



2nd Quarter | 2010

# Sector Strategy

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The U.S. economy has begun its transition from recovery to sustainable growth, an environment that tends to bring increased volatility and more modest stock market returns.

Cyclical Sectors	Defensive Sectors
Consumer Discretionary	Consumer Staples
Energy	Health Care
Financials	Telecom
Industrials	Utilities
Technology	
Materials	

Source: LPL Financial Research 05/20/10

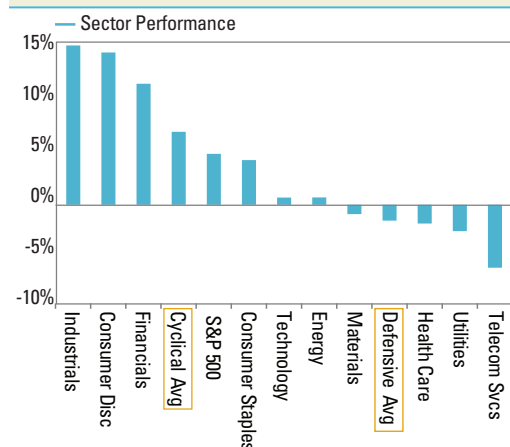
## Moving Toward the Middle

During the early stages of recovery, outperformance of cyclical sectors tends to be dramatic as we have seen during the past year. Now that the March 2009 market low is more than a year behind us and the economy has probably been out of recession for 10 months, we would expect performance between the cyclical and defensive sectors to be more similar in the coming months as headwinds start to emerge. Accordingly, while we maintain our slight preference for cyclicals for Q2 2010, we have tempered our enthusiasm. As discussed in our *2010 Outlook* publication, among the headwinds that we believe will bring increased market volatility later this year are tighter monetary policy from the U.S. and abroad, reduced impact of the U.S. fiscal stimulus, and slowing growth in China.

Another headwind facing the markets, which is reflected in our sector views, is higher expectations. While our assessment of the economic and business cycle always plays a key role in evaluating sectors, gauging the market's expectations has also been a consideration. For example, consensus caught up to our favorable consumer spending outlook, which we believe reduces opportunities in the Consumer Discretionary sector.

With the recent market pullback, we have become more constructive on equities in the short term, and have therefore added some equity exposure back to our models. While we expect cyclicals to fare better as equities recover recent losses, we have not meaningfully altered our sector views. The primary reason for maintaining a cyclical tilt as opposed to a more aggressive cyclical stance is that we are in a volatile economic transition and the headwinds that we expect to limit stock market returns in the second half are getting closer.

### 1 Cyclical Sectors Have Continued to Outpace The Defensives in 2010



Source: FactSet, LPL Financial 5/10/10

Data represents S&P 500 GICS sectors total returns year-to-date

### MIXED SIGNALS OF EARLY CYCLICAL LEADERSHIP

Positive/Moderate Positive	Neutral	Negative/Moderate Negative
Industrials	Consumer Discretionary	Consumer Staples
Technology	Energy	Telecom
	Financials	Utilities
	Health Care	
	Materials	

Source: LPL Financial Research, FactSet through 05/12/10

### Performance Review

Despite average gains of over 100% from the March 2009 lows though May for the cyclicals, or nearly double the performance of the defensives, cyclical sectors have continued to outpace their defensive counterparts this year. We expect cyclicals to fare better as the market recovers recent losses, but we would expect to move toward a more defensive positioning as the market approaches recent highs and headwinds emerge or intensify.



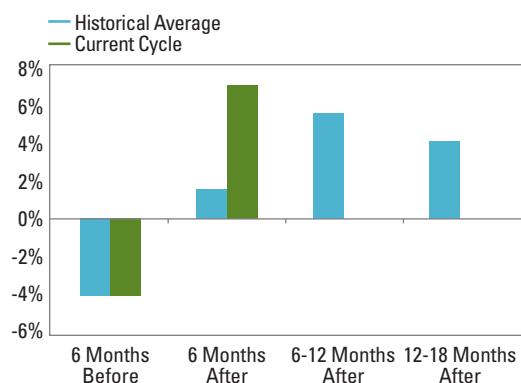
## Consumer Discretionary

### Compass View: Neutral

	S&P 500 Consumer Disc. Index	S&P 500 Index
QTD Performance	3.2%	-0.7%
YTD	14.0%	4.7%
1 mo.	2.4%	-0.4%
3 mo.	17.4%	8.6%
12 mo.	47.7%	35.8%
2010E EPS Growth	32.9%	30.8%
P/FE	16.1	14.2
Dividend Yield	1.3%	1.9%
Beta	1.12	1.00
S&P 500 Weight	10.7%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 5/10/10

#### 2 Consumer Spending\* Decelerates 12 Months Into an Expansion



Source: Ned Davis Research, LPL Financial 04/15/10

\*Government measure of consumer spending.

