The Long View

Investment insights

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Invest ahead of the curve

"E-commerce has forever changed the landscape for traditional U.S. retailers."

Emme Kozloff, Investment Analyst

It's not often you can put a time stamp on a tipping point, but January 9, 2007, probably qualifies. That's the day Steve Jobs introduced what would become one of the great success stories of corporate America: the iPhone.

Since then, the various versions of the phone have sold more than 350 million units, crushed some competitors, mostly replaced paper road maps and put a lot of point-and-shoot cameras on the shelf.

While the iPhone didn't quite change everything, it is certainly an example of a product that was rapidly adopted and dramatically altered the behavior of millions of people around the world. This dynamic is sometimes charted along an "S" curve, which depicts the rapid, exponential increase in sales of a product or a service.

Smartphones are just one example of what seem to be a number of potentially gamechanging developments riding along the "S" curve. From the ramping up of U.S. oil production to soaring online sales, the old ways of doing things seem to be fading and new ways coming to life.

Take shopping. "E-commerce has forever changed the landscape for traditional U.S. retailers," investment analyst Emme Kozloff says. "From the consumer perspective, it's changed the shopping mindset of entire generations, forcing a new model for the retail value proposition."

Even the way we order pizza has changed. Big chains have invested in sophisticated Web-based systems that let customers order and pay for deliveries quickly without having to call. Domino's Pizza, Papa John's and Pizza Hut all now derive 40% or more of their sales from digital orders.

At the World Economic Forum in Davos, Switzerland, in January, Marissa Mayer, Yahoo's chief executive, said the rapid adoption of smartphones and the applications that run on mobile devices will make 2014 a "tipping point" that radically changes the way people work and live. In 2014, Yahoo expects more traffic from its users on mobile phones and tablets than on personal computers, a first for the company.

Indeed, even amidst a challenging environment in developing countries, many businesses are thriving thanks to rapid growth in e-commerce, online games and social media. "Internet-related businesses in developing countries should continue to have solid growth potential, even as economies slow and consumers spend less overall," portfolio manager Winnie Kwan says.

In the race to keep up, many companies are ramping up spending on research and development. The global car industry, for example, is spending more on R&D than ever before. "The auto industry is a good example of an innovative, truly global industry, and also one of the most competitive industries in the world," says portfolio manager Will Robbins.

The pattern depicted by the "S" curve is likely to be followed by a variety of goods and services, but smartphones serve as an example of a product whose adoption has provided numerous companies with an opportunity to grow their business.

For long-term investors, innovation in technology and other fields, and the adoption of products among consumers, can provide an investment opportunity that few could have imagined even a decade ago.

Rob Lovelace
Portfolio Manager
28 years of investment experience

A new revolution

There are periods of fundamental change that can transform the way we live and work. The Industrial Revolution, of course, changed everything from agriculture to the social structure, effectively ending the way mankind had functioned for thousands of years.

Today it seems as if we are in the middle of another revolution, and clearly these changes pose significant challenges and opportunities for long-term investors.

The changes range from digital to medical, from e-commerce changing the way we shop to DNA analysis opening a new era in medicine. There's new technology providing access to previously inaccessible oil and natural gas, and 3-D printing, something that seems straight out of a sci-fi movie.

Those are just a few of the developments that have set in motion a chain of events that would have been hard to imagine even a few years ago.

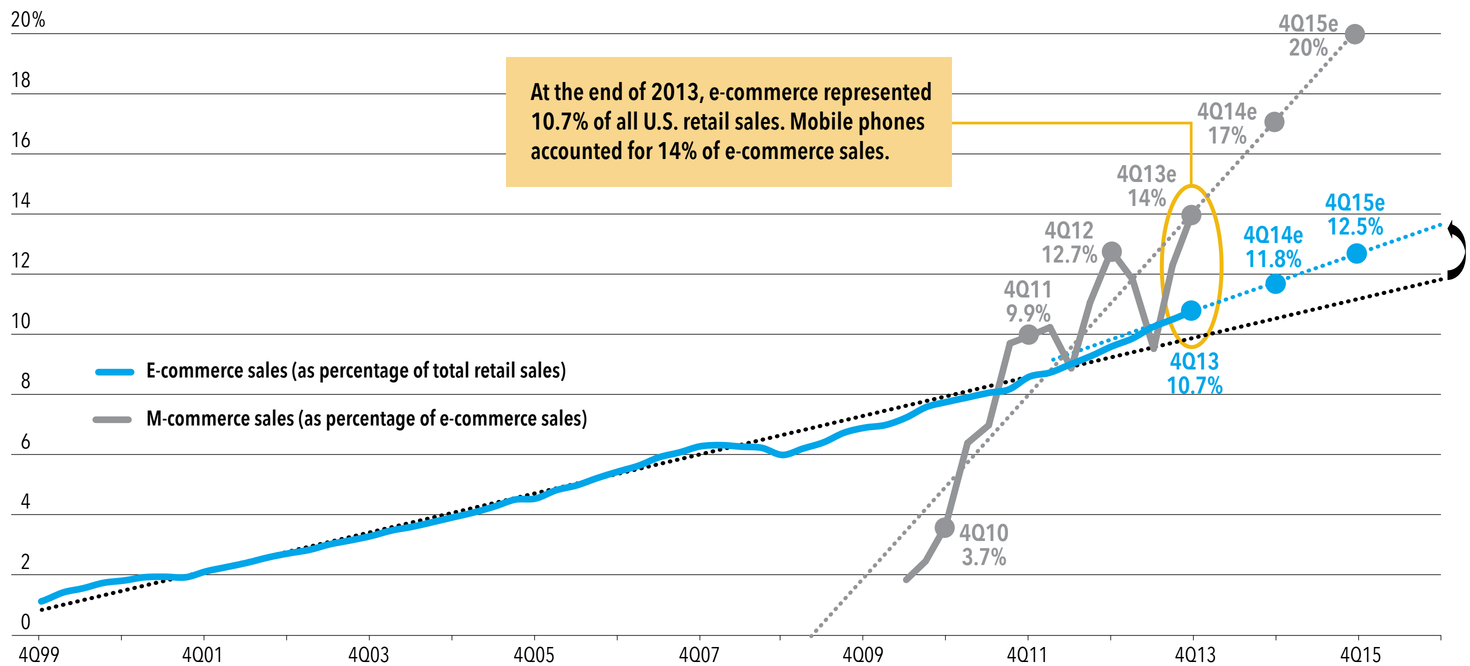
But they are real and represent a new revolution that has the potential to improve the standard of living across the globe, provide companies with new profit opportunities, and investors with potential reward.

