

# THINKNOW

INSIGHTS ON INVESTING AND GLOBAL MARKET.

## EMERGING MARKETS FOCUS

**Quality and value:**  
The power couple?

MFS' approach to  
**risk management**

# THINKNOW

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Michael Roberge, CFA

We created *ThinkNow* magazine to keep investment professionals and investors informed about market events and to share with you some of the great thinking that is happening at MFS.

Our 11 contributors average more than 22 years of industry experience. The group includes portfolio managers, our chief investment strategist, chief investment risk officer, and a senior marketing director.

From emerging markets and investor attitudes to risk management and a market outlook, the articles inside represent a fraction of the investment insights and market and economic commentary pieces that we regularly share with clients.

We encourage you to visit [mfs.com/think](http://mfs.com/think) to check out our videos and white papers featuring a wide range of original thought.

## WELCOME FROM MFS' PRESIDENT AND CHIEF INVESTMENT OFFICER

# MFS' chief investment strategist highlights four opportunities for early 2012



**James Swanson, CFA**  
 MFS Chief Investment Strategist  
 26 years with MFS  
 37 years in industry

### Credit markets

In a marketplace where a lot of distortion and pain has already been priced in, I see four opportunities. The first is the credit markets. After going through a massive dislocation last August, they have come back a bit recently. We are at the point where these markets have priced in a 25% default rate over the next three years. This outcome did not even occur during the recession of 2008/2009. We're not witnessing record high spreads, but we are seeing relative spreads that are indicative of pricing in a recession that will very likely not occur, or were already priced in.

### High-quality stocks

At MFS, high quality means consistent return, consistent cash flow as a percent of market cap, ability to generate margins over time, multiple product lines, and strong balance sheets. Quality has tended to outperform over long periods. It did not outperform in the period from the market low of March 9, 2009 to December of 2010, but it began to outperform in 2011. Over long business cycles, I believe the market will reward best-of-breed companies that can generate cash flow and profits.

### Technology stocks

The old defensive stocks of the Standard & Poor's 500 Stock Index used to be those in sectors whose earnings and stock movements were considered less volatile. These sectors — utilities, health care, consumer staples, and telecommunications — do not look particularly defensive anymore. Technology is what I call the "new defensive." The cyclical nature of technology stocks has been lessened by the increased percentage of technology sales going to the emerging market consumer. So technology's growth is more secular than cyclical. The sector has also developed other new defensive characteristics — low debt, high cash flows, and conservative balance sheets with high margins.

### Dividend-paying stocks

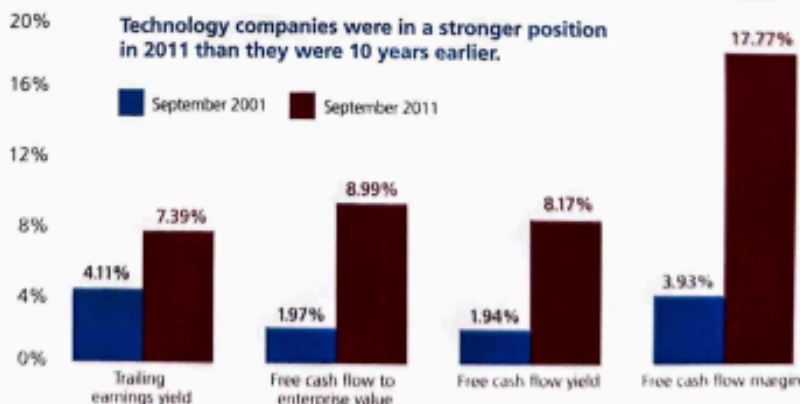
The fourth opportunity is in dividend-paying stocks. Why? Because there is a shortage of yield. The U.S. Federal Reserve Board has effectively created this shortage by promising that short-term policy rates will remain at 25 basis points or lower through 2013. Dividend-paying stocks have tended to do well in the mid to late business cycle.

Read Swanson's blog at [mfs.com/swansonblog](http://mfs.com/swansonblog).



