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The Outlook

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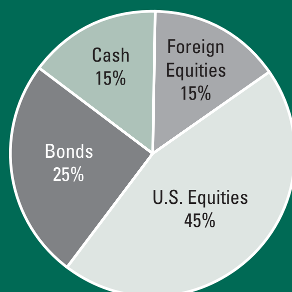
What's Inside

Intelligencer 2
Observatory 3
Mutual Fund Strategies 4
ETF Strategies 5
A Safer Way to Play Europe 6
American Tower 7
Life Sciences 8
Biotech 9
Stock Screen 10
Master List 11
Neural Fair Value 25 12

S&P Equity Research Recommended Asset Allocation



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Staying Positive

Better economic news is making the case for a rally, we believe.

Vaughan Scully
S&P Capital IQ
Editorial

Investors tuning in to the Republican presidential primary coverage as a source of distraction from the ups and downs of the market may be amused (or alarmed) to find the recent struggle voters have endured to choose a candidate closely parallels their own predicament in ascertaining the stock market's future direction. With both groups, a sizeable minority appears to have chosen and accepted a likely course of future events, yet they have not convinced a divided and skeptical majority. While the data arriving with each passing day appears to support the minority's case, it has been maddeningly inconclusive.

For investors, the tussle features on one side a seemingly influential minority who believe that global economic threats to equity market performance are fading. Recent U.S. and some overseas economic reports provide growing evidence that this is the case: holiday spending during December was much stronger than expected, and even if much of it was done on credit, it signals a new level of optimism among consumers that could be the precursor of a much needed strengthening in consumer demand. The Federal Reserve's Beige Book reported that economic activity during November and December advanced "at a modest to moderate pace," which is more than the S&P 500 did in calendar 2011. Most importantly, job growth appears to be returning though whether it is a temporary blip higher or the beginning of a sustained period of significant job creation remains to be seen.

Furthermore, concern that emerging market economies — particularly China — would begin to slow as well has so far proved unfounded. Inflation rates in China, which have led policy makers there to tighten credit, have now declined to their lowest in more than a year, making further tightening less likely. In India, where policy makers have tightened credit as well, industrial production jumped in November, reversing a decline from the previous month. Manufacturing activity in both countries accelerated in December, a sign that they have not been adversely impacted by the slow growth in the U.S. or the recessionary conditions in Europe. Even European Central Bank President Mario Draghi sees "tentative signs of stabilization of economic activity" in Europe.

(Continued on page 3)

S&P 500 OPER. EPS Y/Y % GROWTH ESTS.

	Y/Y % CHANGES	
	Q4 2011	CY 2012
Consumer Discretionary	6.5%	11.6%
Consumer Staples	3.8%	8.9%
Energy	18.9%	3.6%
Financials	10.2%	10.4%
Health Care	4.1%	3.9%
Industrials	7.1%	12.4%
Information Technology	5.4%	8.2%
Materials	-9.4%	8.4%
Telecommunication Services	-10.4%	9.7%
Utilities	-3.2%	-1.9%
S&P 500	6.8%	7.9%

Source: S&P Capital IQ.

Intelligencer

Headlines, Highlights, and What's on Our Minds

PORTFOLIO CHANGES: Neenah Paper (NP 23 ★★★★★) was added to, and Akamai Technologies (AKAM 32 ★★★) was deleted from, the Top Ten Portfolio effective Thursday, January 12. Akamai was also deleted from the Platinum Portfolio effective Friday, January 13.

S&P POSITIVE ON CHINA ENERGY: While S&P Capital IQ recently lowered its 2012 gross domestic product (GDP) growth forecast for China to 7.7%-8.2% from 8.0%-8.5%, it kept its "overweight" recommendation on the country's energy sector.

S&P Capital IQ's Greater China Investment Policy Committee believes China's total energy demand grew by 10% to 11% last year, driven by strong demand for crude oil and electricity in the first half of 2011.

"For 2012, we expect this rate to come down to 7%-8% on slower crude oil demand growth," the committee says. "We stay positive on expected output increase and more product pricing flexibility."

S&P Capital IQ equity analyst Ahmad Halim has a 4-STARS Buy recommendation on China's largest downstream oil product and chemical company, Sinopec (00386 HKD9 ★★★★) (SNP 113 NR), also known as China Petroleum & Chemical, "following a 6% increase in our 2011 net profit forecast, on higher marketing and chemical profits."

S&P has a buy opinion for CNOOC (CEO 192 ★★★★), China's largest offshore oil and gas producer. / Art Epstein

SUPERCOMPUTER RACE: Although International Business Machine's (IBM 179 ★★★★★) Watson became a Jeopardy! TV game show star last year, this super fast computer cannot compete with the world's speediest machines.

About 50 years ago, Seattle-based Cray (CRAY 6 NR) began to dominate high-performance computers worldwide. However, the ranks have begun to shift more quickly of late. In 2010, Cray's Jaguar, then the world's fastest supercomputer capable of 1.76 quadrillion calculations per second (1.76 petaflops), gave up its title to China's Tianhe-1A (2.6 petaflops), according to the TOP500 List of the world's most powerful computers. And in June 2011, Tianhe-1A lost the top spot to the 10.5 petaflop behemoth "K" computer made by Tokyo-based Fujitsu (6702 JPY405 NR).

Not to be left behind, IBM plans to ship 96 supercomputer racks this year — each consisting of 16,384 processors — to the Lawrence Livermore National Laboratory in California, according to *Popular Mechanics* magazine.

When the racks are put together, a 20 quadrillion calculations-per-second monster named Sequoia is expected to become the world's strongest computer, to be used for nuclear weapons simulation, and research projects in astronomy, energy, genetics, and climate change. / Art Epstein ■

MARKET MEASURES

INDEX	CLOSE FRI. 1/13/12	% CHG. YEAR TO DATE	% CHG. PAST 52 WKS.	‡OPERATING —EARNINGS— E2011	E2012	†P/E RATIO FRI. 1/13/12	INDICATED ANNUAL DIVIDEND	% YIELD
S&P 500 Composite	1289.09	2.5	1.4	96.89	106.61	12.09	28.03	2.17
S&P MidCap 400	906.59	3.1	-0.4	50.93	62.89	14.42	13.35	1.47
S&P SmallCap 600	427.22	2.9	2.7	20.93	27.42	15.58	5.28	1.24
S&P SuperComposite 1500	297.57	2.6	1.3	21.62	24.10	12.35	6.20	2.08
Dow Jones Industrials	12422.06	1.7	6.4	...	...	...	...	...
Nasdaq Composite	2710.67	4.1	0.3	...	...	...	...	...
BBB Indus. Bond Yield (10-yr.)	4.47	-0.02 ◊	-1.18 ◊			...	...	...