Going mobile: "M-commerce" drives e-commerce higher

A disruptive force and opportunity, smartphones boost online sales

"The unique capabilities of smartphones are allowing for new user experiences and new value creation. There are a lot of companies that would be much smaller businesses without ubiquitous smartphone adoption."

Brad Barrett, Investment Analyst



Sources: International Strategy & Investment, United States Census Bureau and comScore, Inc. Figures for e-commerce sales exclude autos, gas and restaurants.

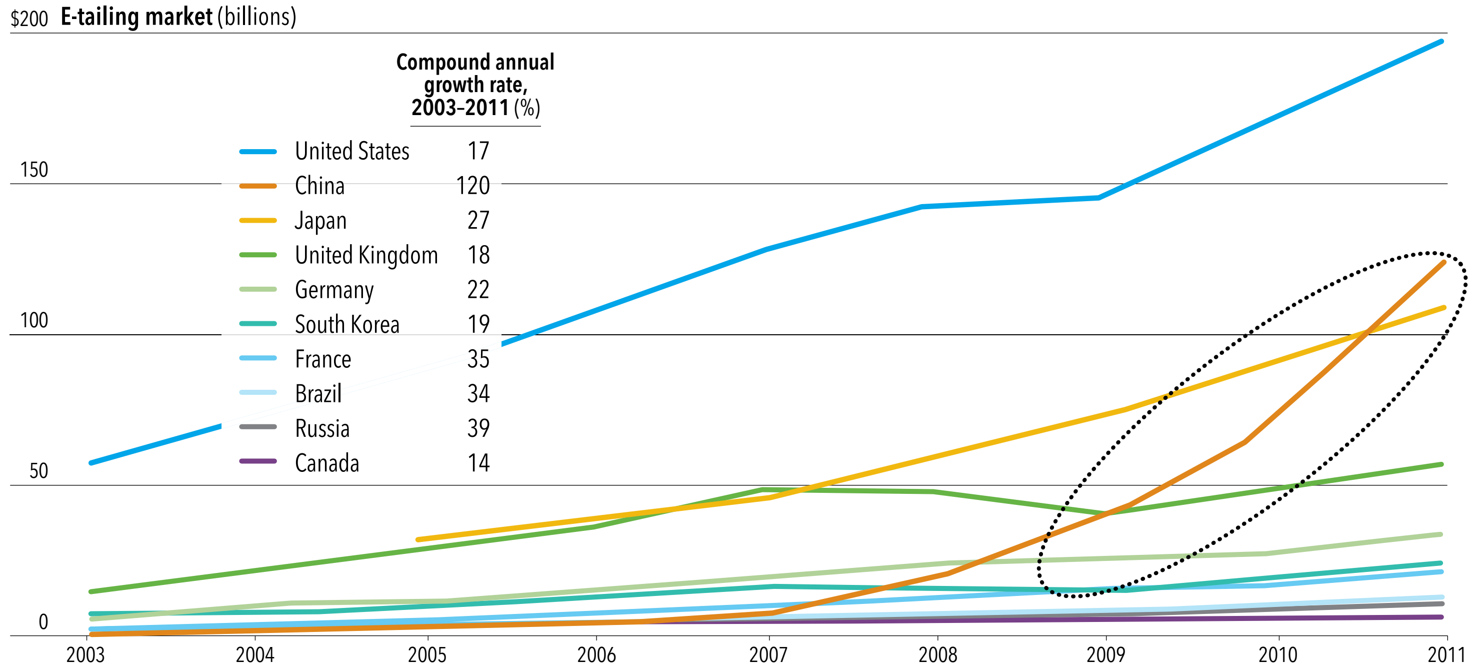
- For many people around the world shopping now means going online as well as going to the store. The acceleration of e-commerce during the past few years has been rapid and dramatic.
- Several factors are driving the transition, including technological developments and demographic trends.
- On the technology front, smartphones and tablets have created a world in which consumers are unchained from the desktop. As consumers have grown more comfortable shopping on mobile devices, the statistics indicate that how often people shop with devices and how much they spend are both increasing.
- A demographic tide may also lift e-commerce. The Millennials, or those born between 1982 and 2001, are moving into prime spending years. Already comfortable with the Internet and online transactions, the group has the potential to not only boost online sales in the near future, but as their incomes rise with age, they are likely to continue pushing the level of e-commerce higher.
- E-commerce isn't a threat to all retail models, but this transition may have a dramatic impact on the physical retail landscape. For bricks-and-mortar retailers that don't adapt to the environment, their shops are likely to be much smaller with fewer employees and less inventory. Some may disappear. Indeed, the rate of growth for U.S. shopping centers has slowed over the past few years. Of course, that's partly due to the recession. But as more and more shoppers go online, the physical retail footprint may continue to decline.