### Technology: "a new defensive?"

S&P 500 Information Technology Sector Index financial characteristics (as of 9/2001 and 9/2011)



Source: Bloomberg. Data as of 30 September 2011

## Thomas Meléndez takes a look at emerging markets equity



**Thomas Meléndez**  
MFS Institutional  
Portfolio Manager  
10 years with MFS  
20 years in industry

**The case for optimism**

One of the main reasons to be optimistic about investing in emerging markets equity is as true today as it was 20 years ago when I started in this business.

**A low base**

I think the emerging market story has legs. Consider that 85% of the world's population lives in EM countries and a high percentage of residents are under 30 years old. We must also look at EM consumption being at a very low base compared with developed economies. For example, the average penetration rate for microwaves in U.S. households is 120%, but in Brazil it's just 30%. Might we see EM rates double or even triple? Absolutely.

**The cause for concern**

Despite the potential for significant growth in consumption and other reasons to be optimistic about emerging markets, other data seem to suggest the need for caution.

**Growth/returns gap**

Most investors would expect EM equity returns to follow economic growth, but a London Business School study of 19 EM countries from 1900 to 2009 found a negative correlation (-0.23) between economic growth and equity returns<sup>1</sup>. Why the disparity? Higher risk levels in these countries.

<sup>1</sup>Dimson, Marsh, and Staunton, 2010. "Economic Growth." *Credit Suisse Global Investment Returns Yearbook 2010*, pp. 13-19.

## Two ways to access opportunities in emerging markets

**Direct investment**

Companies domiciled in emerging markets

- Pros**
- Up to 100% exposure in EM economies
  - Potential to spot early-stage businesses
  - Currency diversification
- Cons**
- Full exposure to the risks
  - Often illiquid or low free float, trading costs high
  - Valuations may reflect hype

**Indirect investment**

Businesses domiciled in developed markets yet earning revenue from emerging markets

- Pros**
- Access to established global brands
  - Experienced management teams
  - Large, liquid stocks
- Cons**
- Majority of sales in sluggish DM
  - May fail to adapt to local business norms
  - Some sectors underrepresented

There are pros and cons to both direct and indirect investing in emerging markets

Source: MFS



Visit [mfs.com/think](http://mfs.com/think) to hear more from Thomas Meléndez.

## Matthew Ryan discusses emerging markets debt — past and present

### Looking back

At the height of the recession, emerging markets were a bystander to most of the turmoil that was going on in the developed markets. That was different than during the 1995 Mexican peso crisis, the 1998 Asian currency crisis, and Argentina's default in 2001. Over the past decade, emerging markets have seen their credit metrics and fundamentals improve, certainly on a relative basis but also on an absolute basis.

### Looking ahead

Looking forward, I feel very good about the asset class. Emerging markets debt will continue to be buffeted by external shocks, including any emanating from Europe's sovereign debt crisis. Still, we expect EMD to be an outperformer in an environment of heightened volatility, mainly because of far superior fundamentals.

### Debt to GDP

Debt to GDP is about 34%. In developed markets it is 94%. EM countries not only went into the financial crisis with better fundamentals, they emerged much stronger, certainly on a relative basis, and even on an absolute basis.

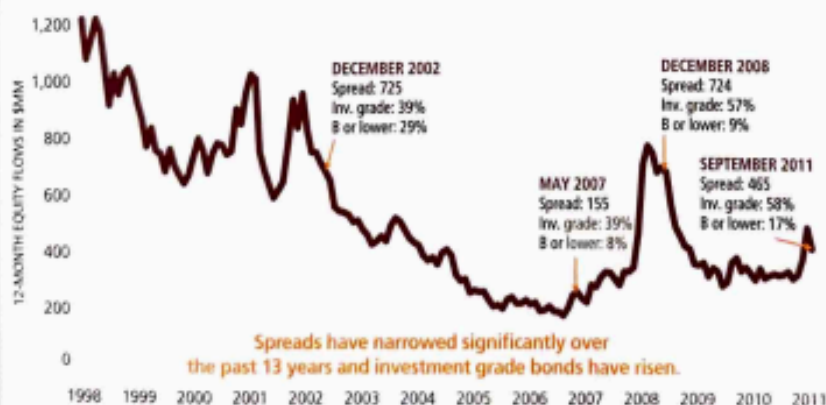
### What are the risks?