Data through 1/13/12. E-Estimated. †Based on estimated 2012 earnings. ‡Before special factors. ◊Actual change in yield (not percentage change). E-Estimate. Sources: S&P Capital IQ and Thomson ONE.

S&P Capital IQ's *The Outlook*

EDITORIAL

Managing Editor Beth Piskora

Senior Editorial Manager Vaughan Scully

Statistician Chris Peng

RESEARCH & ANALYTICS

Managing Director, Global Equity Research Stephen Biggar

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The **McGraw·Hill** *Companies*

S&P CAPITAL IQ EVALUATION SYMBOLS

STARS Rankings

Our evaluation of the 12-month potential of stocks is indicated by STARS:

★★★★★ **Strong Buy**—Total return is expected to outperform the total return of a relevant benchmark by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

★★★★ **Buy**—Total return is expected to outperform the total return of a relevant benchmark over the coming 12 months, with shares rising in price on an absolute basis.

★★★ **Hold**—Total return is expected to closely approximate the total return of a relevant benchmark over the coming 12 months, with shares generally rising in price on an absolute basis.

★★ **Sell**—Total return is expected to underperform the total return of a relevant benchmark over the coming 12 months, and the share price is not anticipated to show a gain.

★ **Strong Sell**—Total return is expected to underperform the total return of a relevant benchmark by a wide margin over the coming 12 months, with shares falling in price on an absolute basis.

NR Not ranked.

Quality Rankings (QR)

Our appraisals of the growth and stability of earnings and dividends over the past 10 years for STARS and other companies are indicated by Quality Rankings:

A+	Highest	**B+**	Average	**C**	Lowest
A	High	**B**	Below Avg.	**D**	In reorganization
A-	Above Avg.	**B-**	Lower	**NR**	Not Ranked

Quality Rankings are not intended to predict stock price movements.

The Observatory

Selected actions for January 6 through January 12.

NAME	SYMBOL	CURRENT PRICE ($)	NEW STARS	OLD STARS	STARS CHANGE DATE	QUALITY RANK
Akamai Technologies	AKAM	33	3	5	1/12/12	B-
American Electric Power	AEP	41	3	5	1/11/12	B
ARM Holdings	ARM	6	3	2	1/6/12	B+
BB&T	BBT	27	3	4	1/10/12	B+
Compuware	CPWR	8	2	3	1/9/12	NR
Guangshen Railway	GSH	18	4	5	1/11/12	NR
Penney (J.C.)	JCP	34	2	3	1/12/12	B
Regeneron Pharmaceuticals	REGN	79	3	4	1/10/12	C
SAP	SAP	53	4	3	1/6/12	NR
Tesco	TSCO	4	3	4	1/12/12	A+
Theravance	THRX	17	4	3	1/9/12	NR
U.S. Bancorp	USB	28	3	5	1/11/12	B+
VeriSign	VRSN	36	2	3	1/11/12	B-
WebMd Health	WBMD	26	2	3	1/10/12	B-

For daily STARS changes, subscribers can call *The Outlook* hotline, 800-618-7827, and put in your subscriber access code.

The Observatory provides a selection of analytical actions — upgrades, downgrades, initiations — from S&P Equity Research. Stocks featured in the Observatory are selected by *The Outlook* according to factors including, but not limited to, newsworthiness, capitalization, and inclusion in a portfolio published by *The Outlook*. Please note that all investments carry risks. Investors should seek financial advice before investing.

All of the views expressed in this research report accurately reflect the research analysts' personal views regarding any and all of the subject securities or issuers. No part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Staying Positive *(Continued from cover)*

On the other hand, there are ample reasons to doubt the ability of the current frontrunner to win support from the skeptical majority. In the U.S., "while private demand has started to pick up, we don't expect significant growth this year," says Beth Ann Bovino, deputy chief economist with Standard & Poor's Economics. "With gains in the jobs market insufficient to reduce the unemployment rate materially, the sovereign debt crisis spooking investors, and the potential for U.S. government dysfunction to lead to something more severe, consumer spending and business investment will remain sluggish" in 2012. In Europe, Draghi has repeatedly warned of "substantial downside risks" to the region's already weak economy.

Early returns have so far mostly favored the minority case, though many challenges loom ahead. The S&P 500 has rallied by about 2% in the first two weeks of the year, and while that may not be a lot, it's 2% more than 2011 delivered. "Better than expected U.S. economic data, such as the recent payrolls and consumer credit reports, as well as the favorable start to the earnings reporting season, have contributed to the advance in equity prices," says S&P Capital IQ's chief equity strategist Sam Stovall. "The market's action during the first five trading days of January issued a positive read on the rest of the year, in our view."

Pessimism still reigns, however, especially with no resolution of the European sovereign debt crisis in sight. The whole picture may yet fall apart — February is the second worst month of the calendar for share price performance behind September, Stovall notes — and fourth quarter earnings estimates for the S&P 500 have come down significantly, to just 6.8% on a per-share basis compared with the 14.6% advance seen in October. "While markets have a habit of humbling forecasters, we still believe the near-term trend is higher" Stovall says. ■

FUND STRATEGIES

Delaware U.S. Growth Fund

A fund where cash flow is king.

Isabelle Sender
S&P Capital IQ
Editorial

The traditional definition of growth investing does little to describe Delaware U.S. Growth Fund's search for what it considers quality companies, and the scrutiny companies endure by the fund's team.

"We place more weight on a company's cash economics and its ability to earn a return on capital above its cost of capital," explains Jeffrey S. Van Harte, chief investment officer for the Focus Growth Equity team at Delaware Investments. "If a company can earn a return on capital that exceeds its cost of capital, it will continue to grow its intrinsic business value. This is our definition of growth."