E-commerce in China has soared

China has become one of the world's most wired retail markets in just a few years

"E-commerce still has a long runway for growth in both developed and emerging markets and continues to gain share as a percentage of total retail sales."

Emme Kozloff, Investment Analyst



Source: Exhibit from *China's e-Tail Revolution: Online Shopping as a Catalyst for Growth*, March 2013, McKinsey Global Institute, www.mckinsey.com/mgi, McKinsey & Company. Reprinted by permission. The segment of e-commerce known as "e-tailing" represents consumer-facing e-commerce transactions. The sellers may be larger businesses (B2C) or microbusinesses and individuals (C2C). McKinsey's definition of e-tailing excludes online job search services, financial services and billing services. E-tailing market data also exclude online travel. Japan's compound annual growth rate covers 2005-2011.

- E-commerce has become a powerhouse industry in China. Although online shopping is just in its infancy, e-tailing produced more than $190 billion in sales in China during 2012, and that may be just the beginning. Online sales are expected to reach about $650 billion in 2020, according to a study of e-commerce in China by the McKinsey Global Institute.
- China's tremendous growth since the turn of the century has coincided with the Internet revolution. The convergence of the two forces since then has unleashed a surge in innovation and entrepreneurship that is reflected in the astonishing growth of e-commerce.
- Consider that in 2011, China's online sales totaled about $120 billion. That amount surpassed Japan's $107 billion, and the United Kingdom's $56 billion. In 2012, e-tailing in China soared to $190 billion. That's nearly a 60% year-over-year sales increase, something exceedingly rare in a market measured in the hundreds of billions of dollars.
- Indeed, while it seems that such rapid growth would be unsustainable, some numbers suggest otherwise. Although China already has the world's largest online population with 130 million residential broadband accounts, that represents only 30% penetration.
- Clearly, the industry's potential is enormous. By 2020, according to McKinsey's projections, Chinese e-tailing will match the combined size of today's market in the U.S., Japan, U.K., Germany and France, reaching about $650 billion.

Alibaba's online sales may be a sign of what's to come in China

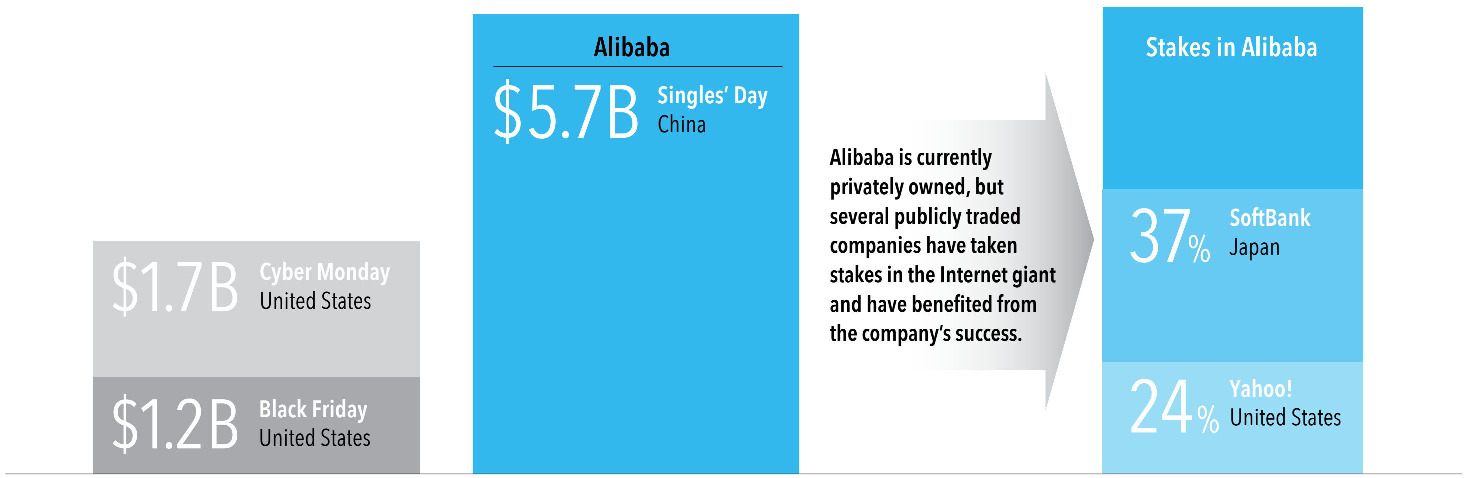
Only the lonely? Alibaba rang up $5.7 billion in online sales last year on "Singles' Day"

