U.S. Equities

Focus on Fundamentals

SUMMARY U.S. stocks have pulled back recently, based largely on heightened fears about Europe's fiscal problems. This headline risk may be distracting investors from the strong fundamentals underlying U.S. equity markets. In this interview, Jonathan Coleman, Chief Investment Officer, Equities, and Jim Goff, Director of Research, discuss how improving U.S. economic signals, continued profitability gains and increased global competitiveness have created a strong case for long-term equity investing.

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Chief Investment Officer, Equities

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Director of Research

KEY POINTS

- Europe remains a headwind for the U.S., but we think it is unlikely to sidetrack the growing number of domestic economic positives that continue to gain momentum.
- U.S. companies remain stronger, more competitive and more profitable than in years past, and current valuations may offer an attractive long-term entry point.
- Our fundamental research continues to identify compelling long-term potential in many well positioned U.S. companies.

Q: WHAT IS YOUR PERSPECTIVE ON RECENT U.S. EQUITY PERFORMANCE?

Jonathan Coleman: The narrative of U.S. markets year to date has been one of modest, but reasonable, economic growth and solid earnings from U.S. publicly traded companies. That being said, it also has been meaningfully influenced by the situation in Europe. Earlier this year, the consensus market view was that European fiscal problems were easing, prompted by the European Central Bank's Long-Term Refinancing Operation, which dramatically enhanced euro-zone liquidity. More recently, however, global and U.S. markets have started to pull back, given rising concerns that European debt pressures are still largely unresolved. While it is a legitimate concern that the U.S. is likely to face slower growth prospects if the euro-zone slips into a deep recession, the overall financial foundation for U.S. companies remains strong. Consequently, our long-term equity outlook is quite positive.

Q: ARE THERE SPECIFIC AREAS OF U.S. ECONOMIC STRENGTH?

Jim Goff: We are seeing a number of positive signs. The way we view it is that many crucial U.S. economic growth drivers have been in the woodshed since the financial crisis began in 2008. Take consumer spending, for example. Consumers haven't spent a lot on automobiles, housing or any other big ticket items in the past four years. Corporate capital spending has been relatively restrained as well, despite strong balance sheets. The housing crisis was a key driver of declines in consumer net worth and confidence, as well as dealing a significant blow to the financial system. These issues seem to be finally turning around. The housing market has shown some initial signs of improvement, and homebuilding stocks have rallied substantially. Credit – a chief driver of marginal economic activity – is also starting to grow again. In addition, while U.S. unemployment signals remain somewhat mixed, the unemployment rate for high-income earners, those who had been earning over $100,000 per year, is modest. As a result, despite a difficult

story for many, overall consumer spending power is in reasonably good shape. There are also positives in other important U.S. sectors. For instance, the energy sector is going through somewhat of a renaissance, with U.S. imports at 20-year lows and production at 15-year highs. There is also a gradual resurgence in industrials taking place, with many companies moving production to the U.S. for the first time in decades, based on improving relative labor costs and low natural gas costs.

Jonathan Coleman: On the credit side, there is also marked improvement in both demand and supply. It is important that these are working in conjunction, because economic stimulus can't result from positives on just one side of that equation. There now seems to be strong alignment in the expansion in these two areas, which makes us optimistic for future economic growth. I also agree with Jim's observation on the domestic industrial revitalization, principally driven by U.S. energy production. Many people have read about the breakthroughs and significant production growth coming from horizontal drilling stimulated with fracking. This has led to an explosion of U.S. natural gas production. In fact, some now refer to the U.S. as the Saudi Arabia of natural gas. This has a positive impact across many industries and has made American manufacturing much more competitive. As American and foreign companies start to relocate jobs back to the U.S., this will have a multiplier effect on the economy as more people gain employment and start to spend incremental earnings.

Q: DOES THIS HELP POSITION THE U.S. TO BENEFIT FROM GROWING DEMAND FROM EMERGING MARKETS?