"We don't start at the income statement. Instead, we start at the cash-flow statement to identify free cash flow and track it to the balance sheet. Ultimately, the deployment of free cash flow, and returns earned on existing and new capital will determine the growth drivers on the income statement," he says.

For example, the fund's top 10 holdings earn returns on capital that exceed their cost of capital by more than 1200 basis points, Van Harte says, compared to an average in the portfolio of 800 basis points.

Other growth criteria for Van Harte's team center around debt-to-cash levels. "Our top 10 also have huge balance-sheet strength, holding more than $160 billion of cash while having only $14 billion of debt," Van Harte says.

In terms of valuations, the entire portfolio is estimated by fund management to be trading at around 77% of what the team's best estimate of intrinsic business value is.

A strong three-year total return compared with peers (22.3% annually as of Jan. 12 vs. a peer average 17.48) helps the fund receive a positive overall performance analytics ranking in S&P Capital IQ's proprietary mutual fund ranking methodology. The fund also receives a positive ranking for its risk considerations.

As for the cost factors category, the fund receives a neutral ranking from S&P Capital IQ. As of September 30, 2011, its maximum front-end sales load was 5.75%, which is a negative input, while its expense ratios were below peer averages, a neutral grade. The third input, turnover, was a positive: 22% compared to 81% among peers.

Historically low turnover is a "core component of our investment philosophy and consistent across all of our strategies," according to Van Harte, who adds that in general, his team takes a "quality vs. quantity" approach "where we make fewer decisions with greater conviction."

The fund's investment holding periods are typically three to five years, losers are usually sold after one or two years, and winners are allowed to run as much as five-to-10 years, or even longer in a few cases, Van Harte states.

The long-term perspective on holdings is in the investors' best interests, says Van Harte, because it allows the team to take advantage of price opportunities among strong businesses that are periodically sold off by market participants "myopically focused on the short term." ■

DELAWARE US GROWTH FUND

Ticker: DUGAX

S&P Ranking: ★★★★★

Current Price: $15

Total Net Assets: $66 million

Asset Class/Region/Type: Equity/Domestic/Large Cap Growth

12-Month Total Return: 6.3

3-Year Total Return (Average Annualized): 22.3

Inception Date: 12/3/1993

Gross Expense Ratio: 1.26

Data through 1/12/12.
*Total returns include reinvested dividends and capital gains, all annualized; calculations do not reflect the effect of sales charges. Source: S&P Capital IQ.

ETF STRATEGIES

Generic Wave May Benefit Drug Retailers

Generics may be lower priced, but they offer retailers higher profit margins.

Joseph Agnese
S&P Capital IQ
Equity Analyst

S&P Capital IQ Equity Research has a positive fundamental outlook for the drug retail sub-industry over the next 12 months. We believe greater sales of generic drugs will support margin expansion, despite increased drug reimbursement pressure. In our view, national drug retail chains are well positioned as their pharmacy departments rise in importance, with prescription sales approaching 70% of total retail sales.

We think drug retailers are well positioned to benefit from a tidal wave of new generic drugs that is expected to come to market over the next several years. Nearly $100 billion in branded drugs are expected to lose patent protection between 2011 and 2015. While generics are significantly lower in price, they contribute more to profits. We believe margin benefits from the coming generic wave will begin in the second quarter of 2012 (following the loss of patent protection for Lipitor at the end of 2011) and grow significantly in the second half of 2012 and in 2013 as generic competition rises for additional branded drugs.

While we expect increased sales of lower-priced generic drugs to negatively impact pharmacy same-store sales in 2012, we believe companies within the retail drug industry are well positioned, as national chains have been able to differentiate their merchandising through exclusive product offerings and improve the convenience of their stores. Additionally, we see in-store health clinic offerings helping drive store traffic. With greater foot traffic in the stores, we see higher demand for prescription and front-end, over-the-counter drug sales.

For investors seeking exposure to the retail drug sector, we advise considering the Consumer Staples Select Sector Fund, which attempts to track the performance of the S&P 500 consumer staples sector. Within this ETF's recent top-10 holdings is CVS Caremark (CVS 42 ★★★★★). Using a blend of S&P Capital IQ's performance, risk and cost metrics, XLP currently carries an overweight ranking. Its recent holdings have largely favorable STARS rankings from our analysts, while it also has holdings with high marks for S&P Quality Rankings and a relatively low expense ratio.

The Vanguard Consumer Staples Index Fund has an overweight score in the performance analytics, risk considerations, and cost factors categories compared with other ETFs in its asset class, resulting in an overall ranking of overweight. Among VDC's top-10 holdings was drug store behemoth CVS, accounting for 3.6% of the ETF's assets.

S&P Capital IQ also has an overall overweight ranking on the Focus Morningstar Consumer Defensive Index ETF, which owns companies engaged in the manufacturing of food, beverages, household and personal products, packaging, and tobacco. An overweight assessment in both risk considerations and cost factors, offsets a marketweight assessment in performance analytics.

The PowerShares Fundamental Pure Large Growth Portfolio offers investors a fourth opportunity to gain exposure to drug retailers through an ETF. PXLG earns an overall ranking of overweight, as favorable inputs for S&P STARS and S&P Fair Value lead to an overweight assessment for performance analytics. The fund also garners an overweight assessment for risk considerations. ■

POSITIVE POTENTIAL IMPLICATIONS

FUND NAME / TICKER	S&P RANKING	*TOTAL RETURN YTD	1-YEAR	3-YEAR	5-YEAR	CURRENT PRICE	EXPENSE RATIO
Consumer Staples Select Sector SPDR / XLP	OW	-1.0	13.1	15.1	6.7	32	0.20
Focus Morningstar Consumer Defensive Index / FCD	OW	-1.3	NA	NA	NA	27	0.26
PowerShares Fundamental Pure Large Growth / PXLG	OW	2.8	NA	NA	NA	20	0.45
Vanguard Consumer Staples Index / VDC	OW	-0.9	12.7	16.1	6.8	80	0.19

Data through 1/12/12. *Total returns include reinvested dividends and capital gains, all annualized; calculations do not reflect the effect of sales charges. OW-Overweight. NA-Not available. Sources: S&P Capital IQ.