"11/11 isn't about numbers, it's about fostering a healthier consumer environment."

Jack Ma, Alibaba Founder

Singles' Day in China set a sales record, nearly doubling Cyber Monday and Black Friday sales in U.S.

Investing in China's Alibaba means going through Tokyo or Sunnyvale in The New Geography of Investing®



Sources: Bloomberg, comScore, Nikkei, *The New York Times*, *The Wall Street Journal*, SoftBank 2013 annual report and *Yahoo! Q4'13 Financial Highlights*, January 28, 2014. Figures for Black Friday, Cyber Monday and Singles' Day represent total one-day online sales in 2013. SoftBank and Yahoo! percent stakes in Alibaba are as of January 2014.

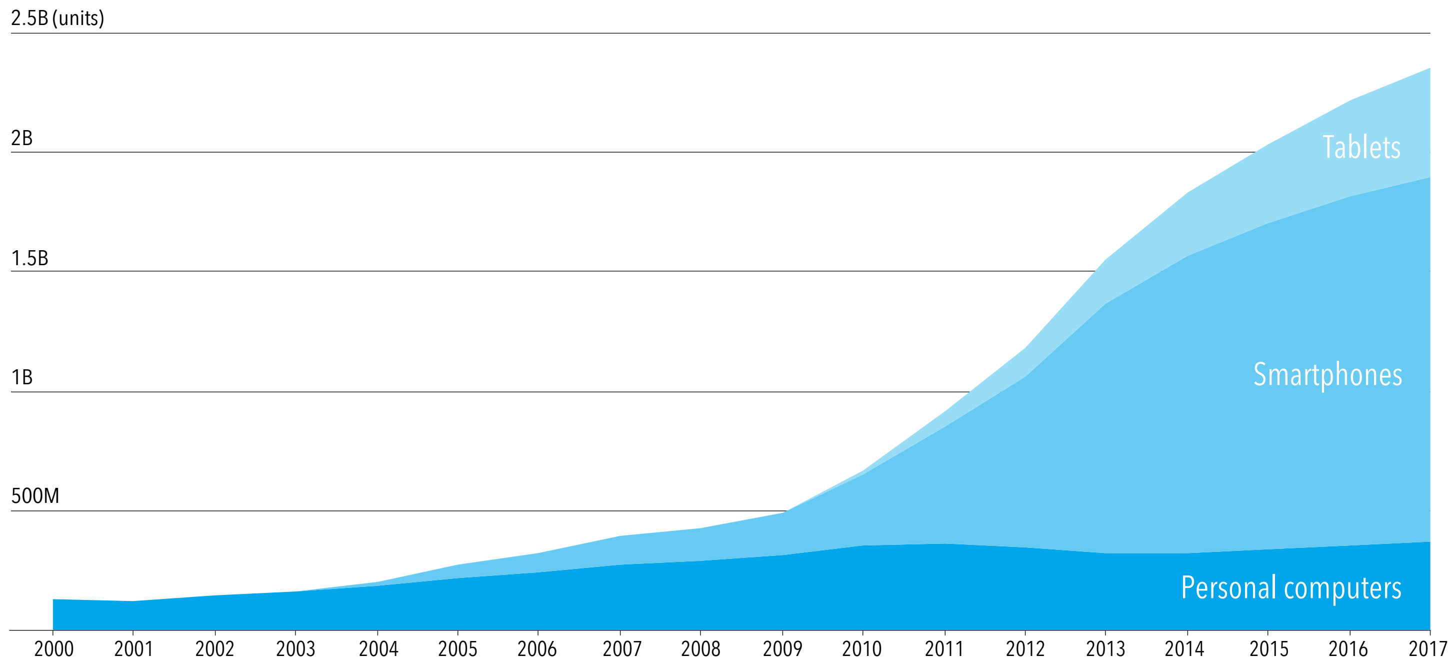
- It turns out 1 may not be the loneliest number after all. In China, the unmarried celebrate their status on "Singles' Day" by showering themselves and each other with gifts. Singles' Day is observed on November 11, which is 11/11, or four lonely ones. But the day isn't just for lonely hearts. Singles' Day has evolved into an online shopping spree without equal, and that's certainly cause for celebration at China's Alibaba.
- Alibaba, an e-commerce company, reported that on Singles' Day last year, it had 402 million unique visitors to its sites. That's about a third of the adult population in China. The company prepared 152 million parcels for shipping. Alibaba processed more than $5.75 billion on its online payments system, a record for a single day of sales.
- Alibaba is a privately held company but has announced plans for an initial public offering later this year. But that doesn't mean investors can't gain exposure to the company today. Among the companies that currently have a stake in Alibaba are Japan's SoftBank and Yahoo! in the United States. SoftBank, the Tokyo-based wireless carrier, holds about 37% of Alibaba. Yahoo! has a 24% stake in the company.
- Those companies, of course, are publicly traded. Yahoo's stakes in both Alibaba and Yahoo! Japan, a separately owned affiliate, contributed about $222 million to the American company's bottom line this quarter, up 49% from the same time a year ago, according to its fourth-quarter 2013 earnings report.