Jim Goff: Absolutely. While we are closely monitoring the situation in Europe, keep in mind that almost half of U.S. GDP growth in recent years has been driven by emerging market demand. These countries now represent, on a purchasing power parity basis, approximately 50% of global GDP and are a main driver for worldwide economic growth. A stronger U.S. industrials base bodes well to take full advantage of this potential. In addition, the U.S. is now producing more agriculture and energy for export to these markets, as well as other crucial products where American companies remain extremely competitive.

Jonathan Coleman: The key point is that many developing countries are becoming domestic consumption markets versus their historical role as primarily export markets to the developed world. We believe this consumer growth engine offers tremendous export potential for U.S. firms.

Q: ARE THESE STRONG U.S. FUNDAMENTALS TRANSLATING INTO A POSITIVE INVESTMENT ENVIRONMENT?

Jonathan Coleman: They certainly foster a constructive climate for U.S. stocks. Across sectors, our research continues to find strong companies getting stronger and separating themselves from second- and third-tier firms. It's one of the reasons we feel confident about the value of fundamental research and the importance of individual stock selection. This approach can be frustrating at times, as in the last several months when markets have been driven primarily by headline risk. On a fundamental basis, however, we are finding compelling long-term investment potential in many solid U.S. companies that have differentiated themselves from the competition.

Jim Goff: The primary question is whether stocks are at risk of a "three-peat" in terms of U.S. markets and economic indicators rolling over again as they did in 2010 and 2011, once again precipitated by crisis in Europe. That is the scenario most investors seem to be expecting. Because the past two market rollovers began in May, investors started to sell this April, driving stock prices sharply lower. We believe that is a positive sign for future equity returns. Europe remains investors' top concern and the primary driver in headline risk and negative sentiment. There are numerous positive, fundamental U.S. economic indicators, but Europe is definitely not one of them. The crisis there has a direct, negative effect on company product demand, but its impact on risk-taking has even greater impact, driving down markets and business investment. This is something investors must closely watch, but ultimately we think the solid U.S. fundamentals and improved competitive position are probably best seen in the strength of the U.S. dollar. That's an indicator of some of the positives we have been discussing and also influences U.S. investment returns.

Jonathan Coleman: The real world is rarely perfectly clear with only investment tailwinds or headwinds. Europe is clearly a headwind for the U.S. economy, although we don't think it is necessarily enough to throw off many of the positives that are occurring. The U.S. private sector is incredibly dynamic, and companies are very lean and mean. Profit margins for this point in the economic cycle are well above prior trends. Although some may debate that, we think it is a reflection of the fact that corporate America has fundamentally restructured the way that it operates over the last decade. U.S. companies now operate much more efficiently through smart investments in technology and process improvements.

Q: DO CERTAIN SECTORS APPEAR MORE ATTRACTIVE NOW?

Jonathan Coleman: We are finding potential across industries. Again, it goes back to the virtues of fundamental research. We think this is exactly the time when it matters most to differentiate between well-positioned companies and those that are not. There are great companies in every sector of the market, and we view it as our job to find the opportunities where the strongest companies can distinguish themselves from the also-rans.

Q: HOW IS THE CURRENT CONTENTIOUS POLITICAL CLIMATE SHAPING MARKET EXPECTATIONS, ESPECIALLY IN LIGHT OF THE UPCOMING NOVEMBER ELECTIONS?

Jim Goff: The dialogue out of Washington is definitely a concern, but it doesn't fundamentally change how we analyze a stock's potential. In my opinion, one of the primary political challenges we face as a nation is the need for stability and incentives to invest and create jobs to help drive long-term economic growth prospects. Unfortunately, that hasn't really happened. Between 2008 and 2010, there was zero new business formation in the U.S., driven partly by the Lehman crisis and, some would say, partly by non-business-friendly government policies. In the second half of 2011, new business formations began to turn around. This is critical for sustained economic expansion. U.S. small businesses are a main driver of growth. The good news is that this segment finally seems to be starting to come back, despite what some would argue are still fairly negative government policies.

