EQUITY INVESTMENT THEMES FOR 2013

By The Boston Company
Asset Management's
US Small Cap Growth Team

First Quarter 2013

Amid an increasingly activist government, we see very compelling investment themes in the construction recovery, the U.S. energy renaissance, cutting-edge technology, the changing health-care landscape and an upswing in deal activity.

EXECUTIVE SUMMARY

The investment landscape is constantly changing, and keeping up with this evolution is a key element to successful investing. Many investment professionals read the latest headlines each day, but do not identify and assess themes that have the potential to enhance — or erode — the opportunity for long-term alpha generation in the equity markets.

The Boston Company's US Small Cap Growth team gathers once a year to examine what lies ahead and how to invest accordingly. They have outlined the following seven distinct investment themes for 2013 and believe these concepts will influence the investing climate over the next several years:

– Low-Return World
– Activist Government
– U.S. Energy Renaissance
– Construction Recovery
– Technology: Cloud and Mobility
– Health Care Revolution
– Merger and Acquisition Activity

While the team focuses on the small- and mid-cap growth equity asset classes, these themes may potentially offer value to any investor, regardless of investment style or market-capitalization preference. With that in mind, here is a closer look at each of the seven 2013 investment themes.

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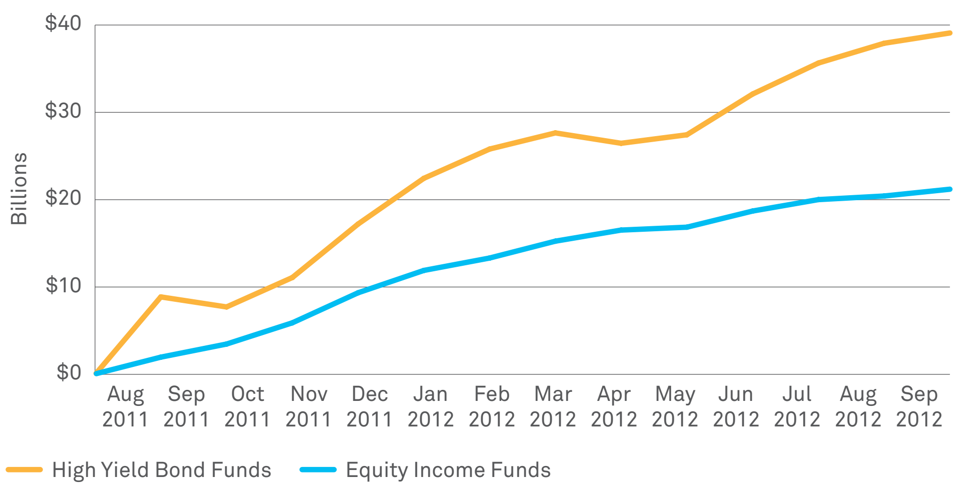
LOW-RETURN WORLD

Since December 16, 2008, the federal funds rate has remained within a target range of zero to 0.25%. This long stretch of historically low rates has spurred an unprecedented hunt for yield. More recently, for what appeared to be the first time in its recorded history, the U.S. Federal Reserve's statement on December 12, 2012 provided investors a clear crystal ball: Short-term interest rates will be kept low until the middle of 2015. Although monetary policy rates in the U.S. and elsewhere remain extremely accommodative, we believe such rates are unsustainably low. There are global ramifications, as central banks around the world move toward easing monetary policy. However, in the U.S. market these actions have resulted in a crowded trade within high-dividend stocks and corporate bonds, as investors scramble to achieve returns with some modicum of "safety" (Exhibit 1). As the Fed embarks on its third round of quantitative easing (QE3), investors have been edged out of the U.S. Treasury and mortgage-backed securities market and forced into the corporate sector. As a result, they are now taking on outsized risk to generate yield, with fewer and fewer natural places to find it.

Exhibit 1 – Cumulative Estimated Net Cash Flows for Yield-Generating Alternatives

September 2011 through September 2012

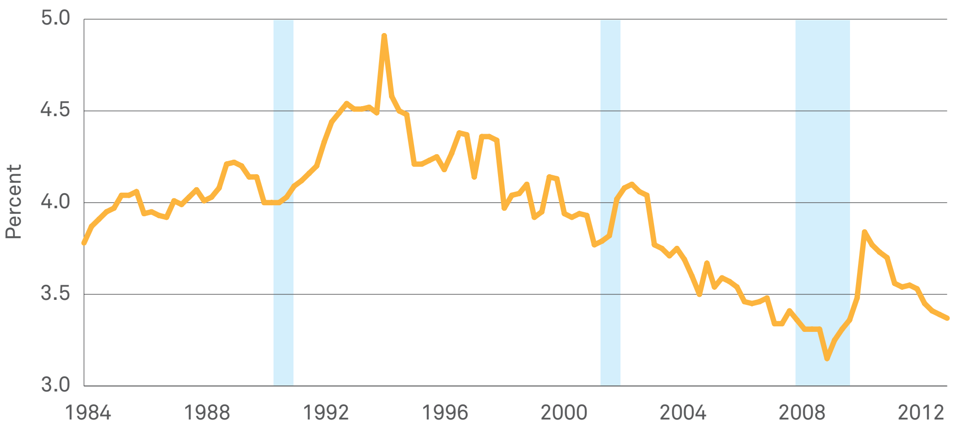


Source: Morningstar Direct, November 2012.

Investors initially pushed into the corporate-bond market and then into less traditional sources of yield, such as utility stocks and real estate investment trusts. In these sectors, especially, investors have focused far less on fundamentals. The current low-rate environment is designed to stimulate economic growth and bolster spending. As a consequence, consumers have little incentive to save, although they are still in the process of deleveraging their personal balance sheets. Mortgage rates remain near historic lows, spurring a nascent recovery in the housing market. This also benefits the construction industry across both residential and non-residential markets.

Conversely, one area that is likely to remain challenged is the Financials sector. Despite improving credit quality and loan growth, banks could continue to feel pressure from low rates that have compressed net interest margins, as seen in Exhibit 2. Overall, we expect that in a low interest rate environment, investors will likely be willing to pay for companies that can deliver growth.

Exhibit 2 – Net Interest Margin for All U.S. Banks (USNIM)



Shaded areas indicate U.S. recessions.

Source: Federal Financial Institutions Examination Council, November 2012. Data period 1/84–7/12.