Smartphone sales topped 1 billion in 2013

Next up for shoppers: The tablet boom gives rise to "couch commerce"

"Smartphones are replacing all kinds of electronic devices. Think about the number of parents using their phones to take pictures and videos of their children at a school play, the number of times you used the map on your phone when you got lost, or the number of people reading books on their smartphones. The creative destruction from smartphones is massive."

Paul Li, Investment Analyst



Sources: Gartner, Inc. and IHS iSuppli.
Data represent worldwide units shipped.

- The smartphone market passed several milestones in 2013. For the first time, more than a billion smartphones were sold worldwide. Another first: Sales of smartphones exceeded the more basic, and usually cheaper, feature phone.
- Tablets show every sign of being the next big thing. Tablet shipments reached 184 million units in 2013, or more than three times the number shipped in 2011.
- The rapid rise of tablets is adding another dimension to e-commerce. Some data suggest tablets may soon be generating more traffic to commerce sites than smartphones, a trend already dubbed "couch commerce."
- For many, the personal computer still remains the device of choice when shopping online. Estimates vary, but perhaps 80% of e-commerce is conducted on a desktop. The percentage of traffic driven to commerce sites by PCs, however, is declining, as are the number of shipments. PC sales reached 358 million in 2010 and have declined every year since then. Last year sales fell to 322 million.
- In contrast, global smartphone shipments grew massively last year as mobile handsets increased in capability and were made available at lower prices.
- Shipments of smartphones have more than doubled since 2011, when 491.4 million units were shipped. Vendors delivered a total of 1.004 billion smartphones, up 41% from 2012. In all, 1.8 billion mobile phones were sold last year. Smartphones made up 55% of the total.

Papal ceremonies highlight a seachange in technology

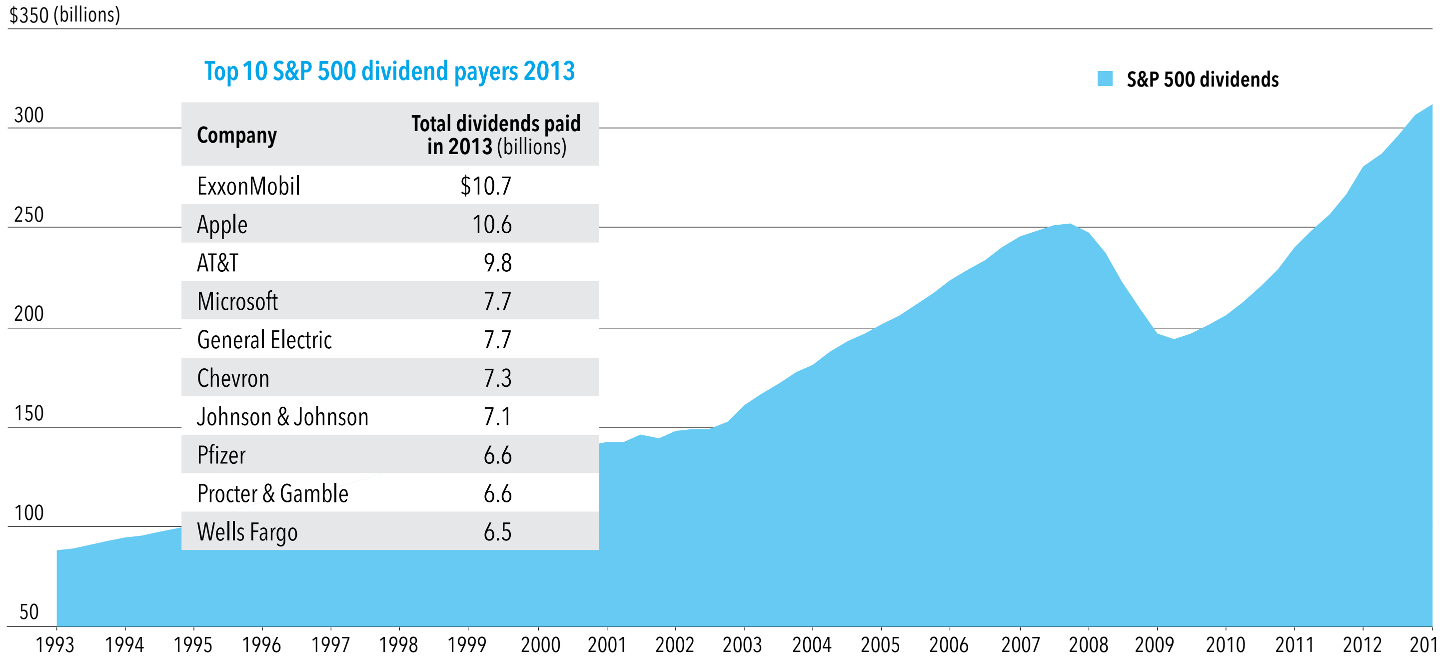
The adoption of the smartphone is captured during ceremonies at St. Peter's Square