The U.K.: a Safer Way to Play Europe?

Alec Young
S&P Capital IQ
Global Equity Strategist

Earnings have proved resilient as European growth slows.

While poor 2011 European equity performance and the region's sovereign debt crisis are leading many U.S. investors to rethink their allocations, developed Europe represents 42% of total international stock market cap, according to S&P Indices, meaning maintaining regional exposure is critical to global portfolio diversification.

Thankfully, while most continental European markets have been highly correlated on the downside over the past year, the region's largest stock market, the U.K. — representing just over one-third of its market cap — has also been its best performing and least volatile, having sidestepped most of the 2011 sell-off. We think this offers wary U.S. investors a way to maintain diversification while also limiting potential volatility.

Since the start of 2011, U.K. equities have outperformed their European counterparts by 12.9%, falling 4.4% vs. a much larger 17.3% decline for Europe ex. U.K. equities. And on a total return basis, they have outperformed even more — declining only 0.7%, vs. Europe's 14.1% swoon (in USD through 1/10). Similarly, year-to-date, the U.K. trails only Germany, while sparing investors exposure to the shaky euro, a protection not offered by German shares. In the wake of this significant alpha, U.K. volatility is currently running 25% below that of continental equities. We see lower U.K. volatility relative to Europe continuing for the following reasons:

- A more defensive sector composition and hence lower beta in the face of what we see as European macro economic headline risk
- Much greater corporate EPS resilience — fewer negative EPS revisions
- A competitive valuation and dividend yield profile despite recent outperformance
- Lower currency translation risk stemming from the pound's relative resilience versus the U.S. dollar when compared to an increasingly weak euro (U.S. investors' foreign equity returns are hurt when the U.S. dollar rises vs. overseas currencies).

The U.K. has long been among Europe's lower beta markets due to its less cyclical sector exposures. Lower weightings in financials, consumer discretionary, and industrials have greatly insulated U.K. equity performance from the region's sovereign headwinds as have higher exposures to defensive areas including consumer staples and telecom. As a result of this counter-cyclical sector composition, the U.K.'s earnings have proved extremely resilient in the face of slowing growth — both at home, and to a greater extent across the channel. Consensus U.K. 12-month forward EPS expectations have been revised up 5% since January 2011 vs. a 4.7% drop for Europe ex. U.K.. We think this helps explain why the U.K. sports one of the lowest betas in the region relative to the S&P 500. The U.K. currently has a trailing 60-month beta versus the S&P 500 of only 1.06 vs. a much higher reading of 1.27 for Europe ex. U.K.

Beyond fundamentals, we think currency trends are increasingly favoring a smoother ride for the U.K. relative to Europe. When U.S. investors buy individual U.S.-listed foreign stocks, mutual funds or ETFs, their returns are hurt when the U.S. dollar rises against overseas currencies. This dynamic has helped U.K. stocks outperform European stocks in dollar terms over the past year as the greenback has rallied far more vs. the troubled euro than it has vs. the sterling. The dollar is up 4.6% vs. the euro compared to only a 1.1% increase against the pound (through 1/9). With Europe likely entering recession and the European Central Bank expected to expand its record €2.7 trillion balance sheet to stave off a deeper credit crunch, we do not think it's hard to foresee further pressure on the €/$ exchange rate, especially given our view that the U.S. economy will exceed low Street expectations, likely bolstering the greenback. ■

DESPITE STRONG OUTPERFORMANCE, U.K. VALUATION & DIVIDEND YIELD REMAIN COMPETITIVE

	YTD (USD)	2011 (USD)	E2012 GDP	E2012 P/E	DIV. YIELD	BETA VS. S&P 500
U.K.	**1.9%**	**-6.1%**	**0.3%**	**9.7X**	**3.9%**	**1.06**
Europe ex. U.K.	0.4%	-17.3%	-0.7%	10.0X	4.0%	1.27
Germany	3.0%	-20.1%	0.2%	9.3X	3.8%	1.40
France	-0.1%	-19.3%	-0.7%	9.2X	4.8%	1.31
Spain	-3.0%	-16.9%	-1.2%	8.7X	6.0%	1.30
Italy	-3.1%	-25.8%	-1.5%	8.0X	5.8%	1.39
Switzerland	0.3%	-9.1%	-0.2%	11.8X	2.4%	0.86
Developed International	1.2%	-14.8%	N/A	11.8X	3.8%	1.10

Data through 1/10/12. NA-Not available. Source: S&P Capital IQ.

Focus Stock: American Tower

James Moorman, CFA
S&P Capital IQ
Equity Analyst

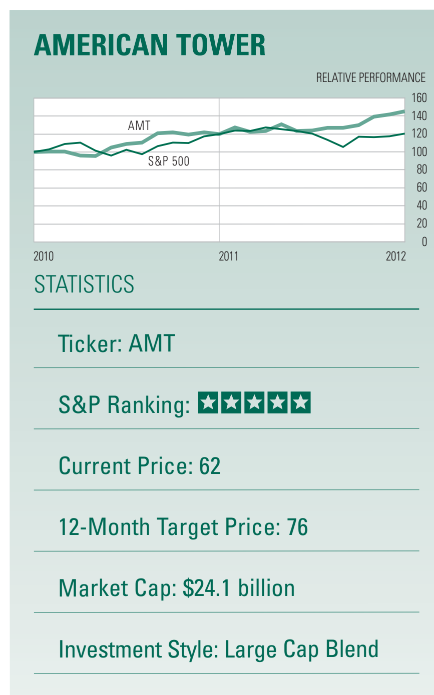
Cash flow rising faster than peers warrants premium valuation, we believe.

This week's Focus Stock of the Week is American Tower Corporation, which carries S&P Capital IQ's highest investment recommendation of 5-STARS, or Strong Buy. American Tower Corporation operates the largest independent portfolio of wireless communications and broadcast towers in North America, based on the number of towers and revenue.

A market leader in the wireless tower industry, AMT has a significant position in the U.S. and internationally. Through a stream of international acquisitions, its international portfolio now accounts for 46% of its total towers. Due to its use of long-term contracts and annual rent escalations of 3%-5% in the U.S., we think that AMT has high revenue visibility. Meanwhile, we believe that increasing data usage and market buildouts from the 700MHz spectrum auctions will provide an additional revenue boost over the next couple of years.