ACTIVIST GOVERNMENT

In the U.S., government regulation has been proliferating. According to the Heritage Foundation, which cites data from the U.S. Government Accountability Office, the Obama administration imposed a total of 106 new major regulations in its first three years. Many of these regulations are driven by the 2010 Dodd-Frank Wall Street Reform, the Patient Protection and Affordable Care Act (ACA) and the Consumer Protection Act.[1]

In the wake of the 2008 financial crisis, the Dodd-Frank Act represents a sweeping change to U.S. financial regulation. It created a Financial Stability Oversight Council "charged with identifying threats to the stability of the financial system, promoting market discipline and responding to emerging risks" and establishes the Federal Deposit Insurance Corp.'s (FDIC) orderly wind-down authority.[2] The act also imposes regulatory frameworks on hedge funds, derivatives and consumer financial products and services.

The legislation's impact on the industry is still uncertain, as many of the agencies have discretion over how they will implement the act's broad provisions. Some of the new policies could potentially limit financial firms' profitability and growth, so we focus on companies that either fall outside the bounds of regulations or can actually benefit from them.

However, calls for heightened scrutiny on the financial markets, even beyond the initial scope of Dodd-Frank, still exist. One example is the recent focus on high-speed trading, where technological mishaps affected trading in such companies as Knight Capital, Facebook and Apple. In the wake of these incidents, a recent essay published by the Federal Reserve Bank of Chicago has called for increased oversight in this area of the market:

[1]James L. Gattuso and Diane Katz, "Red Tape Rising: Obama-Era Regulation at the Three-Year Mark," The Heritage Foundation, March 13, 2012. http://www.heritage.org/research/reports/2012/03/red-tape-rising-obama-era-regulation-atthe-three-year-mark

[2]Lori Schock, "Outline of Dodd-Frank Act and JOBS Act," U.S. Securities and Exchange Commission, June 9, 2012. http://www.sec.gov/news/speech/2012/spch060912ljs.htm

"The extent of these losses and the frequency with which these incidents are occurring in seemingly well-managed firms is focusing attention on the need for risk controls at every level of the trade life cycle; i.e., at trading firms, broker-dealers (BDs), futures commission merchants (FCMs), exchanges, and clearinghouses."[3]

Apart from the Financials sector, another area of massive regulatory overhaul is in Health Care. The ACA included a number of provisions to take effect over the next three years, including increasing Medicaid coverage, subsidizing insurance premiums, incentivizing businesses to provide health-care benefits for employees and requiring individuals to carry health insurance or else be subject to penalty, except for certain exemptions. According to estimates from the Congressional Budget Office (CBO) and the Joint Committee on Taxation, the net cost of ACA's insurance coverage provisions will be about $1.17 trillion over the next decade. The recent Supreme Court ruling actually lowered the CBO estimate by $84 billion, as "the reductions in spending from lower Medicaid enrollment are expected to more than offset the increase in costs from greater participation in the newly established exchanges."[4]

Although this legislation should improve access to health-care coverage, the ensuing investment ramifications are far from certain. Some members of Congress continue to press for modifications and adjustments. The 2012 Supreme Court ruling that upheld its constitutionality, however, likely indicates that some elements of the plan will be implemented. The topic will be discussed in further detail in the section on the Health-Care Revolution.

The final area of regulatory focus is the Environmental Protection Agency (EPA). In late 2011, the EPA issued the Mercury and Air Toxics Standards, the first national standards to mandate reduction of power-plant emissions of mercury and other pollutants such as arsenic, selenium and cyanide. However, the rule is presently being challenged in the U.S. courts, with briefs filed in August by the National Association of Manufacturers and the Chamber of Commerce. They argue that adherence to the rule will prompt a surge in power prices.[5]

Although the EPA's latest regulatory efforts have come under fire, especially from the coal industry, the agency has had a mixed record of defending them in the U.S. courts. In June 2012, a federal appeals court upheld the EPA's greenhouse gas regulations, but two months later, a U.S. court struck down the Cross State Air Pollution rule.

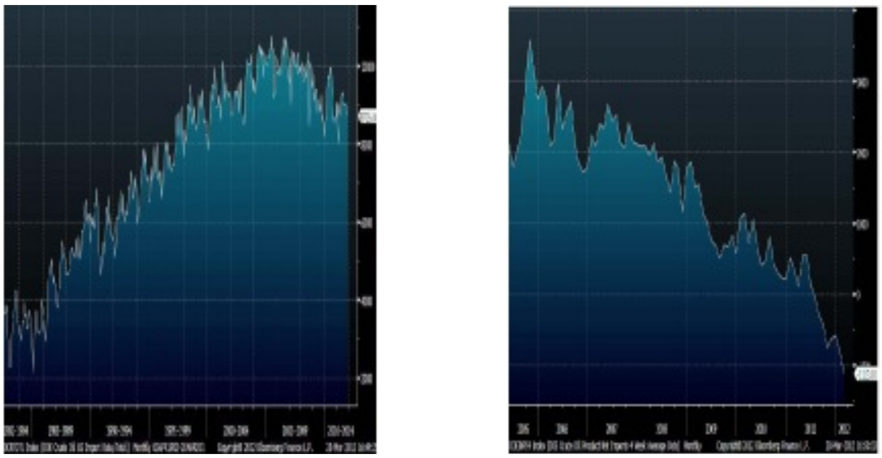
U.S. ENERGY RENAISSANCE

We believe the U.S. is in the midst of an energy renaissance, driven by a meaningful improvement in its ability to produce hydrocarbons due to advances in drilling and completion technologies. Although the U.S. is not yet energy self-sufficient, it is moving rapidly in that direction. Advancements in drilling and completion technologies, access to capital and a drive toward innovation have helped the development of unconventional oil and natural-gas production. While the production of natural gas from American shale plays has surged, the real game-changer has been the cracking of the shale code in North Dakota's Bakken reservoir. U.S. oil production grew rapidly in 2012 and offset weak production in other non-OPEC countries, according to the Energy Information Administration. Without this

[3]Carol Clark, "How to keep markets safe in the era of high-speed trading," The Federal Reserve Bank of Chicago, October 2012. http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2012/cfloctober2012_303.pdf
[4]"Estimates for the Insurance Coverage Provisions of the Affordable Care Act, Updated for the Recent Supreme Court Decision," Congressional Budget Office, July 24, 2012. http://www.cbo.gov/publication/43472
[5]Valerie Volcovici, "Coal plants still pressured despite Romney plan, EPA court loss," Reuters, Aug. 23, 2012. http://www.reuters.com/article/2012/08/23/us-usa-coal-closures-idUSBRE87M15F20120823

production growth in the U.S., oil prices would have responded more sharply to Iran sanctions. The increase in U.S. oil production has made Americans less reliant on foreign sources of oil, as seen in Exhibit 3, and we expect this position to improve further over the next few years.