Dividend payments soared to another record in 2013

After reaching $300 billion for the first time, dividends may be headed higher in 2014

"We expect the first quarter of 2014 to be a very busy positive period for dividends, with 2014 setting another record for payments."

Howard Silverblatt, Senior Index Analyst at S&P Dow Jones Indices



Top 10 S&P 500 dividend payers 2013

Company	Total dividends paid in 2013 (billions)
ExxonMobil	$10.7
Apple	10.6
AT&T	9.8
Microsoft	7.7
General Electric	7.7
Chevron	7.3
Johnson & Johnson	7.1
Pfizer	6.6
Procter & Gamble	6.6
Wells Fargo	6.5

Sources: Standard & Poor's and FactSet. Data for the S&P 500 dividends represent four-quarter sums. The list of top 10 includes companies with preliminary reporting status.

- S&P 500 companies paid out a record $311.8 billion in dividends last year. The total marked a 10.8% increase from the previous year, and also the first time dividends surpassed $300 billion.
- There are several reasons that dividends are likely to continue to grow in 2014. The payout rate, or dividends as a percentage of total earnings, remained at 36% last year, well below its long-term average of about 50%. That suggests the potential for companies to increase dividend payments, especially given the level of corporate profits and abundance of cash on the balance sheets of many companies. Moody's estimates U.S. nonfinancial companies are holding about $1.5 trillion in cash and marketable securities.
- Indeed, 2014 seems to be picking up where 2013 left off. After paying $46 billion more in dividends in 2013 than the year before, S&P 500 companies increased dividend payments during the first two months of 2014.
- In addition, as of January 31, 2014, 420 S&P 500 companies paid a dividend, the most since November 1998. All 30 members of the Dow Jones Industrial Average paid a dividend.
- During 2013, S&P 500 companies increased or initiated dividends 381 times (366 increases, 15 initiations), compared with only 12 decreases.
- In 2013, the information technology sector accounted for 15.4% of the S&P 500 dividends, the largest contribution.

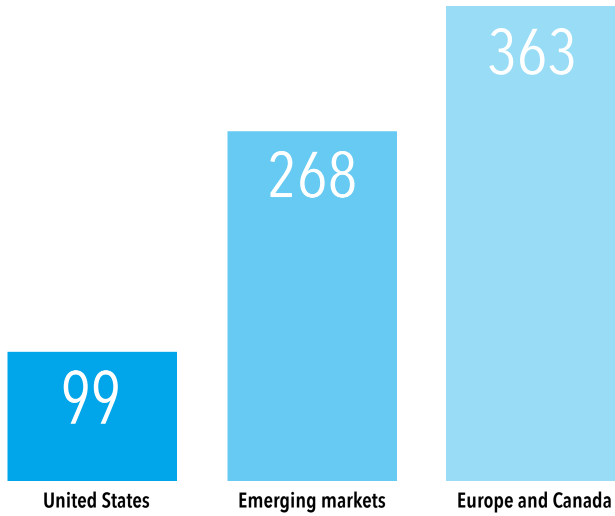
As emerging markets evolve, a new opportunity for income develops

Expansion of dividend culture abroad offers additional dimension to international investing

"Over the past decade, we've seen enormous changes in the dividend culture outside the U.S. Many companies abroad now believe that a percentage of earnings should be returned to shareholders each year."

Andrew Suzman, Portfolio Manager

Many companies with a dividend yield of more than 3% are outside the U.S. ...



... and those companies are represented in numerous sectors

	United States	Emerging markets	Europe and Canada
Consumer discretionary	7	21	33
Consumer staples	11	12	19
Energy	6	32	36
Financials	27	75	117
Health care	4	3	11
Industrials	5	20	40
Information technology	6	28	20
Materials	2	29	26
Telecommunication services	5	26	30
Utilities	26	22	31
Total	**99**	**268**	**363**

Source: RIMES. United States, emerging markets, and Europe and Canada represent the MSCI USA, Emerging Markets, EAFE (Europe, Australasia and Far East) and Canada indexes, respectively. Data are as of December 31, 2013.