In the U.S., wireless penetration is roughly 102%, and we believe that subscriber growth could begin to slow. However, in our view, voice and data usage will rise at a strong pace, as U.S. carriers begin to incorporate unlimited data plans. We think data revenue as a percentage of average revenue per user (ARPU) is in the thirties, but will grow at a solid pace as 4G networks roll out and more 4G smartphones and tablets are introduced. Increased data usage typically means that carriers must either boost capacity at current cell sites or add additional cell sites, with both options likely resulting in increased revenues for AMT, in our opinion.

American Tower recently gained real estate investment trust (REIT) status for its U.S. operations. In converting to a REIT structure, the company paid out $0.35 per share to existing shareholders on December 23, 2011. We believe the conversion to a REIT will allow AMT to minimize taxes on its real estate assets and distribute cash flow to investors, yet still drive growth and repurchase shares. While the company will be required to distribute at least 90% of its pretax profits from its real estate assets, we believe AMT had roughly $1.0 billion in net operating losses (NOLs) in 2011 that can be used to offset pretax income and reduce the total amount of distributions. In our view, the combination of AMT's solid revenue growth, high EBITDA margins (we estimate 64.8% for 2011), and significant NOLs will allow it to distribute cash to shareholders while continuing to invest in the company.



Internationally, we believe that AMT is seizing opportunities to expand at a rapid pace. The company has progressed from roughly 7,021 international towers, or 25.7% of AMT's tower base at the end of 2009, to 18,466 international towers and exposure to eight foreign countries — roughly 46.2% of its total tower portfolio and 26% of revenue — by the third quarter of 2011. We expect the company to keep expanding in these countries as emerging markets tend to have lower wireless penetration rates and are still rolling out 3G networks.

Our 12-month target price of $76 is largely based on 22-times our free cash flow estimate for 2013. The target price also represents an enterprise value of 17-times our 2013 EBITDA estimate, above the industry average. We believe this premium is warranted by our view of AMT's ability to increase cash flow generation faster than its peers.

Risks to our recommendation and target price include slower demand in the tower lease business if carriers begin to cut back on spending, and difficulty servicing AMT's $5.8 billion of debt obligations. There is also a degree of customer concentration as AMT's three largest customers accounted for 51% of 2010 tower revenue.

We view American Tower as well positioned to benefit from the global growth in wireless services. We also believe the company's REIT status will help it to minimize its tax liability, attract new investors, return cash to shareholders and continue to grow internationally. With our target price indicating potential appreciation of 23% from current levels, our recommendation is Strong Buy. ■

Life Sciences Poised for Rebound in 2012

Jeffrey Loo, CFA
S&P Capital IQ
Equity Analyst

Emerging markets, product diversity key for growth, S&P Capital IQ believes.

For the Life Sciences Tools & Services sub-industry of the health care sector, 2011 could not end soon enough. While the S&P Health Care sector index rose 9.6% for the year, easily outpacing the S&P 500, the S&P Life Sciences Tools & Services sub-industry index declined 14.7%.

Sales growth within the life sciences space decreased significantly as its main drivers — the pharmaceutical and academic end-markets — faced substantial headwinds. A poor global economy contributed to reduced research and development spending levels and cautious capital spending within the pharmaceutical and biotech industry, while severe budget issues pressured government budgets in Europe and the United States. As a result, academic labs in the U.S. grew increasingly concerned about possible budget cuts to the National Institutes of Health (NIH), which accounts for about 50-60% of their funding. This concern led to numerous project delays and cancellations, and it also put the brakes on the robust sales growth life sciences companies have enjoyed over the past several years, as academic spending accounts for 40-50% of revenue for life science tools companies, on average.

Fortunately for some of the larger, more diverse life sciences companies with a significant global presence, sales growth was robust in emerging markets such as the BRIC (Brazil, Russia, India and China) countries, driven primarily by the industrial end-markets for food, water, and environmental safety regulations. Sales growth within these markets was above 20% collectively. The industrial end-markets in the U.S. and Europe were also solid, in our view, partially offsetting the slowdown in the pharmaceutical and academic end-markets.

We see the pharmaceutical end-market gradually increasing R&D spending to help alleviate the adverse impact from the patent cliff.

As we enter 2012, life sciences companies face a similar environment, but we expect more stability as we see the pharmaceutical end-market gradually increasing R&D spending to help alleviate the adverse impact from the patent cliff. While the pharmaceutical industry had shifted its focus towards later-stage projects over the past two years, we anticipate increased early-stage and discovery activity in 2012. Further, in December, Congress passed a small funding increase of $300 million to provide the NIH with a total funding level of $30.7 billion. We believe the increase to the NIH funding, although smaller than in past years, is a slight positive for the industry, and will stimulate the resumption of canceled or delayed projects. However, we note that budget pressures could reduce discretionary government spending in the future. The failure of the super committee to identify $1.2 trillion in savings/spending cuts triggered automatic spending cuts that begin in January 2013. Programs to be impacted by funding cuts have not been identified yet, and this will likely be a contentious issue this year. Nonetheless, this leads us to believe that the potential for reduce NIH funding levels will linger for the next year or so.

So where do we think life sciences investors should look for attractive opportunities? Following the significant decline in share price for many life sciences companies in 2011, valuations are well below historical levels, by our analysis. Although we think declining sales growth could justify a contraction in valuation multiples, we believe certain companies are trading at historical lows that are not justified and are attractively valued. In our view, investors should focus on companies with a significant presence in emerging markets, particularly China, those with lower U.S. and European academic funding exposure relative to sales, and those with significant product diversity within the applied markets such as environmental, food, and water safety, as well as in forensics and molecular diagnostics.