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Consumer Discretionary	●	●	●	■	●	■	

● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- After a stellar 2009 in which the sector returned over 40%, Consumer Discretionary is off to an excellent start in 2010 as consumer spending has continued to surpass expectations.
- We downgraded the sector to neutral during Q1 2010 as the market's expectations caught up to ours and as the business spending rebound exceeded that of consumer spending.
- Our forecast is for modest consumer spending growth over the balance of the year—not very different from consensus forecasts. Consumer confidence has rebounded, rising home and stock prices are producing positive wealth effects, and the economy is starting to add jobs; all positives.
- Earnings are expected to rebound over 30% in 2010, roughly in line with the consensus expectations for the overall market, and revisions have been solidly positive. Retailers have benefited from terrific cost controls, improved pricing, and market share gains.
- We believe the sector is fully valued. Historically, Consumer Discretionary has traded at 10% premium to the S&P 500 on a price-to-forward earnings basis. Currently, that premium is closer to 15%.
- As an early cyclical, the majority of sector outperformance tends to occur, on average, within the first 11 months after the start of an economic expansion [Chart 2]. Accordingly, we expect returns similar to those of the broader market.
- Challenges facing consumers which we expect to contribute to modest returns in the near-term include still high consumer debt levels, high unemployment, sluggish income growth, and high energy prices.
- Within the sector, we maintain our preference for Retail due to positive earnings revisions, favorable pricing trends, and stellar inventory management. The Media group has historically performed better later in the economic cycle and, we believe, is more richly valued at this time.



## CONSUMER DISCRETIONARY ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Consumer Discret Select Sector SPDR	XLY	69.54	1.08	2.25	3.63	12/16/98	0.22		69.59	1.13	2.20	3.28
Vanguard Consumer Discretionary ETF	VCR	75.15	1.03		1.74	01/26/04	0.25	0.85	75.48	1.06		1.75
iShares Dow Jones US Consumer Services	IYC	55.97	1.54		0.79	06/12/00	0.48	0.75	56.61	1.53		0.79

Source: MorningStar Direct As of 03/31/10

The performance data quoted represents past performance. Past performance is not an indicator of future results. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain current month-end performance information, please visit the respective fund's website: VCR: [www.vanguard.com](http://www.vanguard.com), IYC: [www.ishares.com](http://www.ishares.com); XLY: [www.spdrs.com](http://www.spdrs.com)

The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.

## Consumer Staples

### Compass View: Moderate Negative

	S&P 500 Consumer Staples Index	S&P 500 Index
QTD Performance	-1.6%	-0.7%
YTD	4.1%	4.7%
1 mo.	-1.5%	-0.4%
3 mo.	5.2%	8.6%
12 mo.	29.4%	35.8%
2010E EPS Growth	8.8%	30.8%
P/FE	14.3	14.2
Dividend Yield	2.9%	1.9%
Beta	0.51	1.00
S&P 500 Weight	10.8%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 5/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Consumer Staples	●	●	●	■	●	■	→

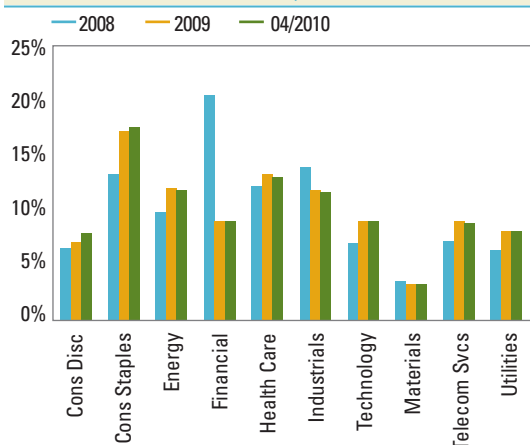
● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- As is to be expected, the defensive Consumer Staples sector lagged during the February through April rally as the cyclical sectors led the market higher, but held up better in the recent pullback. Consumer Staples earnings are generally predictable, but relative performance is better when the economy is slowing or entering recession.
- Earnings per Share (EPS) for the sector are only expected to increase by 9% in 2010, which ranks seventh out of 10 among the S&P sectors and trails estimated EPS growth for the S&P 500 by more than 20 percentage points. This is to be expected from a defensive sector with limited economic sensitivity. Competition and price sensitive consumers have constrained margins while resilience during recession creates tough comparisons.
- Our preference for cyclical investments has kept us from recommending Consumer Staples during the recovery. With the transition from recovery to sustainable growth underway, we are warming up to the sector as reflected in our positive bias demonstrated above. We would expect to

### 3 Dividend Contributions by S&P Sector



Source: S&P, LPL Financial 04/2010

become more positive as more evidence emerges that the economy's momentum is stalling and we increasingly favor defensive investments.

- The sector's attractive dividend profile and signs of headwinds have caused us to take a less negative view of Consumer Staples. Exposure to developing markets and attractive valuations relative to the sector's history are also supportive.
- Chart 3 illustrates that the sector has the highest dividend contribution in the S&P 500. The 3.0% yield is about one percent higher than that of the S&P 500, making for an attractive dividend profile. The sector has more S&P Dividend Aristocrats than any other (10), which includes companies that have raised dividend payouts for 25 consecutive years or more.
- Within the sector, we currently favor the relatively more economically sensitive Food & Staples Retail group for now with its discretionary spending component and slightly higher earnings growth rate.

### CONSUMER STAPLES ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg. Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Consumer Staples Select Sector SPDR	XLP	36.47	6.39	4.84	2.49	12/16/98	0.22		36.13	6.38	4.79	2.33
iShares Dow Jones US Consumer Goods	IYK	47.53	4.59		5.67	6/12/00	0.48	2.11	47.46	4.56		5.65
Vanguard Consumer Staples ETF	VDC	38.34	6.74		7.16	1/26/04	0.25	2.36	39.43	6.71		7.16

Source: MorningStar Direct As of 3/31/10

The performance data quoted represents past performance. Past performance is not an indicator of future results. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain current month-end performance information, please refer to manager's website: VDC: [www.vanguard.com](http://www.vanguard.com), IYK: [www.ishares.com](http://www.ishares.com); XLP: [www.spdrs.com](http://www.spdrs.com).