Exhibit 3 – Crude Oil Imports Are Falling… and We Are Net Exporters of Oil Products



Source: Bloomberg, as of March 2012.

The risk to U.S. crude production is largely tied to the price of crude oil. Unless oil prices fall below marginal costs, the U.S. has significant investment opportunities to grow production. For major U.S. shale oil plays, the marginal cost of production is roughly $70 to $80 a barrel. In the short term, that level should provide a floor for oil prices, with the biggest threat to this price floor being an emerging-market demand shock. Over the intermediate to long term, U.S. production should increase global spare capacity and put downward pressure on oil prices.

Domestically, higher prices and improved efficiency have impacted energy consumption, particularly the establishment of more stringent Corporate Average Fuel Economy (CAFE) standards. By model year 2025, fuel economy will be increased to the equivalent of 54.5 mpg for cars and light-duty trucks, according to the National Highway Traffic Safety Administration (NHTSA). That compares with a projected CAFE level of 32.8 for passenger cars in 2012, using a March 12, 2012, NHTSA summary of fuel economy performance.[6] Naturally, it takes time for these standards to work their way into the nationwide fleet, but over time, they should hinder crude-oil demand.

From an investment standpoint, we believe crude-oil investments should be considered selectively. The energy renaissance has not been lost on the U.S. oil-service industry, as evidenced by the pressure pumping market, where capacity tripled in only two years. Investors may want to consider companies that benefit from the hydrocarbon volume growth story in the U.S., but avoid those companies that would be negatively impacted if commodity prices moderate over time. Another area of focus for investors may be midstream infrastructure, such as pipelines, processing plants and storage, which are needed to support hydrocarbon volume growth in the U.S. In addition, companies that own acreage in emerging shale plays may also be a desirable consideration for investors.

[6] "March 2012 summary of fuel economy performance," National Highway Traffic Safety Administration. http://www.nhtsa.gov/fuel-economy

Natural gas is not (yet) a widely used commodity in the U.S., and an abundance of natural gas being extracted from shale plays has caused the price of this commodity to fall sharply. In 2008, shale gas represented about 5% of U.S. natural gas production; as of 2010, that percentage had jumped to 20%, according to the International Energy Agency.[7] If production were not constrained by demand, we believe it could have approached 35% by now. Demand for natural gas has climbed because of its distinct cost advantage over global gas, coal and petroleum-related products. However, because of abundant U.S. supplies, we expect prices to remain low relative to global gas, oil and coal prices until the market arbitrages this spread by exporting chemicals, substituting natural gas for coal in power generation, converting trucking and transportation fleets to liquefied natural gas (LNG) and building LNG export terminals. We forecast that this scenario will likely take three to five years to evolve. During this time, the U.S. Industrials sector should get a sizable lift from large projects built to take advantage of the country's low feedstock prices.

Forecasting the precise year in which the U.S. becomes self-sufficient in terms of energy may seem to be a productive exercise in theory, but in practice, small changes to projections tend to result in large changes to outcomes. With this in mind, we believe net imports could potentially account for as little as 10% of U.S. energy consumption by 2015, using the following assumptions:

- Natural gas production increases 3% annually due to low feedstock arbitrage.
- NGL (natural gas liquids) production increases 7% to 8% annually due to strong chemical exports.
- Crude oil production grows 10% to 15% annually and backs out imports.
- Nuclear production remains flat.
- Renewable production increases 3% annually.
- Coal production declines 1% annually.
- U.S. energy consumption rises 1% annually.

By 2015, many industry analysts expect that the U.S. Industrials sector could get a sizable lift from large projects built to take advantage of the country's low feedstock prices.

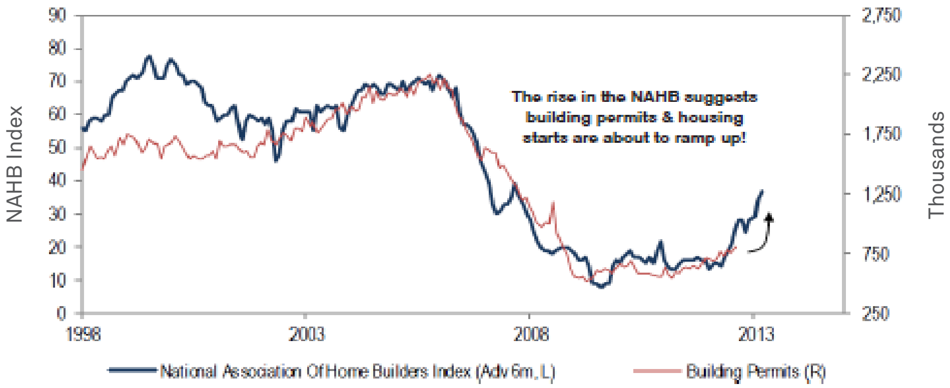
CONSTRUCTION RECOVERY

Another important emerging theme in the U.S. investing landscape is the recovery in the construction industry. General manufacturing activity is slowing in the U.S. and elsewhere, and construction is emerging as a key engine of economic growth. Residential housing was a consistently bright spot for the U.S. economy in 2012. After six years of detracting from U.S. gross domestic product, housing recently contributed 40 basis points to first quarter GDP and 20 basis points in the second quarter, according to the Bureau of Economic Analysis.

Housing starts have been below trend for the better part of five years. After hitting a 50-year low in 2009, housing starts have recovered relatively slowly. Housing starts did grow sharply in 2012, but the absolute level is still below the trough of the last housing cycle. The annualized rate of housing starts is expected to exceed 750,000 in 2012 according to government forecasts, and we believe this could rise to approximately one million in 2013. This comes on the heels of a recent upswing in homebuilder sentiment: The NAHB/Wells Fargo Housing Market Index (please see Appendix for definition), which has been on the rise for the past six months, hit a fresh six-year high in October. As Exhibit 4 shows, housing activity often begins to accelerate roughly six months after homebuilder sentiment starts to rise.

