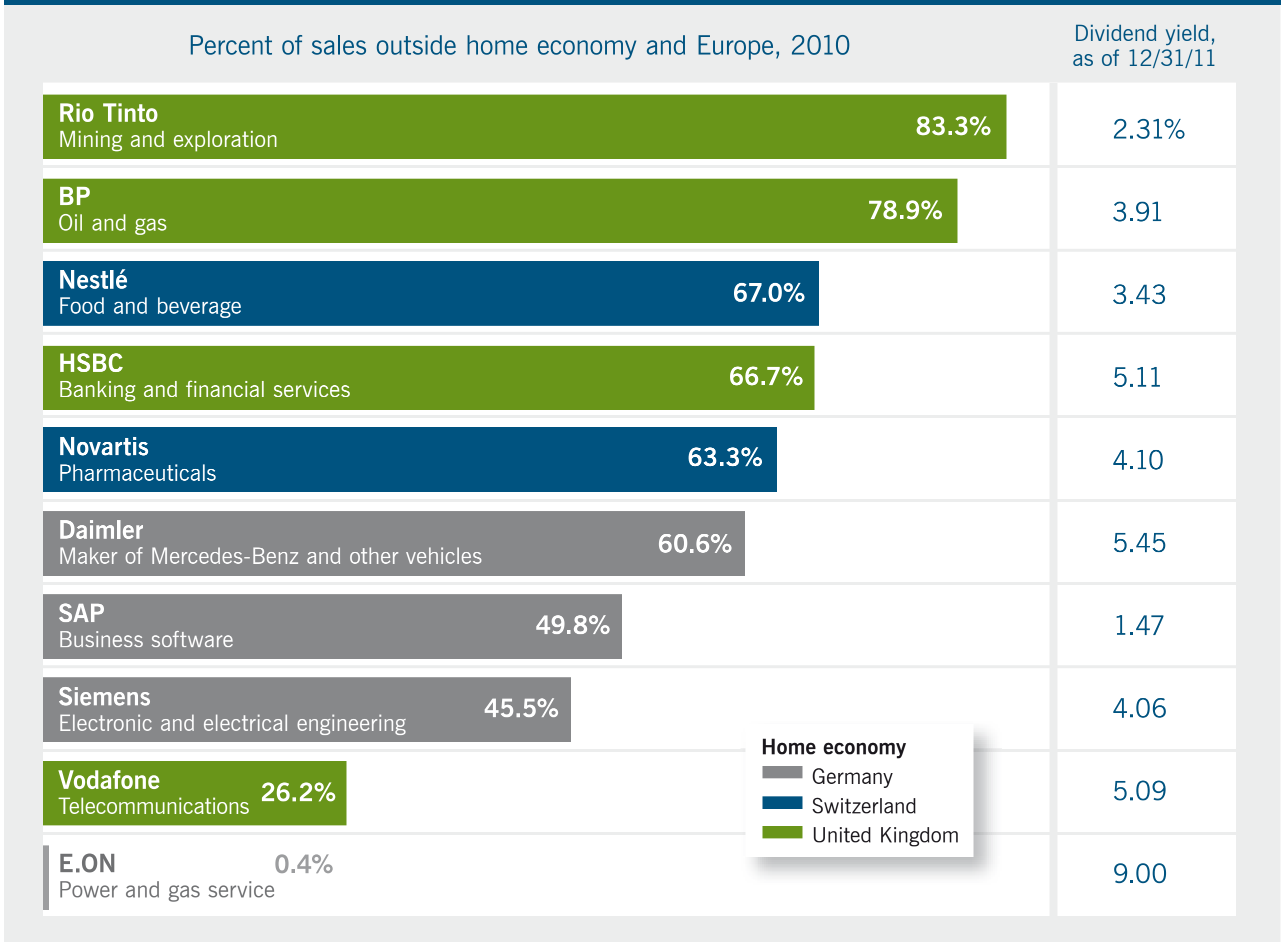
Sources: Barclays, Compustat, FactSet and Standard & Poor's. If a company's dividend is higher than it was 12 months earlier, the company is defined as having raised its dividends (growers). If a company started to pay dividends over the previous 12 months, it is defined as having initiated dividends (initiators). Figure for S&P 500 annual cash dividends for 2011 is an estimate.

- Dividends paid by S&P 500 companies plunged in 2009 in the wake of the financial crisis, but the amount has made a steady climb since then.
- In 2011, investors received an estimated $241 billion in dividend payments from S&P 500 companies, up from $225 billion in 2010 and $211 billion in 2009.
- For the year ended December 31, 2011, 342 companies increased or initiated dividend payments, more than at any time since 1981.
- For investors, companies that pay dividends can sometimes provide a stabilizing force in a portfolio. The incremental return provided by dividend-paying stocks has provided a measure of stability to equities, helping to mitigate volatility and creating a cushion for down markets.
- The number of companies increasing dividends during the past year is good news for income investors, and it could serve them well for years to come. Companies can be reluctant to cut dividends because a reduction is often interpreted as weakness by investors and can damage the stock price. Conversely, when a company consistently has enough cash to reward investors with dividends, it is often an indication of healthy cash flows and good management.

"One of the benefits of dividends is stability. When the stock market falls, dividends can cushion the blow for investors, reducing the volatility of the portfolio."