The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.



# Energy

## Compass View: View Neutral

	S&P 500 Energy Index	S&P 500 Index
QTD Performance	0.0%	-0.7%
YTD	0.7%	4.7%
1 mo.	2.2%	-0.4%
3 mo.	5.4%	8.6%
12 mo.	23.6%	35.8%
2010E EPS Growth	47.0%	30.8%
P/FE	12.5	14.2
Dividend Yield	2.0%	1.9%
Beta	1.29	1.00
S&P 500 Weight	11.3%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 5/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Energy	●	●	●	■	●	■	

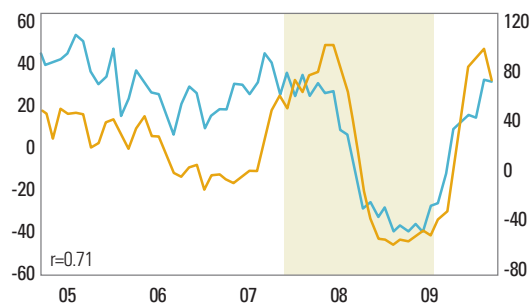
● Negative ● Neutral ● Positive

As of 05/10/2010

Please refer to the *Portfolio Compass* publication for complete details.

### 4 Energy Returns Follow Crude Prices

— S&P 500: Total Return: Energy  
% Change Year-to-Year EOP Dec-30-94=100 (left scale)  
— Spot Oil Price: West Texas Intermediate [Prior '82=Posted Price]  
% Change Year-to-Year \$/Barrel (right scale)



Source: Haver Analytics, LPL Financial 04/15/10  
(Shaded areas indicate recessions)

- Energy has been among the weakest cyclical sectors in 2010. In fact, it was the only cyclical sector that trailed the S&P 500 during the rally off the March 2009 low through the end of the year. The story is similar this year, as the sector is lagging most cyclical sectors and the broader market.
- Energy prices are of course the most important factor in evaluating the sector. In the mid-to-high \$70s, our crude outlook is balanced. Global demand is improving but supplies are sufficient. Accordingly, our Energy sector view is neutral.
- Crude and natural gas inventories remain elevated, while the untapped supply of natural gas has kept prices depressed. Demand is starting to pick up but is still well below pre-crisis peaks. OPEC has excess capacity and will likely ramp up production if oil prices rise much further.
- Energy, which tends to perform best late in the economic cycle, has underperformed its historical seasonal pattern during the recovery, which could mean improved relative performance. A favorable seasonal trend and reasonable valuations could also provide support.
- Our balanced near-term market and oil outlooks are consistent with our neutral view, if not better, on the big integrated oil stocks. Prior to the latest pullback we downgraded our view of the Oil & Gas Services group due to lofty valuations and high sensitivity to energy prices. A positive Mergers and Acquisitions (M&A) outlook keeps us modestly positive on Oil & Gas Exploration and Production for now.



## ENERGY ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Energy Select Sector SPDR	XLE	37.65	7.56	8.69	9.94	12/16/98	0.22		38.01	7.55	8.69	10.07
iShares Dow Jones US Energy	IYE	32.98	7.07		8.50	6/12/00	0.47	1.36	33.14	7.03		8.50
Vanguard Energy ETF	VDE	40.93	7.74		11.48	9/23/04	0.25	1.49	41.45	7.71		11.48

Source: MorningStar Direct As of 03/31/10

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\*Market return annualized are based on the last closing market price for each period.

## Financials

## Compass View: Neutral

	S&P 500 Financials Index	S&P 500 Index
QTD Performance	0.0%	-0.7%
YTD	11.1%	4.7%
1 mo.	-0.4%	-0.4%
3 mo.	12.7%	8.6%
12 mo.	49.6%	35.8%
2010E EPS Growth	116.9%	30.8%
P/FE	15.3	14.2
Dividend Yield	1.1%	1.9%
Beta	1.23	1.00
S&P 500 Weight	16.5%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 5/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Financials	●	●	●	■	●	■	

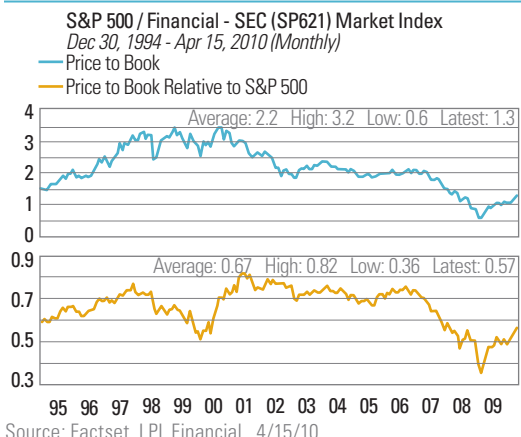
● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- Financials led the rally last year and are outperforming so far in 2010. Among the factors contributing to the strong performance are: better-than-expected economic growth, improving labor markets, rising prices of financial assets and home prices, stabilizing loan delinquencies, and loan loss reserve releases.
- Cyclical forces suggest now would be a good time to own the sector with loan losses stable and showing signs of improvement, the steep yield curve, and solid economic data. But Fed rate hikes loom later this year, losses from commercial real estate remain high, loan demand is sluggish, and the regulatory climate is difficult and uncertain.
- Our neutral view may prove overly conservative if the stock and bond markets continue to move higher, reform legislation that eventually passes is more benign than the market expects, and banks release reserves aggressively in Q2 2010.
- Underperformance could come from more sovereign debt or banking hiccups, especially onerous reform from Washington or from the sector's

5 Financials Still Reasonably Valued Though Book May Still Be Overstated



high level of sensitivity to market moves. Financials lagged during the market sell-off from January 19 through February 8 of 2010 and the latest pullback.