[7] "FAQs: Natural Gas," International Energy Agency. http://www.iea.org/aboutus/faqs/gas/

Exhibit 4 – The Historical Effect that Home Builders' Sentiment Has Had on Housing Activity

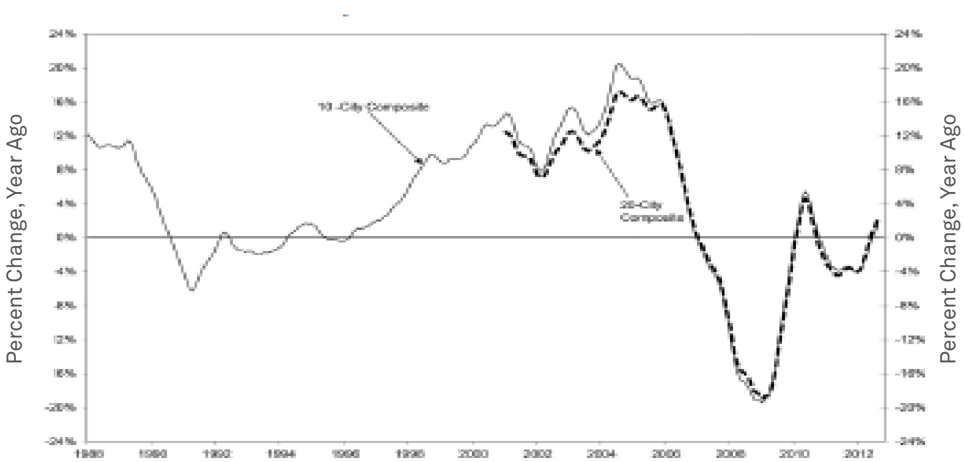


Source: NAHB, as of October 2012.

Driving the improvement in housing activity volumes and pricing are investors, who are snapping up properties to take advantage of low interest rates, housing affordability and a strong rental market, buoyed by less access to credit and ongoing economic uncertainty. As investors have reduced the foreclosure inventory, demand for new homes has improved from depressed levels. Although excess supply is still at a high level, the shadow inventory pipeline is down from its peak, the new home inventory is at a historic low, and the existing home inventory has fallen 43% from its high, according to research from Zelman & Associates.

Pricing is another improving metric in the residential housing market. According to the Standard & Poor's/Case-Shiller Index (please see Appendix for definition), shown in Exhibit 5, home prices across the U.S. rose 2% in August from the year-ago period, its third consecutive increase. Seventeen of the 20 metropolitan areas represented in the survey posted year-over-year gains, providing more evidence that prices have stabilized and are beginning to rise. If that remains the case, refinancing activity should also increase.

Exhibit 5 – Rising Home Prices in the Recent Year Supports the Case of a Recovering Housing Market



Source: S&P Dow Jones Indices and Fiserv, as of September 2012.

Over the next several years, we believe buying should increase due to pent-up demand from household formations. From 2007 to 2010, the growth rate in the number of U.S. households fell two-thirds, compared with the previous decade. In particular, adults aged 18 to 34 accounted for almost three quarters of the overall shortfall in housing formations, clearly a result of the 2008–09 recession.[8] According to the Cleveland Federal Reserve, about 1.5 million households were formed annually in the U.S. between 1997 and 2007; over the next three years, the figure dropped to 500,000 a year. However, we expect household formations to resume their long-term trend of more than 1 million a year over the next five to 10 years. Included in that projection is our assumption that employment will grow by more than one million jobs each year. This should be enough to drive housing starts back above an annual rate of one million units.

Members of "Generation Y" are living back at home with their parents for economic reasons. If the economy improves, we believe it is likely pent-up formations will grow. While they are more likely to rent than buy because of high student-loan debt and a poor impression of real estate as an investment, formations will likely grow nonetheless.

Away from housing, nonresidential construction is also rebounding due to positive trends emerging in power, manufacturing, warehousing/distribution and hospitals. Slower recoveries are materializing in the office and retail segments of the market, while softness remains in federal-government work. Investment opportunities exist in construction and engineering, but are more limited in the public infrastructure space.

Demand is strengthening for commercial real estate loans amid greater credit availability, pointing to a sustained recovery in the nonresidential market. Tenant turnover should continue to support growth, while redesigns and energy-efficiency retrofits are bolstering the market as well.

TECHNOLOGY: CLOUD AND MOBILITY

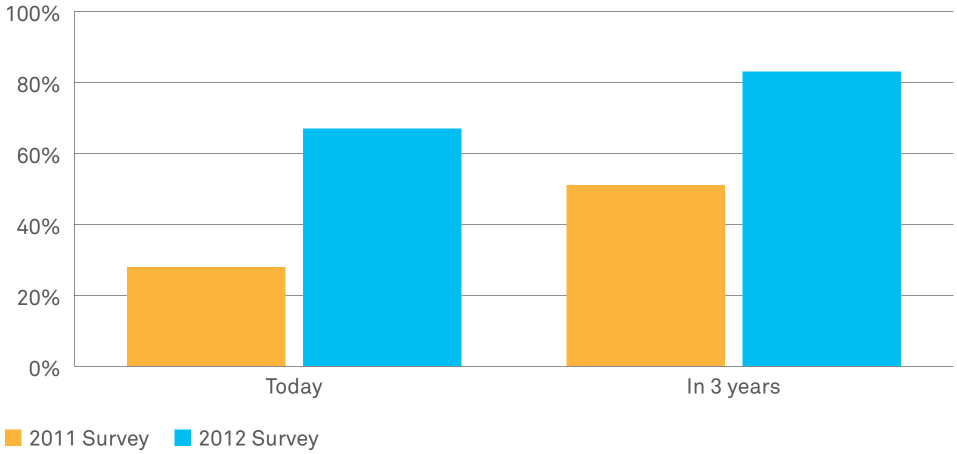
The Information Technology (IT) sector has undergone some seismic shifts over the past 30 years. Beginning in 1990, we saw a significant growth in client servers. Five years later, we witnessed the build-out of the Internet, followed in 2001 by the offshoring movement. In 2012, we began seeing the next wave — cloud deployment — which is radically changing the landscape of IT services and technology.

Corporate IT systems are complex, as multiple versions of software are deployed across enterprises, and several protocols and networking technologies exist side by side. The emergence of the cloud is enabling companies to transition to a far more simplified architecture, eliminating redundancies and the need for complicated or burdensome IT infrastructure.