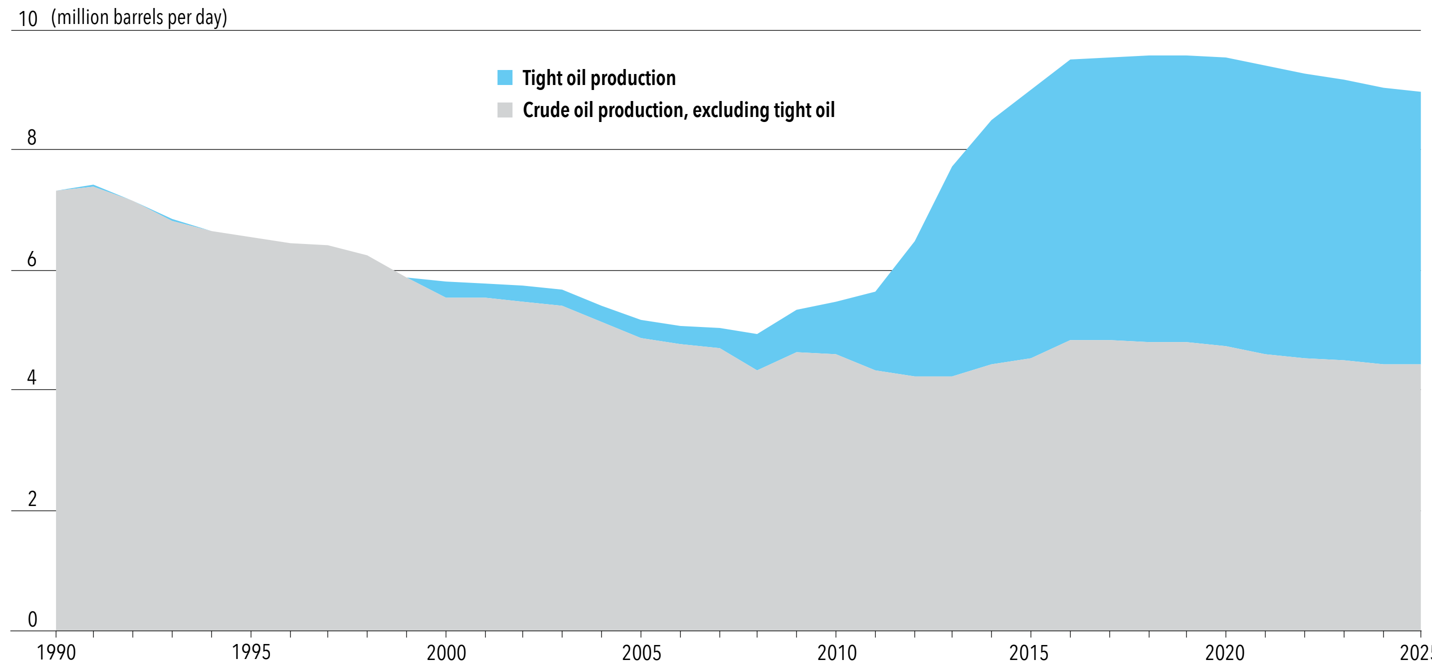
- International equities aren't always associated with dividends, but a growing number of companies from Asia to Europe have initiated or raised dividend payments in recent years. These companies now represent an increasingly important element of international investing, especially for investors seeking income during retirement.
- The chart shows that as of December 31, 2013, there were 631 companies outside the U.S. with a dividend yield of at least 3%. Inside the U.S., there were only 99 such companies.
- Now that many of the companies that are committed to returning value to investors are in emerging markets, dividends have become a key driver of total return. Over the past 15 years, dividends accounted for about 30% of the compound annual growth rate for the MSCI Emerging Markets, a percentage that has accelerated in recent years.
- As companies in emerging markets continue to evolve, dividends probably will play a more prominent role in total return.
- That's important because steady dividend payments over a long period of time often indicate a profitable, well-managed company that's willing to share its good fortune with shareholders. In short, dividends are often a hallmark of quality.
- In addition, relatively steady dividend payments can serve as a cushion against market volatility.

American gusher: U.S. oil production set to surpass Saudi Arabia

Now that drillers can loosen up "tight oil," American crude is soaring

"The energy renaissance is huge. This is an investment theme that is durable and has the potential to fundamentally change this country."

Rob Lovelace, Portfolio Manager



Source: U.S. Department of Energy, Energy Information Administration. Tight oil is embedded in low-permeable sandstone, carbonate and shale rock; shale oil is a type of tight oil.