There are specific EM countries in which adverse events are either likely, potentially looming out there, or already occurring. For example, there is a concern about a hard landing in China. It's not a big component of the emerging market debt indices, but it is a bigger component of the EM equity indices. China accounts for about 40% of incremental global demand and is the number one consumer of several key commodities. The Chinese have a huge impact on the global economy and many EM economies because many of these economies are commodity exporters.



**Matthew Ryan, CFA**  
MFS Portfolio Manager  
15 years with MFS  
25 years in industry

### Improving fundamentals of emerging markets debt



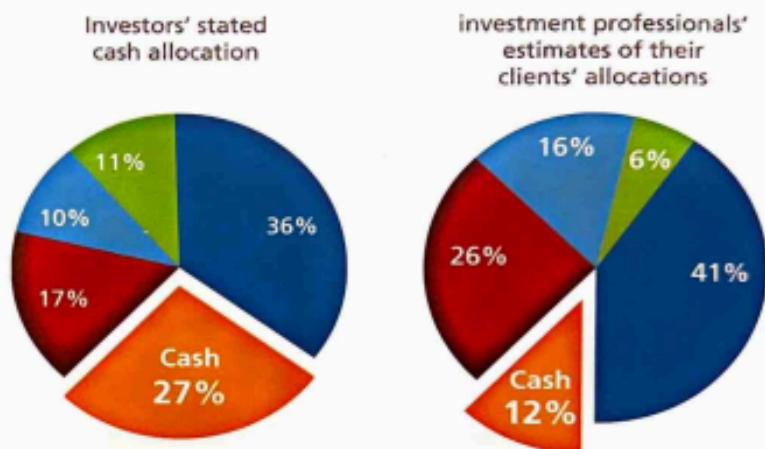
The ratings refer to the percentage of the JPMorgan EMBI Global Index rated investment grade and B or lower.  
Sources: Bloomberg, JPMorgan EMBI Global Index, as of 30 September 2011. Principal and interest of U.S. Treasury securities are guaranteed by the U.S. government if held to maturity.

It is not possible to invest directly in an index. Past performance is no guarantee of future results.

## INSIGHTS

## Investors are still favoring cash...

MFS® in October 2011 conducted a third round of its Investing Sentiment Survey. Previous surveys found investors increasingly turning to cash, and this latest round reveals an even greater cash allocation.



## SURVEY METHODOLOGY

MFS® sponsored an online survey by Research Collaborative, an independent research firm, from September 28 to October 13, 2011, of 929 individual investors with \$100,000 or more in household investable assets and 644 licensed investment professionals who have been licensed for at least three years with \$500,000 or more in annual mutual fund sales. All investor respondents make or share in making financial decisions for their households. MFS was not identified as the sponsor of the survey.

Investment professionals significantly underestimate how much their clients are holding in cash.

■ Cash ■ U.S. bonds/Bond funds ■ Global investments ■ Other ■ U.S. stocks/Stock funds

## OTHER KEY SURVEY FINDINGS:

- Fear and the desire for protection and security are the primary motivators for investors increasingly turning to cash.
- The shift to cash seems to be a more permanent shift in mindset and not a short-term response to market conditions.

## ...how do we get them back to a portfolio that matches their long-term goals?



MFS' Senior Managing Director of Retail Marketing William Finnegan offers **three questions** investment professionals may want to consider to address this attitude shift and determine how to effectively help investors' overcome market fears and inertia.

### 1

#### Is this a permanent or temporary shift in investor mindset?

"At this point it appears to be a more permanent shift. Investors have been severely shaken by the volatility of the stock markets. It will take a prolonged period of lower volatility and positive returns to change their mindset. The old notion of missing the best days in the market probably will not work. A more sensible approach is to guide investors back more slowly. Look to more conservative equity products or balanced products that have had historically lower volatility. As investors attitudes about the markets improve, they may be willing to consider taking on more risk."

#### WHAT ELSE YOU CAN DO?

- Talk to your clients regularly and communicate simply, transparently, and authentically.
- Ask probing questions to determine why investors are feeling the need for larger safety nets and listen for the emotions that may be driving their investing decisions.
- Reach out frequently and proactively to inform, reassure, and provide perspective.
- Don't forget about younger investors — their need for advice is pressing and they present a significant business-building opportunity.