Within our life sciences tools & services coverage universe, we believe the best-positioned companies are Thermo Fisher Scientific and Life Technologies. We think these companies are also well positioned to pursue external growth opportunities to complement organic growth or may use capital deployment for share buybacks, which would support their shares. ■

POSITIVE IMPLICATIONS

COMPANY / TICKER	‡STARS	‡QUALITY RANKING	*RISK	STYLE	CURRENT PRICE	12-MONTH TARGET PRICE	†P/E RATIO	YIELD (%)
Life Technologies / LIFE	5	B	Medium	Growth	47	58	11.2	Nil
Thermo Fisher Scientific / TMO	5	B	Low	Growth	50	70	10.3	Nil

*Based on our analysts' assessment of qualitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. Please note that all investments carry risks. ‡See definitions on page 2. †Based on S&P estimated fiscal 2012 earnings. Source: S&P Capital IQ.

Biotechs Gain from New Drug Approvals

Steven Silver
S&P Capital IQ
Equity Analyst

Strong pipeline, patent expiration may increase merger activity.

As the 2012 calendar year begins to unfold, S&P Capital IQ has a positive 12-month fundamental outlook for the biotechnology industry, and we see several key themes that support our view.

We believe that the industry will benefit from improving new drug approval trends seen during 2011 from the U.S. Food and Drug Administration (FDA). In 2011, the FDA approved 30 new drugs, well above 21 in 2010 and the most since the 36 seen in 2004. Importantly, several of these drugs represented significant advances in the way diseases such as hepatitis C, lupus, and melanoma are treated.

In addition, we are also encouraged that the FDA's 2012 budget was approved with a 2% increase to $2.5 billion. Lastly, we view positively a rise in the percentage of new drugs approved on the first review cycle to 63% in 2011 from approximately 50% in 2010, according to the FDA. Although we do see potential for reviews to be extended by two months when the industry's Prescription Drug User Fee Act is reauthorized in late 2012, we would expect these delays to result in enhanced communication between the agency and biopharma companies, which we think would further boost the first cycle approval rate.

Meanwhile, we expect strong merger and acquisition activity. We expect the large pharma industry will make acquisitions and enter into new partnerships, as it seeks to offset the impact of expiration of many key patents. Notably, in late 2011, Pfizer (PFE 22 ★★★★) lost patent exclusivity on its cholesterol-lowering drug Lipitor, whose 2011 sales we estimate to be about $9.1 billion. Eli Lilly (LLY 40 ★★★) lost exclusivity on Zyprexa, which we estimate had 2011 sales of $4.6 billion. Now that the pharma industry has digested several mega-mergers that were completed in 2009, and largely re-prioritized the industry drug pipeline, we expect deal flow to be robust. However, both Genzyme and Cephalon were acquired during 2011, so fewer large-cap, independent biotech companies remain. We also see large-cap biotech companies providing competition for acquisitions, as evidenced by Gilead Sciences' recently proposed acquisition of Pharmasset (VRUS 137 NR).

We see more collaboration between biotech companies (including large pharma companies that have previously acquired biotech companies) and generic drugmakers, as the biopharma industry prepares for the introduction of biosimilar drugs. However, we do not anticipate biosimilars reaching the market until the second half of the decade, and view their market prospects as uncertain due to likely FDA restrictions on interchangeability with current drugs, and more modest price discounts compared to what is seen in the pharmaceutical generics industry.

Among individual companies in our coverage universe, we expect Celgene to secure regulatory approval of its main revenue contributor Revlimid for earlier stages of treating prevalent blood cancer multiple myeloma, first in Europe and possibly in the U.S. by year end. In addition, we expect Celgene to report late-stage data from its Apremilast program, which we see bolstering our view that the company possesses the strongest growth prospects among large-cap biotechs.

In early 2012, we expect Gilead Sciences to complete its aforementioned acquisition of Pharmasset, moving Gilead towards the top of the list among prospective players in the next-generation hepatitis C market. Despite what we consider a lofty $11 billion acquisition price, we view Gilead as well positioned to rapidly pay down recently issued debt, using robust cash flows from its core HIV franchise. Also in 2012, we expect Gilead to secure approval of its wholly owned "Quad" treatment for HIV, which we see boosting its profit margins, as it has sold its leading HIV combination drug Atripla, earning a zero gross margin on the partnered component.

In addition, within our coverage universe, we anticipate the FDA approving the following new drugs this year: Kalydeco for cystic fibrosis from Vertex Pharmaceuticals; and Gattex for short bowel syndrome from NPS Pharmaceuticals. ■

POSITIVE IMPLICATIONS

COMPANY / TICKER	‡STARS	‡QUALITY RANKING	*RISK	STYLE	CURRENT PRICE	12-MONTH TARGET PRICE	†P/E RATIO	YIELD (%)
Celgene / CELG	5	B-	Low	Growth	73	92	16.6	Nil
Gilead Sciences / GILD	4	B	Low	Growth	45	52	10.4	Nil
NPS Pharmaceuticals / NPSP	4	C	High	Blend	7	13	NM	Nil
Vertex Pharmaceuticals / VRTX	4	C	High	Blend	37	42	8.9	Nil

*Based on our analysts' assessment of qualitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. Please note that all investments carry risks. ‡See definitions on page 2. †Based on S&P estimated fiscal 2012 earnings. NM-Not meaningful. Source: S&P Capital IQ.

Recommended Industrials Stocks

Beth Piskora
S&P Capital IQ
Editorial

S&P Capital IQ Equity Strategy advises overweighting the industrials sector.

On the first trading day of the new year, S&P Capital IQ Equity Strategy changed its recommended weighting for the industrials sector to overweight from marketweight.

The industrials sector accounts for 10.8% of the S&P 500 index; S&P Capital IQ Equity Strategy advises an 11.8% weighting.

S&P Capital IQ equity analysts have a positive 12-month fundamental outlook for the sector. The S&P Capital IQ consensus estimates for earnings growth of 7.2% for the fourth quarter of 2011, and 9.8% for all of 2012. The fourth-quarter growth estimate is third-highest of the 10 sectors, surpassed only by energy and financials.

"Things are still not rosy in the U.S. or Europe, but emerging markets are contributing to industrials sector growth," says Michael Jaffe, group head for industrials equity research at S&P Capital IQ. "This continues a long-term theme, the industrialization of emerging markets."

The 7.2% earnings growth forecast for the fourth quarter is down from a 20.2% improvement in the prior quarter.