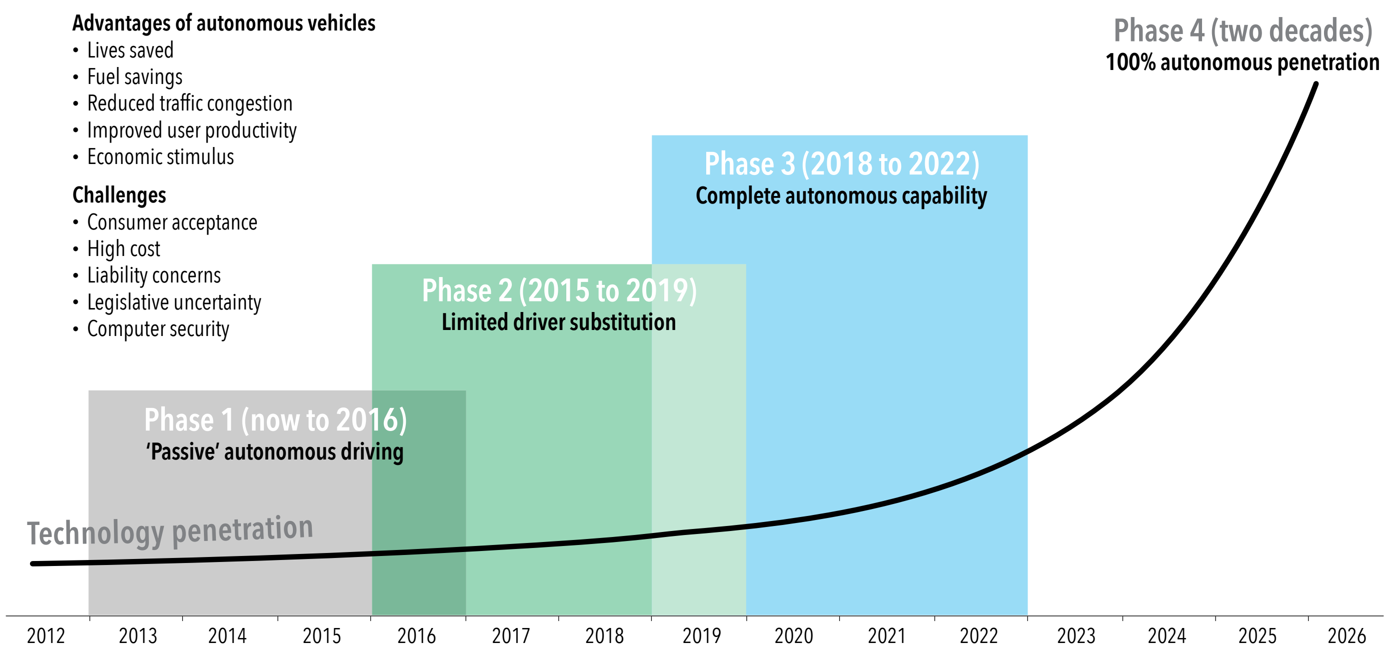
- The energy industry in the United States is in the midst of an extraordinary transformation, and the changes may have the potential to redefine America's economic future.
- The turnaround in U.S. oil production is sometimes referred to as the "shale gale" because it stems from the ability to reach previously inaccessible oil that was locked in shale that couldn't be cracked. Now, because of the relatively new drilling technology, the amount of accessible oil in the U.S. is far greater than believed just a few years ago. By 2020, the International Energy Agency estimates the U.S. will displace Saudi Arabia as the world's biggest producer, pumping 11.6 million barrels per day.
- The surge is mostly due to innovations in horizontal drilling and hydraulic fracturing, which involves pumping water, chemicals and sand at high pressures to break apart underground rock formations. The process is called "fracking" and has raised a variety of environmental concerns that are still at issue.
- The increased production has set in motion a chain of events that would have been hard to imagine even a few years ago, including an end to the nation's energy dependency on foreign oil.
- In just the past several years, numerous industries have benefited from the energy boom. Steel plants, trucking fleets, electric utilities, chemical and fertilizer makers are all among the businesses being bolstered or, in some cases, revitalized by the abundance of oil and natural gas made accessible by innovation.

The driverless car may be just down the road

The auto industry is committed to making self-driving cars a reality

"We're seeing an explosion of innovation in the auto industry. We'll have self-driving cars on the road in not too many years, and a lot of companies are going to benefit from the process it takes to get there."

Kaitlyn Murphy, Investment Analyst



Source: © 2014 Morgan Stanley.

- At the 1939 World's Fair in New York, one of the most popular exhibits was called "Futurama," which depicted a city where radio-controlled cars moved people safely along automated highways to vast suburbs. The exhibit was sponsored by the General Motors Corporation.
- Today, "Futurama" is nearly upon us. Numerous automakers, and several technology companies, are working on vehicles that would use an array of sensors and massive amounts of data to navigate roads without a human driver.
- The projections vary widely for how many, and how quickly, driverless cars will ply the roads. A recent IHS Automotive study estimates 54 million will hit the streets worldwide by 2035.
- The commitment to such cars, however, is beyond debate. The auto industry at large is dedicated to bringing commercially viable self-driving technology to the masses. Audi, BMW, Nissan and Mercedes have targeted self-driving capabilities by 2020. Tesla has targeted 2016 and Ford 2017. The "self-driving" capabilities are referred to as Level 3, or full automation in certain situations, such as highway driving.
- Level 4 is full automation in all situations. Only Google is talking about that level. The company revealed in 2010 that it was working on self-driving cars. Google already has logged about 500,000 test miles on its driverless cars.
- There will be many hurdles for such transformative technology, but none seem insurmountable. Indeed, the driverless car may be just down the road.

The statements in *The Long View* are the opinions and beliefs of the speaker expressed when the commentary was made and are not intended to represent that person's opinions and beliefs at any other time.

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