Investment opportunities are robust in this dynamic environment. IT services is a $600 billion-plus market that is growing at about a 3% to 4% pace (source: Gartner). Cloud computing alone is a roughly $40 billion market with a projected compound annual growth rate of 25% over the next decade, according to IDC. Adoption of the cloud is picking up dramatically. As seen in Exhibit 6, a May 2012 report from Morgan Stanley Research showed that the firm's latest CIO survey indicated that 67% of respondents were using the public cloud, compared with only 28% in the 2011 survey.

[8]Timothy Dunne, "Economic Commentary: Household Formation and the Great Recession," The Federal Reserve Bank of Cleveland, Aug. 23, 2012. http://www.clevelandfed.org/research/Commentary/2012/2012-12.cfm

Exhibit 6 – Percent of Respondents Using the Public Cloud



Source: © 2012 Morgan Stanley, as of May 2012.

Vendors have plenty of work ahead in helping their corporate clients untangle their existing infrastructure and rebuild their systems in a cloud format. As customers shift from buying their hardware, software and infrastructure to renting it via the cloud, they will need help adjusting to the new model. This will likely accelerate secular growth, enable service-order-management (SOM) gains for industry leaders, increase cross-selling opportunities and raise deal sizes and improve pricing. For example, consulting firm Deloitte LLP, which offers specialized guidance to clients implementing a cloud strategy, achieved a 5% gain in realized prices in 2012.

During this vital transition period, clients are likely to standardize on IT service providers instead of using an "a la carte" approach. This will exacerbate the emergence of clear winners and losers among IT service vendors. The cloud transformation offers the promise of simplicity, but could prove to be more complex and difficult than offshoring.

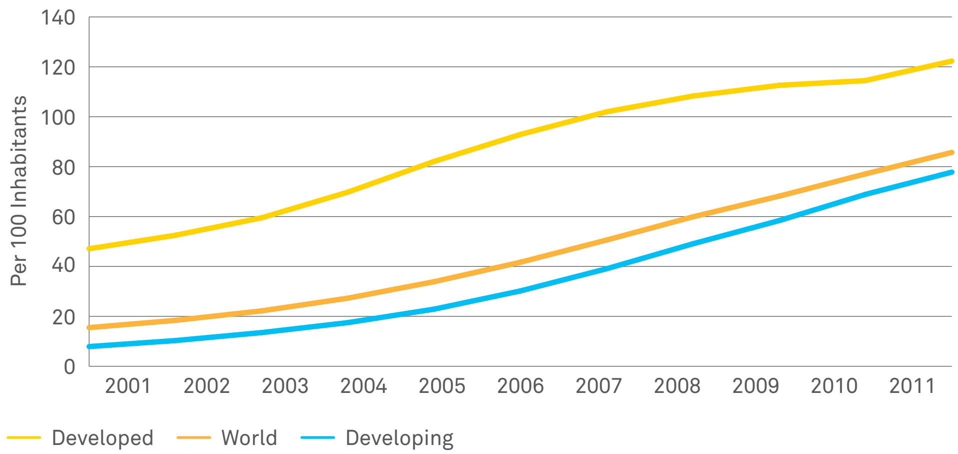
Thanks to the Internet, the cloud is also making inroads with consumers, who have experience with similar Internet-based e-mail services such as Gmail and Yahoo!. The cloud essentially represents a convergence of computing, communications, entertainment and mobile devices. At the end of the day, most of the applications that consumers use will be available as an app, and information will be hosted on the cloud.

Mobility is another key investment theme in 2013. Total mobile-cellular subscriptions approached the six billion mark at the end of 2011, marking a global penetration rate of 86%, according to a June 2012 report from the International Telecommunication Union.[9] Mobile broadband subscription growth surged 40% in 2011, versus much lower growth rates of 5% in developed markets and 18% in developing countries, according to ITU data, for fixed broadband.

Using data obtained from CTIA-The Wireless Association database, by the end of 2011 mobile cellular penetration in developing countries passed the 75% mark, reaching an estimated 78 per 100 inhabitants. This represents more than a doubling since 2006 when it stood at 30%. Mobile penetration rates within developed countries grew as well, as shown in Exhibit 7, but are obviously not as strong, given the relative maturity of the market. According to CTIA, mobile-phone users are talking, texting and surfing the Internet more than ever. In 2011, U.S. consumers used almost 2.3 trillion minutes, a 2% increase from 2010, and sent and received more than 2.3 trillion SMS text messages, up 12% from the year earlier.

[9]"Key Statistical Highlights: ITU data release June 2012" http://www.itu.int/ITU-D/ict/statistics/material/pdf/2011%20Statistical%20 highlights_June_2012.pdf

Exhibit 7 – Mobile-Cellular Subscriptions per 100 Inhabitants, 2001–2011

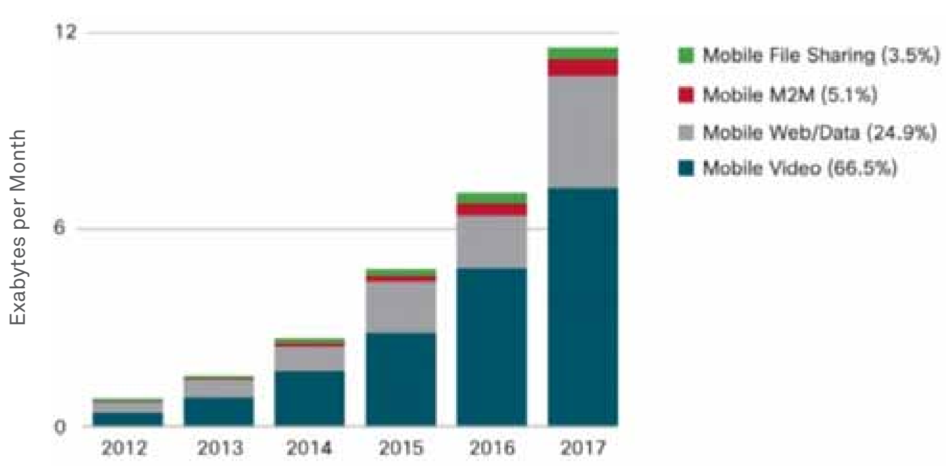


Source: ITU World Telecommunication/ICT Indicators database, as of October 2012.