"We think this shows that the major uncertainties seen in the global economy in recent months will cause some deceleration in industrials sector growth trends, as many businesses and individuals have likely grown more cautious in their spending," says Jaffe. "At the same time, we think this period will prove to be a soft patch in an ongoing sector upturn. In that regard, we see factors such as robust economies in emerging nations, and the need to replace aging equipment and replenish inventories in developed markets continuing to lift industrials sector performance. We also think these factors will cause some ongoing gains in the transportation area."

Despite sporting only a slightly above average P/E, the industrials sector's 2012 estimated Capital IQ consensus EPS growth of 13% is the highest of any sector and well above the S&P 500's 8.1% estimated gain.

"We believe the industrials sector is poised for outperformance as investors discount a gradual economic recovery in the U.S. as well as solid growth in Asia, believing European woes will remain relatively contained," says Alec Young, S&P Capital IQ's global equity strategist.

The stocks listed in the table garner 4- or 5-STARS rankings from S&P Capital IQ equity analysts, as well as a Quality Ranking of at least A-.

"One negative for the industrials sector is the defense industry," states Jaffe. "With the U.S. and other governments looking to make budget cuts, defense spending, a large part of many government budgets, is likely to get cut."

The S&P 500 industrials sector is also tracked by an exchange-traded fund, Select Sector SPDR-Industrials (XLI 35 Overweight). ■

STOCK SCREEN OF THE WEEK

COMPANY / TICKER	‡STARS	‡QUALITY RANKING	*RISK	STYLE	CURRENT PRICE	12-MONTH TARGET PRICE	†P/E RATIO	YIELD (%)
• C.H. Robinson Worldwide / CHRW	4	A+	Low	Growth	66	95	21.4	2.0
Canadian Pacific Railway / CP	4	A-	Medium	Foreign	69	74	14.9	1.7
Carlisle / CSL	4	A-	Medium	Blend	48	48	13.7	1.5
Caterpillar / CAT	4	A+	Medium	Blend	102	129	11.1	1.8
Cintas / CTAS	4	A-	Low	Growth	37	39	17.1	1.4
Clarcor / CLC	4	A	Medium	Growth	51	55	19.2	0.9
CSX / CSX	4	A-	Medium	Value	24	27	13.0	2.0
• Deere / DE	4	A	Medium	Blend	84	99	9.8	2.0
Dover / DOV	4	A	High	Growth	60	72	12.0	2.1
Eaton / ETN	4	A	Medium	Blend	49	55	10.8	2.8
Expeditors International / EXPD	4	A+	Medium	Growth	43	60	21.7	1.2
• Fastenal / FAST	5	A	Medium	Growth	46	48	31.7	1.1
General Electric / GE	4	A-	Medium	Blend	19	20	13.0	3.6
Graco / GGG	4	A-	Medium	Growth	42	46	16.0	2.1
Grainger (W.W.) / GWW	4	A+	Medium	Blend	194	205	18.5	1.4
Heico / HEI	4	A	Medium	Growth	56	67	28.4	0.2
• Honeywell / HON	4	A-	Medium	Value	57	65	13.1	2.6
ITT / ITT	4	A-	Medium	Growth	22	23	13.1	Nil
Norfolk Southern / NSC	4	A-	Medium	Blend	78	85	13.6	2.2
Parker-Hannifin / PH	5	A	Medium	Blend	83	110	11.0	1.8
Pentair / PNR	4	A	Medium	Blend	37	40	13.7	2.2
Snap-On / SNA	4	A-	Medium	Value	54	65	10.8	2.5
Smith (A.O.) / AOS	5	A-	Medium	Blend	43	55	14.9	1.5
• United Technologies / UTX	4	A+	Low	Growth	77	92	13.1	2.5

• Master List issue. *Based on our analysts' assessment of qualitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. Please note that all investments carry risks. **Standard & Poor's Ratings, which operates independently from S&P Capital IQ. ‡See definitions on page 2. †Based on S&P estimated fiscal 2012 earnings. Source: S&P Capital IQ.

Total Return Portfolio

12/31/2011 — 1/6/2012

To enter the Total Return Portfolio, which is designed for long-term total return, a stock must have a current yield at least equal to or greater than that of the S&P 500. The company must not have cut its regular dividend in the past five years at the time of entry into the portfolio, and that dividend must be secure in the opinion of the S&P analyst who follows the stock. There is no S&P Quality Ranking requirement for this portfolio. S&P's Senior Portfolio Group may replace any stock in the portfolio with another stock at any time for reasons that can include a downgrade in the S&P STARS, a dividend reduction, or other fundamental factors.

The Total Return Portfolio underperformed its benchmark from the beginning of the year through January 6, rising 0.7% vs. a 1.7% gain in the S&P 500. The data on this page show which stocks contributed to, or detracted from, the portfolio's performance year to date through January 6. ■

TOTAL RETURN PORTFOLIO

COMPANY / TICKER	‡STARS	‡QUALITY RANKING	*RISK	STYLE	CURRENT PRICE	12-MONTH TARGET PRICE	†P/E RATIO	YIELD (%)
Abbott Laboratories / ABT	4	A	Low	Growth	56	61	11.3	3.4
Altria Group / MO	5	A	Low	Blend	29	30	13.6	5.7
AT&T / T	5	B+	Low	Value	30	34	11.9	5.9
Chevron / CVX	5	A	Medium	Blend	105	132	7.7	3.1
Coca-Cola / KO	5	A+	Low	Growth	68	77	15.9	2.8
Deere / DE	4	A	Medium	Blend	84	99	9.8	2.0
ExxonMobil / XOM	5	A+	Low	Blend	85	103	9.9	2.2
Honeywell / HON	4	A-	Medium	Value	57	65	13.1	2.6
ITC Holdings / ITC	4	NR	Low	Blend	73	84	18.3	1.9
Kinder Morgan Energy / KMP	5	NR	Low	Blend	83	96	35.5	5.6
KLA-Tencor / KLAC	4	B	High	Growth	49	54	13.0	2.9
McDonald's / MCD	5	A	Medium	Growth	101	109	17.5	2.8
Microsoft / MSFT	4	A-	Low	Growth	28	33	10.1	2.9
PPG / PPG	5	B+	Medium	Blend	88	105	12.1	2.6
United Parcel / UPS	4	B+	Low	Growth	75	95	15.3	2.8

*Based on our analysts' assessment of qualitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. Please note that all investments carry risks. †Price/earnings ratios are based on S&P estimated fiscal 2012 per-share earnings. ‡See definitions on page 2. Source: S&P Capital IQ.