— Joyce Gordon, *portfolio counselor*

Many companies in the MSCI Europe Index do business beyond Europe's borders



Sources: MSCI, RIMES; and company annual reports for the fiscal year ended 2010. The companies shown are those that have the largest market capitalization weights in each sector of the MSCI Europe Index. The sectors are as follows: materials (Rio Tinto), energy (BP), consumer staples (Nestlé), financials (HSBC), health care (Novartis), consumer discretionary (Daimler), information technology (SAP), industrials (Siemens), telecommunication services (Vodafone) and utilities (E.ON). The percent of sales for BP reflects revenues outside the United Kingdom only; for SAP and Siemens, it represents revenues outside Europe, Africa and the Middle East. As of 9/30/11, all companies were holdings in EuroPacific Growth Fund®; Nestlé and Novartis were in the fund's top 10 equity holdings. MSCI Europe Index is a free float-adjusted market capitalization-weighted index that measures equity market results in the developed market in Europe, consisting of more than 15 developed-market country indexes.

- For much of the past two years, Europe has been shrouded in gloom. Sovereign debt crises, tough austerity measures, and a volatile common currency have weighed on the markets and investor sentiment. Yet many companies in Europe are thriving.
- That's partly because there are a number of dynamic companies in Europe that are making up for a dip in revenues from Western markets by exporting to developing countries, many of which have expanding economies and represent a new market for goods and services.
- In fact, many of the largest companies listed on the MSCI Europe Index are doing the bulk of their business outside their country of domicile.
- The global economy has gone through many dramatic changes during the past two decades, and those changes have profoundly transformed the way many companies do business. Because of increasingly open trade, many companies located abroad are generating significant revenue outside their home market. As a result, today's investment environment requires a global perspective that takes into account the changing nature of the world's markets and places a premium on security selection.

"We look for companies, in Europe and elsewhere, with diverse revenue streams and exposure to customers and clients around the world. Many European-domiciled companies are not necessarily impacted by the economic state or momentum of any individual country in Europe."

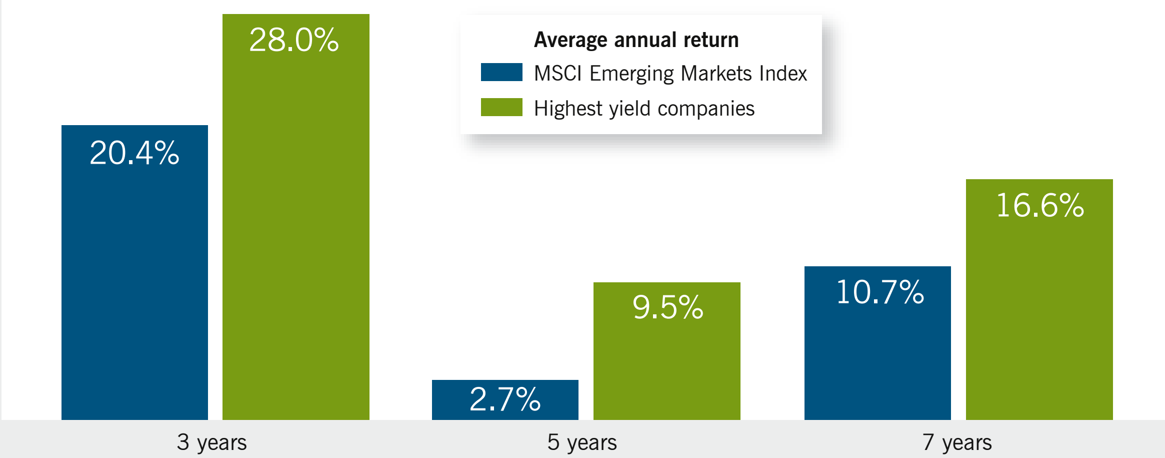
— Mark Denning, *portfolio counselor*

Dividends can be a sign of quality companies in developing countries

As emerging markets evolve, opportunities for dividend-investing arise

The returns from companies with the highest dividend yields have outpaced the index

All periods ended 12/31/11



Sources: MSCI and FactSet. The highest yield companies represent those whose dividend yield is in the top 20%. MSCI Emerging Markets (EM) Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market results in the global emerging markets, consisting of more than 20 emerging stock markets throughout the world. The index is unmanaged and, therefore, has no expenses.

- Political and financial systems in many developing countries have come of age during the past two decades. Emerging markets, particularly those in Latin America and Asia, generally fared better than traditional developed markets during the recent economic downturn. Populous nations, such as Brazil, India and China, are experiencing not only economic growth but economic diversity as well.
- Companies that serve these rapidly expanding economies can be potentially attractive investments, and in some cases the companies have adopted a policy of rewarding investors by paying dividends. Many companies that pay the highest dividends have also been among those with the highest returns.
- The chart shows that companies with dividend yields that ranked in the top 20% of the index, or the highest yield securities, provided an average annual return of nearly 600 basis points more than the index during the seven years ended December 31, 2011.
- Investing outside the U.S. entails some additional risks, and yet many developing countries now have more competent fiscal and monetary policies than in the past. Improved legal, regulatory, and economic climates within many developing countries have brought increased stability and transparency.

"The emerging markets have relatively unlevered balance sheets, access to capital like they've never had before, access to technology and a rapidly growing middle class. That's where the growth potential is going to be."

— Gordon Crawford, *portfolio counselor*

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