

# Newsletter

## BGF US Flexible Equity Fund

Q1 2010 REVIEW FOR PROFESSIONAL INTERMEDIARIES ONLY



**Fund manager**  
Bob Doll

### Market summary & outlook

The US recession ended approximately nine months ago. Massive policy stimulus broke the downward spiral in asset values and economic activity, but is only beginning to trigger a self-sustaining revival in confidence and spending. It is hardly a surprise that the greatest destruction in wealth and the deepest recession since the 1930s dealt a powerful blow to business and consumer confidence. The speed and severity of the economic and financial meltdown was extraordinary and is bound to have lingering effects. However, once an economic recovery process begins, it tends to continue barring some new shock or serious policy mistake. Real GDP growth is likely to be around half the normal recovery, implying that it will take quite some time before there is any sense that economic conditions have returned to an acceptable level.

Labour market trends continue to hold an important key to the economic outlook. We believe the labour market is on the verge of turning around, but there is little sign of strong job growth. Given the underlying pace of population growth, employment probably needs to rise by approximately 125,000 a month just to maintain the current unemployment rate. The health of the labour market is the key driver of consumer confidence. And perhaps that will be even more true this time around given the lingering weakness in house prices, concerns about rising taxes down the road, and a general distrust of the equity market rally.

The majority of Federal Reserve policymakers undoubtedly share our concern about the lethargic pace of economic recovery. Inflation trends give the Fed no cause for early action. Most price indexes are consistent with low and contained inflation. Meanwhile, inflation expectations have remained within their recent broad trading range. As far as fiscal policy is concerned, the Obama Administration is still looking for ways to add stimulus, rather than impose restraint. Nonetheless, the period of maximum fiscal thrust has ended, and state and local governments are also being forced to cut spending and raise taxes in order to bring budgets into balance. Waning fiscal support is an additional reason for the Fed to be cautious about raising rates.

The Obama Administration finally won its long and difficult battle to pass healthcare reform. The final bill was not as

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ambitious as originally planned, but extending coverage to those previously without insurance represented a major breakthrough. It is clear that recent reforms will have to be followed by much more decisive actions to contain healthcare costs because expanding coverage will actually add to spending. The healthcare debate and challenge is only just beginning.

The equity market continues to grind higher in response to the favourable backdrop of low interest rates and improving earnings. Moreover, valuations remain reasonable and there is no indication that investors have become dangerously euphoric. The performance of financial sector earnings has been especially strong, with after-tax profits rising above pre-crisis levels. The extremely steep yield curve effectively gives financial institutions a licence to print money, and this has been one of the prime intents of the Fed's easy money stance. A steep yield curve always plays an important role in recapitalising the financial sector after a crisis. Non-financials earnings remain far below their earlier peak. Although productivity has held up remarkably well in the current cycle, pricing power has been very restrained. Our expectation of a moderate economic recovery points to a gradual, rather than spectacular, rise in corporate earnings this year. But, that will still be sufficient to allow equity prices to move up.

The underlying backdrop to risk assets remains positive and we continue to recommend an above-average weighting in equities. The economic recovery may be weaker than normal, but it should be sustained. Longer term, we remain concerned about the looming fiscal consequences of demographic trends and the threat of a major financial crisis if the authorities fail to take pre-emptive action to cut entitlement spending. The difficulty of pushing through the recent healthcare legislation does not bode well for the chances of taking even tougher action down the road. It is too soon for investors to flee from risk, but fiscal concerns likely will assume Greek-like proportions within the next five years.

### Fund update

The re-risking of the market continued into the first quarter as cyclical stocks outperformed the more defensive areas of the market. US Flexible Equity underperformed. The largest detractor was an underweight in the financial sector. The sector outperformed in the latter half of the period on moderating credit deterioration and easing regulatory concerns. Positive performance was mostly driven by stock selection in healthcare and consumer discretionary.

## Performance to 31 March 2010

	Q1 2010	Latest 6 months	1-year	3 years	5 years	Since launch p.a.*
BGF US Flexible Equity Fund	4.84%**	12.59%	40.59%	-6.31%	0.80%	5.97%
Russell 1000 (USD) Index	5.70%%	12.11%	51.60%	-3.98%	2.40%	6.51%
S&P 500 Composite (USD)	5.39%	11.75%	49.77%	-4.17%	1.92%	5.90%

\*Fund inception date: 31 Oct 2002

\*\*Reported Fund performance over the quarter was negatively impacted by the timing differential between pricing of the Fund and its benchmark.

Fund performance shown as at 31 March in USD on a NAV price basis with income reinvested. Performance figures are calculated net of annual fees. Past performance is not a guide to future performance.

Source: Fund: BlackRock Investment Management (UK) Limited (BIM (UK) L) – Indices: Datastream, BIM (UK) L.

The majority of the portfolio's underperformance came from utilities, information technology and financials. Within utilities, falling natural gas and rising thermal coal prices hurt the performance of independent power producers, an area where we maintain an overweight. These stocks trade near record-low valuations on replacement cost, with leverage to a cyclical rebound in the deregulated power markets. In technology, underperformance was company-specific within several of our software and IT services holdings. We remain comfortable with the stable and recurring cash flow characteristics of our software and services holdings – especially as compared to semiconductors and communications equipment where we believe expectations are high for the sustainability of recent trends.

An underweight in financials, in general, and commercial banks, in particular, was the largest detractor to performance. The late-quarter strength in the sector was largely based on signs of regulatory pressures easing, further recovery in the capital markets and moderating credit deterioration. We remain concerned with the long-term issues, including further capital impairment in commercial real estate, the outcome of financial reform legislation making its way through Congress and potential negative impact on today's financial services business model and returns on assets. These unknowns are enough to give us pause when it comes to the banks; we maintain our preference for insurance providers.