Portfolio Focus: AT&T Still Strong Without T-Mobile

Contrary to previous expectations, 2012 will not be the year in which AT&T swallows T-Mobile USA, a subsidiary of Duetsche Telekom whose 34 million customers make it the fourth largest U.S. wireless carrier. In December, A&T announced the two parties had withdrawn their application for a merger from the Federal Communications Commission and the U.S. Justice Department, and that it would take a $4 billion pre-tax charge in the fourth quarter of 2011 to reflect the payment of a breakup fee to Deutsche Telekom. The proposed $39 billion, announced in March, would have been the largest U.S. corporate transaction of 2011 and would have made AT&T into the largest U.S. wireless carrier in front of chief rival Verizon Wireless.

Without the merger, S&P Capital IQ equity analyst Todd Rosenbluth believes AT&T is still highly attractive, due to its strong profitability and its nearly 6% dividend yield.

AT&T's sale of 6 million smartphones in October and November is a sign the company is able to execute its business plan without T-Mobile, he says. While the subsidies AT&T provides to make these sales will hurt its fourth quarter cash flow, Rosenbluth believes they will be important in driving revenue growth. He also believes the company, which raised its dividend by 2.3% in December to $1.76/share, will extend its string of more than 25 consecutive years of higher payments, and will generate strong free cash flow from both wireless and wireline segments to support future payments. / Vaughan Scully ■

Harness Our Quant Power

Standard & Poor's Neural Fair Value 25 Portfolio buys what are deemed undervalued issues with superior return potential.

Neural fair value rankings are derived from two quantitative stock selection systems proprietary to S&P: the neural model and the fair value model.

The neural rank is based on "neural networks," an artificial intelligence system that replicates the brain's ability to learn from mistakes. The neural model identifies the factors that led to outperformance over the most recent six-month period and determines which stocks should benefit from those factors in the future. Stocks are ranked in five tiers, from most attractive (5) to least (1).

The fair value model calculates the price at which a stock should trade, based on fundamental data.

Neural fair value rankings also include the earnings surprise indicator, which tags those issues most likely to beat earnings estimates, and the timing index, which tells investors whether or not a stock meets certain trend requirements that have proved favorable to long-term capital appreciation.

Year to date through January 6, the portfolio rose 3.0% vs. a 1.6% gain in the S&P 500. ■

NEURAL FAIR VALUE 25 PORTFOLIO

COMPANY / TICKER	NEURAL	FAIR VALUE	TIMING	***EARNINGS SURPRISE	*S&P INDEX	**RISK	STYLE	CURRENT PRICE
Aetna / AET	3	5	+	A	500	Medium	Blend	44
CACI International / CACI	3	5	+	A	Small	Medium	Growth	57
Capella Education / CPLA	5	5	+	B	Small	NA	Growth	41
Cardinal Health / CAH	3	4	+	C	500	Medium	Blend	42
Celgene / CELG	3	4	+	B	500	Low	Growth	73
Check Point Software / CHKP	5	2	N	B	...	High	Growth	52
Children Place Retail / PLCE	2	4	+	A	Small	NA	Growth	49
Cisco Systems / CSCO	5	5	+	A	500	Low	Growth	19
Computer Science / CSC	3	4	N	A	500	Medium	Blend	25
eBay / EBAY	5	5	+	D	500	Medium	Growth	32
Focus Media / FMCN	1	5	+	A	...	NA	Foreign	21
General Dynamics / GD	3	5	+	B	500	Low	Growth	71
GT Advanced Technologies / GTAT	1	5	+	A	Small	NA	Growth	8
Hewlett-Packard / HPQ	5	5	+	B	500	Medium	Blend	27
IAC/InterActiveCorp / IACI	2	3	+	B	...	Medium	Blend	42
● Int'l Business Machines / IBM	5	4	+	B	500	Low	Growth	181
KBR / KBR	3	4	+	A	Mid	NA	Value	31
Lincoln Electric / LECO	2	4	N	B	Mid	Medium	Growth	41
Lockheed Martin / LMT	5	3	+	A	500	Medium	Growth	82
Tempur-Pedic International / TPX	3	4	+	B	...	High	Growth	60
Teradata / TDC	3	2	N	B	500	Medium	Blend	48
Time Warner / TWX	3	4	+	A	500	Medium	Blend	38
UnitedHealth Group / UNH	3	4	+	C	500	Medium	Growth	53
US Airways / LCC	1	4	N	C	...	High	Blend	6
Western Union / WU	3	1	+	B	500	Medium	Blend	19

● Master List issue. *500-S&P 500; Mid-S&P MidCap 400; Small-S&P SmallCap 600. **Based on our analysts' assessment of quantitative factors, including financial strength, potential share volatility, competitive position, industry cyclicality, regulatory/legal issues, and other factors. ***This indicator divides stocks into five tiers, designated by the letters A through E, based upon their ability to beat earnings estimates. "A" ranked stocks are most likely to show future positive earnings surprises, while "E"-ranked stocks are most likely to report negative earnings surprises. "N" indicates data was not available to determine the indicator. NA-Not available. Source: S&P Capital IQ.

Performance calculations do not take into account reinvestment of dividends, capital gains taxes, or brokerage commissions and fees. If the foregoing had been factored into the portfolio's investment performance, it would have been lower. This performance calculation also does not take into account timing differences between the portfolio selections and purchases made based on those selections by actual investors. Over certain periods, the portfolio incurred losses and over time the portfolio is expected to continue to pose a risk of negative investment returns. Because the portfolio has a high turnover rate, we believe it is best suited for tax-deferred accounts such as IRAs and is less suited for other accounts. Investors should seek financial advice before investing based on the portfolio. This portfolio does not address the specific investment objectives, financial situation, and particular needs of any person. Stocks in the portfolio will not be suitable for all investors. Readers should be aware that past performance is not an indicator of future results.