### 2

#### Is our intellectual response appropriate?

"The depth and length of the employment recession makes even the most "job secure" person nervous. So, it is important to discuss why so much cash and don't settle for the first answer. Some investors just need the comfort of cash to sleep at night. But others, when they understand just how many months of expenses they can cover with their cash cushion, and the real return on their cash, may be willing to discuss some conservative alternatives."

### 3

#### Should we provide simple or complex solutions?

"The answer appears obvious, but judging by products coming to market, it may not be all that obvious. New products designed to dampen volatility while providing acceptable levels of returns may incorporate some pretty technical strategies. Investors want more information about what they are buying and how it works. If they can't understand it, it probably is not for them. Using more traditional balanced or allocation products, that are more easily understood, might be a good way to help clients know what they own and how it might react in varying market environments."



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## Investing in value with a quality bias: Does history confirm its merits?



**Katrina Mead, CFA**  
MFS Institutional  
Portfolio Manager  
14 years with MFS  
17 years in industry



**Jonathan Sage, CFA**  
MFS Portfolio Manager  
12 years with MFS  
16 years in industry

MFS has long believed that focusing on investing in higher-quality companies at compelling valuations can accrue meaningful benefits for our clients over time.

Katrina Mead and Jonathan Sage, MFS portfolio managers, set out to test this thesis. They looked at the performance of the largest 1,000 companies in the United States from 1975 to 2010 and a similar universe of large-cap non-US stocks from 1989 to 2010. Results confirmed the "high quality at compelling valuation" investment approach that MFS follows.

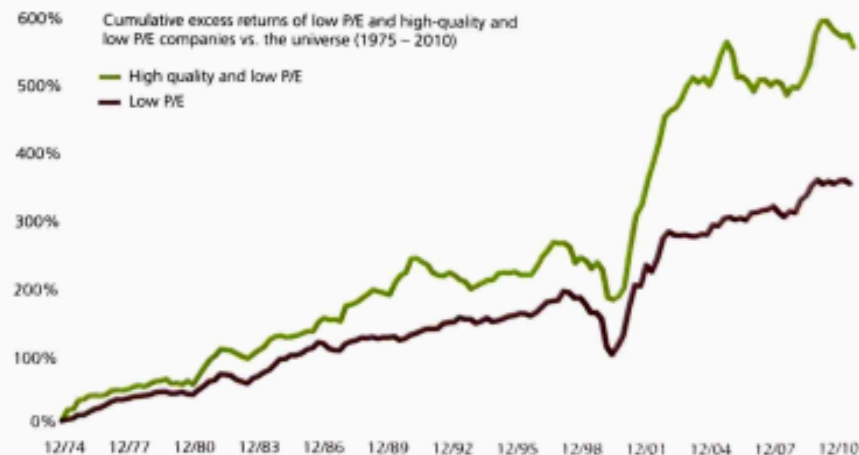
A few highlights:

- Quality characteristics of companies tend to be persistent over time.
- Investing in quality without regard for valuation is not a compelling way to drive alpha over time; valuation is an even more significant driver of longer-term investment performance.
- Owning companies that are both high quality and inexpensively valued is shown to be the most effective way to generate sustainable, long-term performance.
- There is a modest benefit, about 35 basis points per year of outperformance, to owning stocks of high-quality companies regardless of valuation over the entire 35 years.
- When quality and value were combined, outperformance was even more significant: 610 basis points per year.

Visit [mfs.com/think](http://mfs.com/think) to listen to more investment insights from MFS.

### Quality and value have been powerful drivers of long-term equity performance over the past 35 years

Stocks in the quintile with the lowest P/E ratios outperformed the broader 1,000 stock universe by 490 basis points per year over the 35-year period examined. When quality and value were combined, outperformance was even more significant: 610 basis points per year.



Sources: Compustat and MFS. Note: This analysis does not include transaction costs. Based on a buy and hold strategy that was rebalanced quarterly. They are not intended to represent any actively managed portfolio.