- Valuations remain attractive, although legislation will likely clip some profits and book value may still be overstated. Nonetheless, sector price-to-book value multiples remain close to their pre-Lehman Brothers historical trough and at a reasonable level considering expected profitability.
- Within the sector, we favor the Diversified Financials and Capital Markets groups due to attractive valuations and growth opportunities. The fundamental outlook for the banks is brightening but the risk profile remains above-average. We have become increasingly positive on REITs because of the income, improving labor and credit markets, and diversification opportunities.

FINANCIALS ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Financial Select Sector SPDR	XLF	82.92	-8.53	-1.94	-0.73	12/16/98	0.22		83.57	-8.49	-1.94	-1.23
iShares Dow Jones US Financial Sector	IYF	75.37	-6.70		-0.19	5/22/00	0.48	1.00	76.73	-6.67		-0.19
Vanguard Financials ETF	VFH	75.55	-6.09		-4.72	1/26/04	0.25	1.37	75.55	-6.11		-4.72

Source: MorningStar Direct As of 3/31/10

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The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

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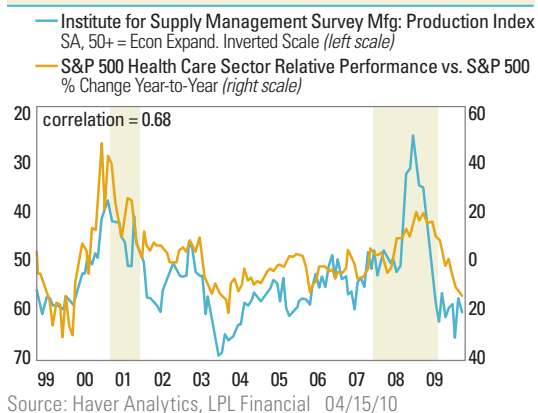
# Health Care

## Compass View: Neutral

	S&P 500 Health Care Index	S&P 500 Index
QTD Performance	-5.0%	-0.7%
YTD	-1.7%	4.7%
1 mo.	-4.3%	-0.4%
3 mo.	-2.2%	8.6%
12 mo.	28.8%	35.8%
2010E EPS Growth	8.4%	30.8%
P/FE	11.6	14.2
Dividend Yield	2.0%	1.9%
Beta	0.73	1.00
S&P 500 Weight	11.3%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 5/10/10

### 6 Defensiveness of the Health Care Sector Reflected in Inverse Correlation to the ISM Manufacturing Index



	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Health Care	●	●	●	■	●	■	→

● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- Health Care lagged during the recovery in 2009 along with the rest of the defensive sectors as the market strongly favored cyclical investments. Healthcare reform concerns also played a role. The sector's defensive characteristics, illustrated in the inverse correlation to a key manufacturing survey in [Chart 6](#), have continued to hurt relative performance in 2010.
- Our positive bias toward the sector reflects the removal of uncertainty now that the legislation has passed, as well as attractive valuations and our cautious market outlook in the second half of 2010. In addition, some health care companies will benefit from the massive overhaul because broader insurance coverage will increase consumption of health care products and services.
- Relative valuations for the Health Care sector at a 15% discount to the forward P/E multiple for the S&P 500 are near multi-decade lows. Despite patent losses, the sector is expected to grow Earnings per Share (EPS) at almost 10% this year, though that trails the roughly 30% growth expected by the S&P 500. Weak earnings revisions over the past one and three months are a concern.
- Our slight preference for cyclical investments keeps us from a more positive view of the sector. Looking forward, we would expect to become more constructive if more of the headwinds cited in our *2010 Outlook* publication emerge and we shift more toward a more defensive stance.
- Within the sector we continue to favor Biotech due to an above-average growth outlook and potential for more consolidation. Our Pharmaceutical view is neutral as the growth outlook is impaired by drugs coming off patent, but generic demand is very strong and valuations are quite favorable. We maintain our negative view of Managed Care due to the severity of insurance reforms.



## HEALTH CARE ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Health Care Select Sector SPDR	XLV	34.62	3.17	1.65	3.80	12/16/98	0.22		35.15	3.18	1.70	3.80
iShares Dow Jones US Healthcare	IYH	35.73	3.87		2.08	6/12/00	0.48	1.08	36.29	3.87		2.08
Vanguard Health Care ETF	VHT	37.63	4.16		3.15	1/26/04	0.25	1.10	38.82	4.15		3.16

Source: MorningStar Direct As of 03/31/10

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The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.