But the significant growth engines in the wireless industry, according to CTIA data, were active smartphones and wireless-enabled PDAs, which number 111.5 million, up 43% from 2010, and wireless-enabled tablets, laptops and modems, which total 20.2 million, a 49% rise from 2010. Perhaps the most startling jump came from wireless network data traffic: At the end of 2011, the total stood at 866.7 billion megabytes, a 123% surge from 2010 levels.[10]

Wireless usage is expected to continue growing. According to recent projections from the Cisco Visual Networking Index (please see Appendix for definition), more than 10 billion mobile-connected devices will be in operation in 2017, and global mobile data traffic will increase 13-fold between 2012 and 2017, with two-thirds of that traffic being video.[11]

Exhibit 8 – Mobile Video Will Generate Nearly 70% of Mobile Data Traffic by 2017



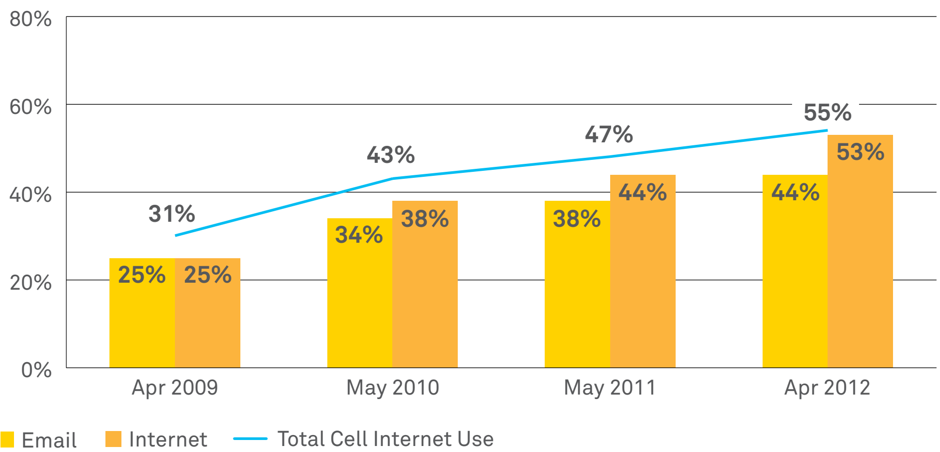
Figures in legend refer to traffic share in 2017.
Source: Cisco VNI Mobile Forecast, 2013.

[10]Dr. Robert Roche, "CTIA Wireless Industry Indices Report," CTIA-The Wireless Association, May 17, 2012. http://blog.ctia.org/2012/05/17/indices-report/
[11]"Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2012-2017," Feb. 2013. http://www.cisco.com/en/US/solutions/collateral/ns341/ns525/ns537/ns705/ns827/white_paper_c11-520862.html

As consumers grow increasingly reliant on their smartphones to perform a wide range of functions — ranging from voice communication, text messaging and e-mail capabilities to calendar management, gaming, music and Internet access — wireless traffic should remain robust for years to come. In our opinion, this provides a compelling investment opportunity in companies that help carriers improve service and facilitate mobility. In fact, online access is becoming a more widely accepted part of everyday smartphone usage, as shown in Exhibit 9 from a Pew Research Center study.[12]

Exhibit 9 – More Than Half of Adult Cell Owners Go Online Using Their Phones

Percentage of Adult Cell Owners Who Use the Internet or E-mail on Their Phone



Source: Pew Research, as of June 2012.

The ongoing shift toward mobility is not happening in a vacuum. It requires cloud capabilities and connectivity to work. As users rely less on their desktop PCs and more on their smartphones and tablets, this creates a potential new set of winners in the equities space. Those companies focused on refining the user experience through platform innovation, e-commerce and social networking should benefit. The emerging "digital wallet," which enables consumers to pay for retail products and services with smartphone-enabled technology, also represents a growing area of opportunity. On the downside, the shift from desktop to mobile is hurting Internet advertising, given different monetization rates. While it may seem counterintuitive, mobile ad rates trail those of desktop, but we expect mobile advertising to grow at a rapid pace. We will continue to monitor emerging opportunities in the space.

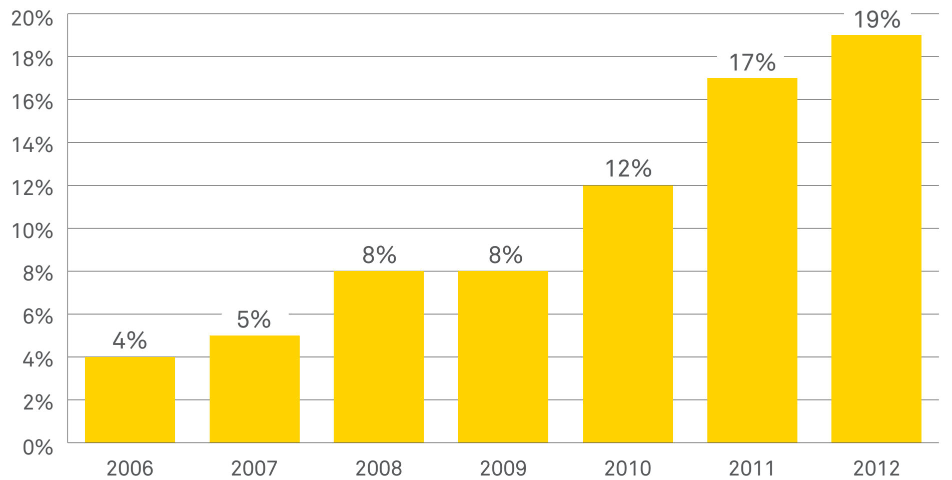
HEALTH-CARE REVOLUTION

During the past year, the Health Care sector has faced some notable overhangs, namely the Supreme Court ruling on the constitutionality of health-care reform legislation, the presidential election and the ongoing budget dilemma. As the uncertainty surrounding these events subsided, sector fundamentals became more important to investors. Even with 2012's uncertainties, the sector managed to perform well within the small-cap growth benchmark. This performance was fueled by positive clinical data, new drug approvals and acquisition activity within the biotechnology segment. While the fiscal cliff and the budget remain ongoing concerns, we believe total health-care spending will expand and continue to draw investors to the sector. We are forecasting mid single-digit percentage growth in total health-care spending, driven by strong demographic trends, especially within the aging baby boomer group.