It goes back to the earlier point about the lack of purchases in automobiles, housing and other items during the last four years. I like the way Warren Buffett described it. Household formation has been incredibly low. Eventually, however, hormones will take over and household formation will come back. The prolonged period of underinvestment solidifies the intermediate term outlook, as demand begins to rebound. Similarly, there is a natural dynamism in the U.S. economy. People want to create businesses, and that desire has been repressed for a long time.

Jonathan Coleman: I agree that business confidence is rebounding, but I think we are entering a risky period. Rather than highlighting this as either a red or blue debate, we need leadership from the heads of both political parties right now. We need compromise on important issues, such as tax reform, regulatory policies, spending cuts and revenue increases, but our leaders seem to be getting more wrapped up in party grandstanding than reaching meaningful solutions on these difficult issues. While this political discord may keep markets on edge over the next year or so, we don't try to position our portfolios based on granular predictions of who might win the election, for example. As we engage in our fundamental research process, we may evaluate the impact of various election outcomes on a company or sector, but it isn't something we take strong views on or dramatically modify portfolios to reflect a position.

Q: WHAT ABOUT EQUITIES IN CONTEXT OF THE CURRENT LOW INTEREST RATE ENVIRONMENT?

Jonathan Coleman: That is definitely a positive factor that makes us more optimistic about the longer-term outlook for equities, particularly in terms of two important metrics. First and foremost are the free cash flow yields that companies provide us as equity investors. Second are the attractive equity dividend yields relative to the 10-year U.S. Treasury. Free cash flow yields on many growth companies are now between 7% and 10%, compared to a sub-2% risk-free rate on a 10-year government bond. Obviously, the market is implying a substantial risk premium for equities. Over the long term, we view that as an attractive entry point to invest. Stocks offer the opportunity for return of a portion of that substantial free cash flow in the form of dividends and stock repurchases, which many companies are stepping up right now. They also provide the optionality of growth for the future, since well-positioned companies should be able to increase their revenues and cash flows, and deploy that capital in positive ways. This is particularly true in the domestic large cap segment, where we are finding solid free cash flow multiples and attractively priced companies with globally driven growth potential.

Q: WHAT IS YOUR OUTLOOK FOR CORPORATE EARNINGS?

Jim Goff: Over the past four years, there has been a huge juxtaposition between the bad news emanating from governments and debt markets, and the really good news in corporate earnings. The market has been macro and panic driven at times, but it eventually has settled down at points in time and started to reflect positive corporate fundamentals.

Some strategists argue, based on cyclically adjusted 10-year price/earnings (P/E) ratios, that markets are at a cyclical peak, and stocks are overvalued. We disagree with that conclusion. We don't think this has been much of an upcycle so far, and the tremendous growth in U.S. profits during the past decade is not just an ephemeral thing that is going to fade away. Profit margins should remain strong, and valuations are not demanding. As Jonathan mentioned, free cash flow yields are particularly attractive relative to interest rates and supportive of equities.

Q: IN SUMMARY, IT SOUNDS LIKE YOU ARE BOTH BULLISH ABOUT CURRENT U.S. EQUITY PROSPECTS LONG TERM?

Jim Goff: On the whole, yes. It is understandable that short-term volatility can be disconcerting to investors, particularly given the past few years of extreme market swings, but we think stock fundamentals paint an optimistic investment picture. There are many positive underlying developments in the U.S. economy, in terms of small business growth, overall improvement in many sectors including energy and industrials, and the beginnings of a housing market recovery. With these types of tailwinds, U.S. corporate revenues and profitability should have reasonably strong underpinnings. Also, don't underestimate the dynamism of U.S. companies' ability to adapt, innovate and create value.

Jonathan Coleman: Furthermore, current valuations offer an undemanding starting point, especially relative to prevailing interest rates. Stock prices may not be in the cheapest quartile of long-term price-to-earnings ratios, but they certainly are not substantially above historical averages. Overall, we think this offers significant potential for investors willing to ride out the current turbulence.

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C-0612-020 06-30-13

188-15-16983 06-12