## Industrials

### Compass View: Moderate Positive

	S&P 500 Industrials Index	S&P 500 Index
QTD Performance	1.4%	-0.7%
YTD	14.6%	4.7%
1 mo.	1.9%	-0.4%
3 mo.	16.0%	8.6%
12 mo.	48.6%	35.8%
2010E EPS Growth	17.1%	30.8%
P/FE	16.9	14.2
Dividend Yield	2.0%	1.9%
Beta	1.22	1.00
S&P 500 Weight	10.7%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 05/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Industrials	●	●	●	■	■	■	

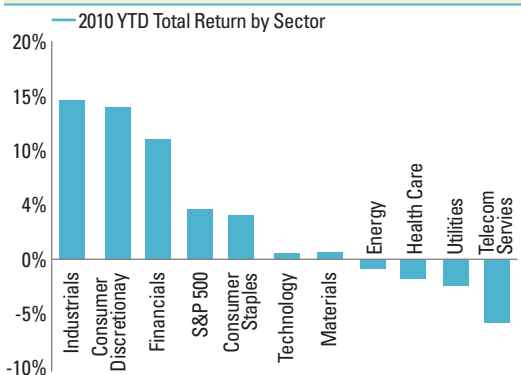
● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- After a strong cyclically-driven rally off the March 2009 lows, Industrials is the best performing sector so far in 2010. The primary drivers of performance have been much better-than-expected manufacturing activity, booming exports, and healing in the credit markets.
- Our view of the Industrials sector remains modestly positive as we expect most of the forces noted above to remain in place during the second half of 2010. The sector has late cycle characteristics. It historically performs well when business spending outpaces consumer spending, which we expect for the balance of 2010. Though the gap is closing, our U.S. economic growth forecasts for 2010 are still above consensus.
- Tailwinds are starting to fade and headwinds are starting to emerge. Global monetary policy is starting to tighten. China's economy is poised to slow. Fiscal stimulus is starting to fade. Commodity price sensitive businesses may weaken. Accordingly, we believe a modestly positive view is prudent.

7 Industrials is the Best Performing Sector Year-to-Date



Source: FactSet, LPL Financial 05/11/10

\*S&P 500 Industrials GICS sector total return vs. S&P 500 Index total return

- Valuations are another concern. The sector is trading at a nearly 20% premium to the S&P 500's next 12 months price-to-earnings ratio, compared to the historical average near the market. Even though the profit outlook is improving and Earnings Per Share (EPS) growth will likely reach the mid teens in 2010, valuations look full.
- Within the sector we favor the Machinery and Transportation industry groups due to their exposure to improving economic conditions. Machinery is well positioned to benefit from exports. Our view of Aerospace & Defense is negative, though valuations and the industry's defensive characteristics suggest possibly becoming more positive later in the year despite minimal defense spending growth..

INDUSTRIALS ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Industrial Select Sector SPDR	XLI	72.47	2.60	2.47	4.59	12/16/98	0.22		73.25	2.58	2.40	4.34
iShares Dow Jones US Industrial	IYJ	69.62	2.58		1.21	6/12/00	0.48	1.24	70.58	2.60		1.21
Vanguard Industrials ETF	VIS	71.82	2.76		4.52	9/23/04	0.25	1.48	72.35	2.78		4.49

Source: MorningStar Direct As of 03/31/10

The performance data quoted represents past performance. Past performance is not an indicator of future results. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain current month-end performance information, please visit the respective fund's website: VIS [www.vanguard.com](http://www.vanguard.com), IYJ: [www.ishares.com](http://www.ishares.com); XLI: [www.spdrs.com](http://www.spdrs.com)

The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.

# Technology

## Compass View: Moderate Positive

	S&P 500 Info Technology Index	S&P 500 Index
QTD Performance	-1.2%	-0.7%
YTD	0.7%	4.7%
1 mo.	-1.3%	-0.4%
3 mo.	9.9%	8.6%
12 mo.	39.2%	35.8%
2010E EPS Growth	36.4%	30.8%
P/FE	14.3	14.2
Dividend Yield	0.9%	1.9%
Beta	1.03	1.00
S&P 500 Weight	19.1%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 05/10/10

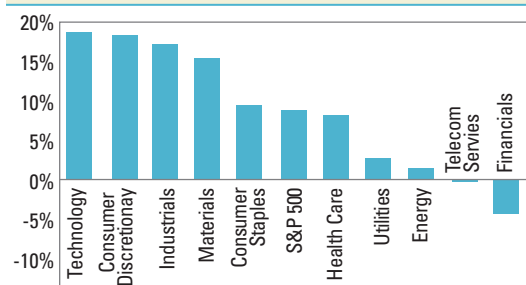
	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Technology	●	●	●	■	■	●	■

● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

### 8 Technology Earnings Revisions Are Strongly Positive in 2010



Source: FactSet, Thomson Reuters, LPL Financial 05/12/2010

- After topping the sector rankings in 2009, the Technology sector has lagged behind the S&P 500 in 2010. Still, the sector's roughly 1% gain is good enough for fifth place in this year's sector rankings and is beating three of four defensive sectors.
- Despite our expectation for continued market volatility, we recommend an overweight to the sector due to strong fundamentals and attractive relative valuations. We expect strong corporate profits to translate into technology spending. Balance sheets are strong. Product cycles such as Windows 7, smart phones, e-readers, and various other Internet devices are providing a lift.
- Strong earnings also support our sector view. Consensus sector estimates have risen 17% this year (in 2010), well ahead of the S&P 500 and the four defensive sectors (see [Chart 8](#)). Q1 2010 earnings season was very strong for Technology, with about 90% of S&P 500 companies exceeding consensus earnings per share estimates.
- Lofty expectations are a concern for Technology, which appears to be a crowded trade based on analyst ratings, price targets and strategists' recommendations. However, valuations are very attractive, at a forward price-to-earnings multiple that is less than 10% higher than the S&P 500, well below historical average levels even excluding the Internet bubble.
- We continue to favor the areas of the sector most leveraged to business spending. Hardware valuations are attractive. Supply-demand forces are still tilting favorably for Semiconductors, but the environment is starting to become less conducive to outperformance. Software is well positioned for the outgoing product upgrade cycle. For now, limit exposure to IT Services until the sector outlook is less positive.