[12]Aaron Smith, "17% of cell phone owners do most of their online browsing on their phone, rather than a computer or other device," Pew Internet & American Life Project, June 26, 2012. http://pewinternet.org/~/media/Files/Reports/2012/PIP_Cell_Phone_Internet_Access.pdf

Another important trend is the ongoing industry-wide positioning for health-care reform. Insurers have been consolidating to prepare for exchange setups, with only a few smaller state-specific regional players remaining in the market. If the exchange system is established successfully, more employers could gradually reduce health-care benefits and force their workers into the state exchanges. The shift could be similar to that from defined benefit plans, or pensions, to defined contribution plans. Health-care costs are clearly shifting to the consumer through higher co-pays, higher-deductible plans (see Exhibit 10) and less employer-based coverage. While we expect the sector to benefit initially from at least 15 million more Americans covered by insurance, we also expect utilization to remain under pressure as more health-care costs are borne by the consumer.

Exhibit 10 – Percentage of Covered Workers Enrolled in a High-Deductible Plan with a Savings Option, 2006–2012



Source: Kaiser/HRET, as of September 2012.

In an effort to increase market share and maintain negotiating clout, hospitals are snapping up physician practices ahead of reform implementation, as they strive to create accountable care organizations, or ACOs, that could benefit from financial incentives created by Medicare's Shared Saving Program.[13] As ACOs proliferate and the industry shifts to electronic health records, health-care IT could be a significant winner.

Although increased regulation and budget pressures may lead investors to question industry R&D investment, we expect investment spending in biopharmaceuticals and medical technology to expand, since the market will continue to reward breakthrough treatments and cost-effective solutions that offer better patient outcomes. One measure of R&D investment and productivity is the number of FDA approvals of new chemical entities. After hitting a low of 18 in 2007, approvals totaled 34 in 2012, their highest level in seven years (source: FDA). The agency's more balanced view and willingness to approve new drugs could be a result of political pressure to address mounting health issues, such as cancer, diabetes and obesity. We expect drug pricing in the U.S. to remain relatively insulated from reimbursement pressures as long as a generic equivalent or a substitutable product is unavailable. Biopharmaceutical companies with unique drugs have great flexibility in setting prices and garnering annual price increases. Without such differentiation, however, products face a tougher sell. "Me too" products will undergo greater scrutiny.

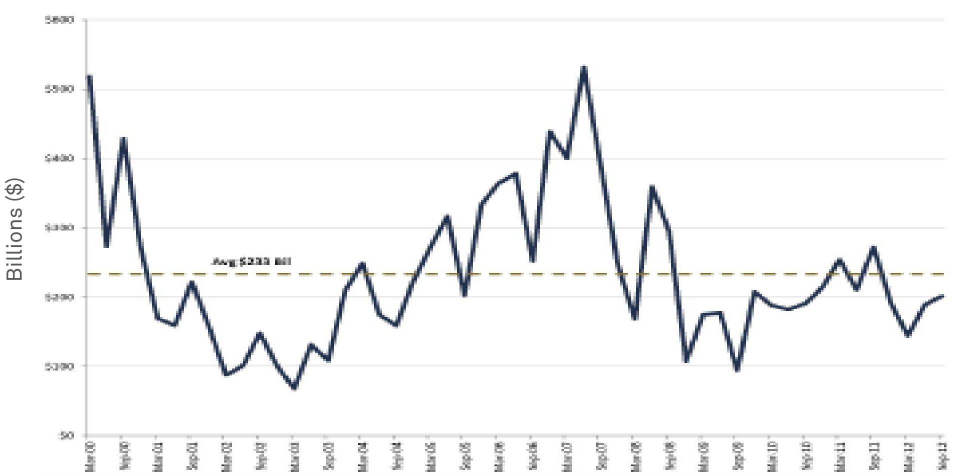
[13]Fact Sheet: First Accountable Care Organizations Under the Medicare Shared Savings Program," Centers for Medicare & Medicaid Services," April 10, 2012. http://www.cms.gov/apps/media/press/factsheet.asp?Counter=4334&intNumPerPage=10&checkDate=&checkKey=&srchType=1&numDays=3500&srchOpt=0&srchData=&keywordType=All&chkNewsType=6&intPage=&showAll=&pYear=&year=&desc=false&cboOrder=date

It is our opinion that ongoing developments and innovation in the Health Care sector will undoubtedly present compelling investment opportunities, especially within biotech, specialty pharmaceuticals, Medicaid managed care and selected health-care services. Many of these companies are positioned for any economic environment and can thrive in a climate of health-care reform and implementation.

MERGER AND ACQUISITION ACTIVITY

We expect to see a significant broad-based pickup in consolidation through mergers and acquisitions (M&A) over the next year. This trend offers the potential to generate attractive returns for investors. In the U.S., year-to-date transactions as of October 2012 totaled $662 billion, a 20% decline from the year-earlier period.[14] This is representative of an ongoing lull in the M&A marketplace, as deal volume remains below its historical average after seeing a slight increase in 2011 (see Exhibit 11). As uncertainties surrounding the U.S. elections and fiscal cliff dissipate and the Eurozone makes headway in resolving its debt crises, companies may become more confident about putting their capital to work.

Exhibit 11 – Below-Average M&A Volume May Suggest Market Is Poised for an Uptick in Activity



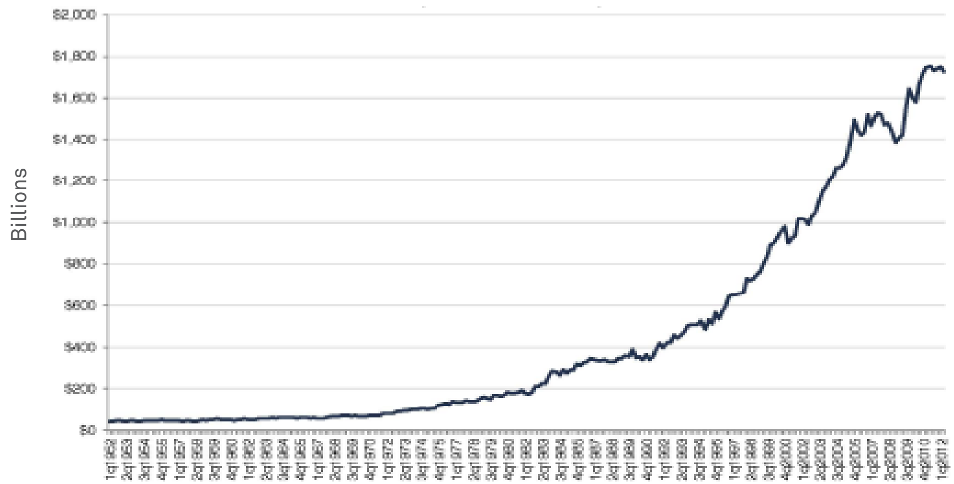
Source: Bloomberg.