Healthcare accounted for the largest contribution to portfolio performance. The passage of the reform bill resolved much of the uncertainty that clouded the outlook for the sector. While it's still too early to assess the long-term impact of the legislation (as much of the bill does not go into effect until 2014), our analysis suggests that the near-term impact on operating results is minimal. Underlying fundamentals continue to improve, valuations are attractive and we believe that broader participation will be net positive for many of our portfolio companies.

In consumer discretionary, performance was driven by speciality retailers that benefited from strong holiday sales and better inventory management which resulted in a less promotional retail environment. We see a continuation of better-than-expected top-line sales growth and operating discipline as catalysts for further positive earnings surprises.

Energy and materials were modestly positive. We have reduced our overweight in energy equipment and services and we have moved to a slight underweight in the integrated oil companies which we believe will be relative underperformers in a higher commodity price environment. In materials, speciality chemicals holdings outperformed on renewed industrial demand, volume increases and pricing power.

At quarter-end, the largest overweights were in materials, healthcare and consumer discretionary and the largest underweights were in financials, industrials and telecommunication services. As always, we rely on a disciplined investment process and a belief in the importance of portfolio construction and risk management to strive to deliver consistent outperformance over the long term.

## Q1 2010

Largest contributors:		Greatest detractors:	
Allocation	Selection	Allocation	Selection
Consumer discretionary (o/w)	Healthcare (MIL, MYL, PFE)	Financials (u/w)	Utilities (AES, NRG, EIX)
IT (u/w)	Consumer discretionary (LTD, ROST, GRNM)	Energy (o/w)	IT (WDC, CSC, MFST)
Materials (o/w)	Telecoms (NIHO, VZ, Q)	Telecoms (u/w)	Consumer staples (LO, GIS, CL)

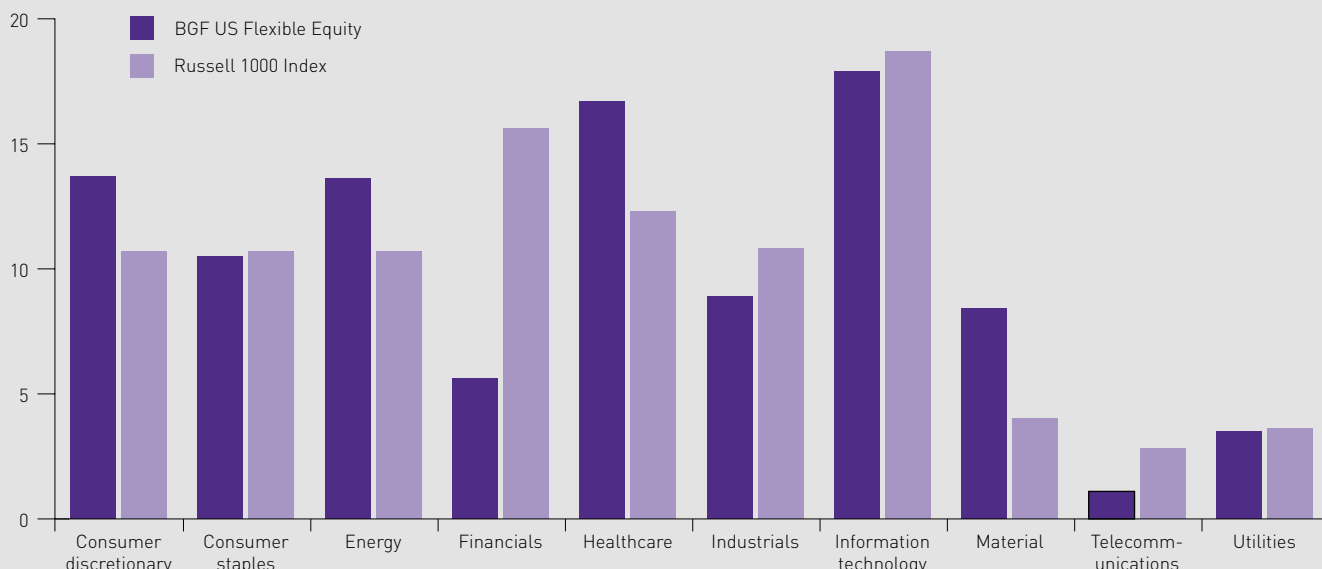
## Six months to 31 Mar 2010

Largest contributors		Greatest detractors	
Allocation	Selection	Allocation	Selection
Financials (u/w)	Healthcare (MIL, MYL, WLP)	Industrials (u/w)	Utilities (NRG, AES)
Consumer discretionary (o/w)	Telecoms (NIHD, VZ, Q)	Energy (o/w)	IT (MFST, u/w AAPL & ORCL)
Healthcare (o/w)	Materials (WLT, FCX)	IT (u/w)	Consumer discretionary (HRB, u/w F & AMZN)

## BGF US Flexible Equity Portfolio Characteristics

Top 10 Holdings	
Microsoft Corp	2.92%
Johnson & Johnson	2.50%
International Business Machines Corp	2.40%
Philip Morris International Inc	1.89%
Exxon Mobil Corp	1.84%
ConocoPhilips	1.63%
Amgen Inc	1.51%
Freeport-McMoran Copper & Gold Inc	1.38%
United Health Group Inc	1.34%
Colgate-Palmolive Co.	1.34%

## Sector Weights



Sources: FactSet (which does not include management fees or transaction costs) and BlackRock. The opinions expressed are those of BlackRock as of April 2010, and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of any individual holdings or market sectors.

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