## TECHNOLOGY ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Vanguard Information Technology ETF	VGT	59.93	5.72		2.18	1/26/04	0.25	0.52	60.20	5.73		2.19
iShares Dow Jones US Technology	IYW	58.11	5.77		-6.46	5/15/00	0.48	0.35	58.46	5.79		-6.46
Technology Select Sector SPDR	XLK	49.45	4.47	-8.40	-1.61	12/16/98	0.22		50.06	4.50	-8.42	-2.14

Source: MorningStar Direct As of 03/31/10

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\*Market return annualized are based on the last closing market price for each period.

## Materials

## Compass View: Neutral

	S&P 500 Materials Index	S&P 500 Index
QTD Performance	-3.6%	-0.7%
YTD	-0.9%	4.7%
1 mo.	-3.0%	-0.4%
3 mo.	8.5%	8.6%
12 mo.	30.6%	35.8%
2010E EPS Growth	77.4%	30.8%
P/FE	15.4	14.2
Dividend Yield	1.8%	1.9%
Beta	1.46	1.00
S&P 500 Weight	3.5%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 05/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Materials	●	●	●	■	●	■	

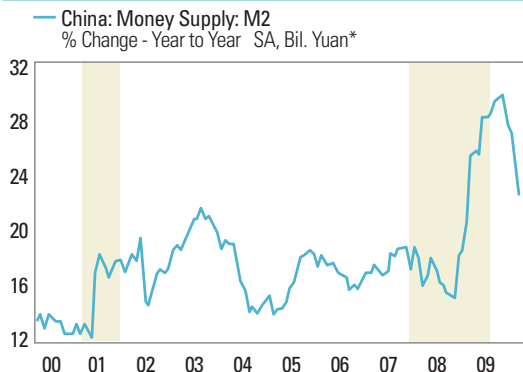
● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- The Materials sector was one of the leaders during the 2009 rally but has struggled so far in 2010. The sector has been hurt by China's efforts to slow its economy, a strong dollar, and underperformance during the market's recent slide.
- Materials tailwinds have started to fade in 2010, which led us to downgrade our sector view to neutral on April 14, 2010. China is slowing its economy through loan curbs, higher bank reserve requirements and various real estate restrictions. Money growth is slowing as a result (see [Chart 9](#)). Several foreign central banks have raised interest rates including Australia and India.
- The dollar has reversed its 2009 slide, rallying over 10% off December 2009 lows versus a basket of major U.S. trading partners' currencies. Dollar strength is a headwind for commodity asset class prices that may continue due to high market volatility and as interest rates potentially rise. The Federal Reserve may soon signal the start of an interest rate hiking campaign, which could push the dollar even higher.

9 China Has Slowed its Money Supply to Stave Off Inflation *M2 is a measure of money supply*



Source: Haver Analytics, LPL Financial 04/20/10  
\*Seasonally adjusted GDP in Chinese currency (Yuan).

- On the positive side, the sector may continue to benefit from improved U.S. economic growth. Mining and construction equipment are seeing strong rebounds in demand. Vehicle demand has improved markedly. Housing is picking up and commercial real estate is stabilizing. Stimulus funds in the U.S. remain unspent.
- Within the sector, we favor the Metals & Mining industry due to our relatively more positive outlook for base metals. Once more evidence surfaces that China is slowing, the environment should become more positive for more defensive areas within the sector such as Containers and Packaging and even Chemicals. These industry groups could stand to benefit from lower input costs if energy prices fall.

MATERIALS ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Materials Select Sector SPDR	XLB	55.57	4.77	6.47	6.90	12/16/98	0.22		55.35	4.77	6.49	6.85
iShares Dow Jones US Basic Materials	IYM	83.50	6.40		7.87	6/12/00	0.47	1.05	83.74	6.42		7.87
Vanguard Materials ETF	VAW	63.59	5.50		7.93	1/26/04	0.25	1.29	63.37	5.53		7.93

Source: MorningStar Direct As of 03/31/10

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The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.



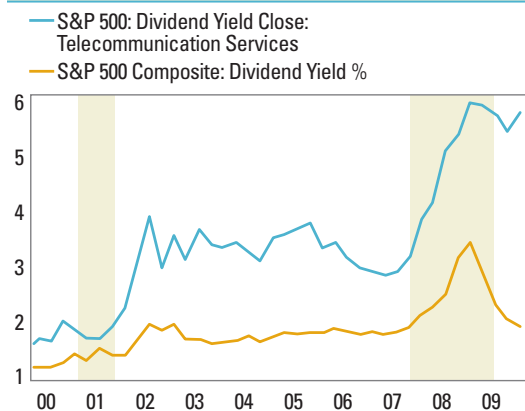
## Telecommunication Services

Compass View: Moderate Negative

	S&P 500 Telecom Index	S&P 500 Index
QTD Performance	-1.5%	-0.7%
YTD	-5.8%	4.7%
1 mo.	-1.6%	-0.4%
3 mo.	2.6%	8.6%
12 mo.	6.7%	35.8%
2010E EPS Growth	3.3%	30.8%
P/FE	14.4	14.2
Dividend Yield	6.0%	1.9%
Beta	0.58	1.00
S&P 500 Weight	2.7%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 05/10/10

### 10 Telecom Sector Dividend Yields Are Well Above the S&P 500



Source: Haver Analytics, LPL Financial 04/20/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Telecommunication Services	●	●	●	■	●	■	■

● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- After the worst 2009 of any of the 10 S&P sectors, performance for the Telecom sector has not looked much better in 2010. The sector's defensiveness has worked against it as the cyclical sectors led. These characteristics, coupled with fundamental and regulatory challenges, have hurt sector performance and are the primary reasons for our still moderately negative view.
- Growth is clearly challenged. The sector is only expected to grow earnings this year at a low single-digit rate due to limited economic sensitivity, saturated developed wireless markets, ongoing landline losses, and lack of pricing power. Prices for both wireline and wireless access are roughly unchanged over the past year but the trend is down.
- Valuations are reasonable, but not attractive in our view especially given earnings revisions have been negative this year. The sector is trading at a forward 12-month P/E multiple slightly above the market, roughly in line with historical averages despite the lackluster growth outlook.
- Interest rates may rise and dividends may lose their favorable tax treatment in 2011, reducing the relative attractiveness of the sector's healthy payouts.
- The hefty dividends offered by the sector represent a risk to our negative view. Yields at near six percent are well above the sector's historical average (3–4%), the S&P 500 (1.9%, see [Chart 10](#)) and even long-term Treasuries (10-Year Treasury yield is 3.5%). Although we expect dividends and defensive investments to become increasingly attractive later this year, we prefer to focus on REITs and High-Yield Bonds for income in Q2 2010.
- Within the sector, we favor the large, integrated service providers over smaller carriers and pure wireless service providers due to attractive dividends, better potential profitability, and stronger balance sheets. The growth outlook for pure wireless infrastructure companies is attractive as broadband demand increases.



## TELECOMMUNICATION SERVICES ETFs TO BE CONSIDERED

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
iShares Dow Jones US Telecom	IYZ	30.64	0.38		-7.72	5/22/00	0.48	3.53	30.44	0.39		-7.73
Vanguard Telecom Services ETF	VOX	32.42	4.40		4.81	9/23/04	0.25	3.94	32.15	4.40		4.94

Source: MorningStar Direct As of 03/31/10

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\*Market return annualized are based on the last closing market price for each period.

## Utilities

### Compass View: Moderate Negative

	S&P 500 Utilities Index	S&P 500 Index
QTD Performance	1.2%	-0.7%
YTD	-2.4%	4.7%
1 mo.	2.0%	-0.4%
3 mo.	2.6%	8.6%
12 mo.	21.6%	35.8%
2010E EPS Growth	2.1%	30.8%
P/FE	12.2	14.2
Dividend Yield	4.3%	1.9%
Beta	0.61	1.00
S&P 500 Weight	3.4%	

Sources: Thomson, FactSet, LPL Financial  
Performance through 05/10/10

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Utilities	●	●	●	■	●	■	

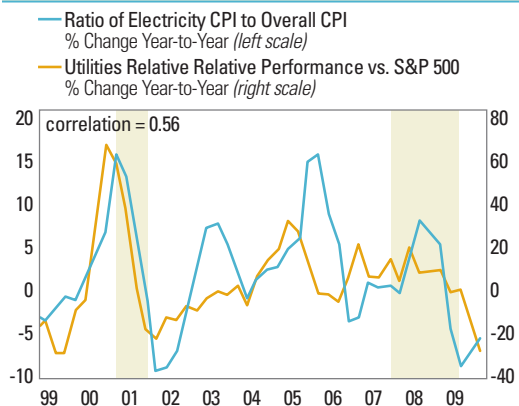
● Negative ● Neutral ● Positive

As of 05/12/2010

Please refer to the *Portfolio Compass* publication for complete details.

- Like the other defensive sectors, Utilities lagged the market dramatically from the March 2009 lows through the end of the year. The underperformance has continued this year due to the market's preference for cyclicals as well as some of the sector's fundamental challenges.
- Our Utilities view remains moderately negative due to our preference for cyclical investments as well as fundamental challenges facing the sector. These include sluggish though recovering power demand, weak pricing, volatile and depressed natural gas prices and regulatory risk associated with Washington's goal of cleaning up power generation.
- Chart 11** illustrates the sector's sensitivity to pricing, represented by the ratio of the Consumer Price Index (CPI) for electricity to the overall CPI. The changes in this ratio correlate to shifts in sector relative performance. Until power companies get better pricing, relative performance is unlikely to improve meaningfully.
- Investors look to the Utilities sector for yield. As in the Telecom sector, if investors begin to favor defensive, dividend-oriented investments, sector

**11 Limited Pricing Power Is Consistent with Utilities Sector Underperformance**



Source: Haver Analytics, FactSet, LPL Financial 04/20/10

performance would improve. The sector is currently yielding more than double the S&P 500 (4.3% vs. 1.9%) and more than the 10-year Treasury (3.5%). At the same time, however, higher tax rates on those dividends are likely in 2011 and interest rates may rise, reducing the relative attractiveness of dividends.

- The sector’s regulatory outlook has improved with cap-and-trade likely dead. Still, the cost of cleaner power generation remains a risk. Energy policy may get more attention from Congress after financial reform gets done, likely early this summer.
- Within the sector, we continue to favor the regulated and integrated utilities over the independent power producers to limit natural gas price risk and the potential negative impact of regulatory requirements.