As companies look to continue growing in an overall low-growth environment, we expect they will turn to acquisitions to achieve organic growth and opportunities for "cost synergies." Such synergies generally result from a firm's combined ability to exploit economies of scale, eliminate duplicated functions, share managerial expertise and systems, access new sales channels and raise larger amounts of capital.

Companies certainly have the means to snap up smaller players across all industries. Corporate cash balances have continued on an upward trajectory in the U.S. over the past two decades (see Exhibit 12). With interest rates remaining low for the foreseeable future, stockpiling reserves has become a less appealing option. This creates an impetus for strong companies with healthy balance sheets to acquire market share, talent, intellectual property and new products while weaker competitors retrench.

[14] "Zachary R. Mider, "M&A to Grow More 'Robust' Next Year, Effron Says," Bloomberg, Oct. 25, 2012. http://www.bloomberg.com/news/2012-10-25/m-a-to-grow-more-robust-next-year-effron-says.html

Exhibit 12 – Non-Financial Corporate Business Total Liquid Assets



Source: Federal Reserve, as of October 2012.

On the opposite side of the transaction, an acquisition could be appealing to smaller-capitalization companies compared to the alternatives of remaining a stand-alone firm during a slow economic recovery or completing an initial public offering (IPO). Although costs and complexity can vary significantly among individual IPOs, it is a quite expensive undertaking for most firms. In a recent PricewaterhouseCoopers survey, 87% of chief financial officers said their firms spent more than $1 million on one-time costs associated with their IPO, while companies on average incur $1.5 million of recurring costs as a result of being public.[15]

From a sector perspective, we believe the most robust consolidation opportunities exist within Health Care and Technology. Within Health Care, large pharmaceutical companies need to fill pipeline gaps while facing patent cliffs as well as selective geographic expansion. Takeover premiums in biotechnology averaged about 78% in 2012,[16] representing what we believe to be a significant alpha-generation opportunity.

Health-care service providers have also seen increased deal activity as they seek more scale, better buying power and more diversification. Health plans want to go where the growth is, such as the government Medicare Advantage plans. In Technology, we expect the software-as-a-service space to be a key driver of M&A. So far, it has been largely a North American phenomenon, but international demand should improve, as should the prospects for more deals.

CONCLUSION

In the current low-return environment, the market is placing more emphasis than usual on companies that are providing real growth. While global GDP growth remains tenuous, The Boston Company's US Small Cap Growth team will use our thematic work to focus on areas that do have growth. Amid an increasingly activist government, we see very compelling investment themes in the construction recovery, the U.S. energy renaissance, cutting-edge technology, the changing health-care landscape and an upswing in deal activity.

[15]"Considering an IPO? The costs of going and being public may surprise you," PricewaterhouseCoopers, September 2012. http://www.pwc.com/en_US/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf
[16]Sanford Bernstein industry report, citing Dealogic, Capital IQ data.

APPENDIX

NAHB-Wells Fargo Housing Market Index is based on a monthly survey of National Association of Home Builders members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. The HMI is a weighted average of separate diffusion indices for these three key single-family series. The first two series are rated on a scale of Good, Fair and Poor and the last is rated on a scale of High/Very High, Average, and Low/Very Low. A diffusion index is calculated for each series by applying the formula "(Good-Poor+100)/2" to the present and future sales series and "(High/Very High – Low/Very Low + 100)/2" to the traffic series. Each resulting index is then seasonally adjusted and weighted to produce the HMI. Based on this calculation, the HMI can range between 0 and 100.

S&P/Case-Shiller Home Price Indices are published on the last Tuesday of each month at 9 a.m. ET. They are constructed to accurately track the price path of typical single-family homes located in each metropolitan area provided. Each index combines matched price pairs for thousands of individual houses from the available universe of arms-length sales data. The S&P/Case-Shiller National U.S. Home Price Index tracks the value of single-family housing within the United States. The index is a composite of single-family home price indices for the nine U.S. Census divisions and is calculated quarterly. The S&P/Case-Shiller Composite of 10 Home Price Index is a value-weighted average of the 10 original metro area indices. The S&P/Case-Shiller Composite of 20 Home Price Index is a value-weighted average of the 20 metro area indices. The indices have a base value of 100 in January 2000; thus, for example, a current index value of 150 translates to a 50% appreciation rate since January 2000 for a typical home located within the subject market.

Cisco Visual Networking Index (VNI) is Cisco's ongoing effort to forecast and analyze the growth and use of IP networks worldwide. The comprehensive Cisco VNI Forecast is the company's ongoing initiative to track and forecast the impact of visual networking applications on global networks. Networks are an essential part of business, education, government, and home communications. Many residential, business, and mobile IP networking trends are being driven largely by a combination of video, social networking and advanced collaboration applications, termed "visual networking."

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The following are some **principal risks** associated with mutual funds that may engage in investments or strategies related to the topic of this brochure:

Equity funds are subject generally to market, market sector, market liquidity, issuer and investment style risks, among other factors, to varying degrees.

Bond funds are subject generally to interest rate, credit, liquidity and market risks, among other factors, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes, and rate increases can produce price declines.

Small and midsize companies carry additional risks because their earnings and revenues tend to be less predictable, and their share prices more volatile than those of larger, more established companies. They also tend to be less liquid than larger company stocks.

The technology sector involves special risks, such as the faster rate of change and obsolescence of technological advances, and has been among the most volatile sectors of the stock market.

The stock prices of health-care companies are very volatile, particularly when their products are up for regulatory approval and/or under regulatory scrutiny. The types of products or services provided by these companies can become obsolete quickly, and subsequent liability for their products may impact their share prices.

The market value of companies in the energy and natural resources sectors may be affected by numerous factors, such as events occurring in nature, inflationary pressures, and domestic and international politics. Interest rates, commodity prices, economic, tax, and energy developments, and government regulations may affect the supply and demand for natural resources and the share prices of companies in this sector.

Investing internationally involves special risks, including changes in currency exchange rates, political and economic instability, less market liquidity, lack of comprehensive company information, and differing auditing and legal standards. Emerging markets tend to be more volatile than the markets of more mature economies, and generally have less diverse and less mature economic structures and less stable political systems than those of developed countries.

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