**UTILITIES ETFs TO BE CONSIDERED**

Exchange-Traded Fund	Ticker	Avg Annual Total Return			Since Inception	Inception Date	Gross Expense Ratio	30-Day SEC Yield	Mkt Ret Annlzd* 1-Year	Mkt Ret Annlzd 5-Year	Mkt Ret Annlzd 10-Year	Mkt Ret Annlzd Since Incep
		1-Year	5-Year	10-Year								
Utilities Select Sector SPDR	XLU	20.51	3.89	4.81	3.76	12/16/98	0.22		21.10	3.88	4.71	3.52
iShares Dow Jones US Utilities	IDU	23.58	3.39		3.57	6/12/00	0.48	3.80	23.55	3.40		3.58
Vanguard Utilities ETF	VPU	22.53	4.08		7.26	1/26/04	0.25	3.96	23.03	4.07		7.27

Source: MorningStar Direct As of 03/31/10

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The performance data quoted reflects the reinvestment of dividends and capital gains, is net of expenses and but does not reflect the maximum advisory fee of 3.0%. Such fee, if taken into consideration, will reduce the performance quoted above.

\*Market return annualized are based on the last closing market price for each period.

# Equity Sector Compass

May 12, 2010

## Pullback Helps Near-Term Outlook for Cyclical; Still Favor Technology and Industrials

We continue to favor the cyclical sectors but have tempered optimism as the economy transitions from recovery to sustainable growth. Technology remains well positioned for a corporate spending rebound, though expectations are high. The business-and export-led recovery and stimulus funds have continued to benefit Industrials. Despite strong earnings and improving labor markets, our Consumer Discretionary view is neutral due to our modest spending outlook. Our Materials view is neutral because of tightening U.S. and Chinese monetary policy, though the demand outlook remains positive. Regulatory uncertainty keeps us from becoming more positive on Financials following credit improvement in Q1 2010 earnings reports. Reform impact has weighed on Health Care, but valuations are attractive. Our neutral Energy view reflects our balanced outlook for crude prices in the mid-to-high \$70s. Our positive Consumer Staples bias reflects the increasingly attractive dividend profile.

	Fundamentals	Technicals	Valuation	View					Bias	S&P 500 Weight (%)	Comment	Industry Views	
				Negative	Neutral	Positive	Most Favored	Least Favored					
CYCLICAL													
Materials	●	●	●	■	■	■	■	■	3.4	Benefiting from U.S. and China-led growth, although monetary policy tightening measures remain a key concern.	Metals & Mining	none	
Energy	●	●	●	■	■	■	■	■	11.0	Our crude outlook is balanced in the mid-to-high \$70s. Inventories and dollar strength are risks.	Exploration & Production	Refiners	
Industrials	●	●	●	■	■	■	■	■	10.7	Strong business spending / export rebound and stimulus still in the pipeline outweigh full valuations.	Transportation, Machinery	Aerospace & Defense	
Consumer Discretionary	●	●	●	■	■	■	■	■	10.5	Neutral view reflects higher expectations and modest spending outlook, although job growth is supportive.	Retail	Household Durables	
Technology	●	●	●	■	■	■	■	■	18.8	Balance sheets, earnings, product cycles and valuations are all positives, but expectations are high.	Hardware, Software, Semis, Networking	IT Services	
Financials	●	●	●	■	■	■	■	■	16.6	Regulatory risk is high, but the likely peak in credit losses and loan loss reserve releases are encouraging.	Diversified Financials, Capital Markets	Insurance	
DEFENSIVE													
Utilities	●	●	●	■	■	■	■	■	3.5	Rising interest rates and sluggish growth, but benign policy outlook and yields are partial mitigating factors.	Regulated	none	
Health Care	●	●	●	■	■	■	■	■	11.7	Valuations are attractive but reform continues to weigh; still prefer Tech and Industrials among cyclical.	Biotech	Managed Care	
Consumer Staples	●	●	●	■	■	■	■	■	11.1	Lackluster growth, but dividends are increasingly attractive and Emerging Market exposure helps.	Food & Staples Retail	Household & Personal Products	
Telecom	●	●	●	■	■	■	■	■	2.7	Stagnating core business, policy risks and preference for cyclical keep us negative despite big yields.	Diversified	none	

★ Denotes change in view from last issue. ● Negative ● Neutral ● Positive  
Investing in sectors may be more volatile than diversifying across many industries.

**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Standard and Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size.

The S&P Materials Index is comprised of companies that engage in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

These indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Investments in specialized industry sectors have additional risk such as credit, regulatory, operational, business, economic and political risk which should carefully be considered before investing.

Principal Risk: An investment in Exchange Traded Fund (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETFs involves additional risks: not diversified, the risks of price volatility, competitive industry pressure, international political and economic developments, possible trading halts and Index tracking error.

***Investors should consider the investment objectives, risks, charges and expenses carefully prior to investing. The prospectus contains this and other information. You can obtain a prospectus from your financial representative. Read carefully before investing.***

EPS: Earnings per share are calculated by dividing a company's net income by its total number of shares outstanding. 2010E EPS Growth reflects Thomson's consensus EPS estimate for 2010 divided by 2009. Earnings per share serve as an indicator of a company's profitability. Earnings per share are generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

P/FE Multiple: A tool for comparing the prices of different common stocks by assessing how much the market is willing to pay a share of each corporation's estimated future earnings. It is calculated by dividing the current market price of a stock by the earnings per share estimate for the future period.

Dividend yield shows how much a company pays out in dividends each year relative to its share price.

Gross Expense Ratio is the total annual fund operating expense ratio, which can be found in the fund's most recent prospectus.

The fund's 30-day yield is based on yield to maturity of a fund's investments over a 30-day period and not on the dividends paid by the fund, which may differ.

Beta: Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

The fast price swings of commodities will result in significant volatility in an investor's holdings.

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