# Q & A

WITH



**Michael Roberge, CFA**  
MFS President and  
Chief Investment Officer

16 years with MFS  
22 years in industry

## Deep roots, investment in our business, and global integration

Discuss MFS' unique relationship with your parent company, Sun Life Financial.

**Michael Roberge:** We have had the good fortune of being owned by Sun Life Financial since 1982. That has provided us stability throughout the organization. They have definitely understood that we are a separate business. If you look at asset managers that have been owned by insurance companies and banks, historically they have not been very good asset managers over time. This is usually the case because the banks and the insurance companies provide an overlay on top of those firms. Sun Life has been extremely good about letting us run our own business.

Can you tell us about some of the firm's growth plans?

**Roberge:** From a strategic perspective, we need to continue investing back in the business so we can keep offering products with the potential to provide solid long-term results for our clients. We plan to open a new investment office in Hong Kong. We recently added two people to cover Brazil. In late 2011, Sun Life transferred McLean Budden, a Canadian investment manager, to MFS. Overall, we continue to hire people, and we continue to seek alpha opportunities for our clients across our entire platform of products.

Can you talk about the firm's long-term investment in research?

**Roberge:** It took the company 20 years to build our global research platform. It has been extremely complicated to bring together and coordinate efforts around the world, but we've seen this investment pay off. Today, we have people on the ground in over 80 countries. A question I often get is "Do you really need to be in so many countries?"

In my opinion, the art of investing requires sitting across the table from a firm's management team and reading their body language. We need to assess whether that team's strategy makes sense and whether they can execute on that strategy.

Having a strong local presence in these countries gives us a distinct advantage over the competition. We have 200 people on the investment side and organize our staff around sector teams. We start with one big team, but work in dynamic, nimble teams that can respond quickly to any movements in the market.



## Our global research platform at work



**Ted Maloney**  
MFS Director of Research  
7 years with MFS  
11 years in industry



**Stuart McPherson**  
MFS Research Analyst  
2 years with MFS  
25 years in industry

### The Case: Valuing mining stocks

*The future price of commodities such as iron ore is an important item for MFS' global capital goods team, for the three MFS analysts who cover mining stocks, and for the rest of the team members who need to think about the price as a function of input costs that can or cannot be priced through to customers. MFS' global team of analysts shares valuable pricing and market data that impacts how we value companies and where we decide to invest.*

**Ted Maloney:** Because of the interconnect- edness of our global research, we are always helping each other to make sure we get to the right answer.

It is important to me — not just as someone who is partly responsible for the global capital goods team, but someone who's also responsible for a handful of industrial stocks — to have a real understanding of and real input into what the team is coming up with for its framework for the price of iron ore. We actively encourage this kind of collaboration across geographies and asset classes. But, the magic is that it doesn't take a lot of encouragement because our investors realize very quickly that they will be better investors in their own stocks if they actually understand what's going on globally.

**Stuart McPherson:** The analysts who cover mining stocks globally sat around the table to hammer out an agreed framework of normalized (long-term) target prices for key commodities, including copper and iron ore. We agreed that while marginal cost is a good starting point, it is not a great basis for normalizing the prices of commodities.

We reached agreement on the premium we should apply to each commodity, given supply and demand fundamentals and long-term historical experience. This enabled us to come up with a common commodity price framework, a key input when forecasting earnings at mining companies and ultimately valuing their shares. Clearly, if we get things wrong during this process, we are liable to get the stocks wrong and suffer from bad performance. We have chosen to do it this way, *i.e.*, through cooperation and consistency, but there is a selfish aspect as well because we think we'll deliver better forecasts, better valuations, and better performance numbers by cooperating.



Visit [mfs.com/think](http://mfs.com/think) for more on MFS' global research platform



**Kevin Beatty**  
Director of Equity –  
North America  
10 years with MFS  
26 years in industry

### Collaboration is key between equity and fixed-income analysts

During a capital goods meeting years ago, one of our equity analysts said, "I spoke with this company's CFO late yesterday, balance sheet's fine, he ran me through the debt maturities and there seems to be no problem from a cash flow perspective." Our fixed-income analyst, meanwhile, responded, "It's not that the CFO is lying to you. It's just that there's nothing happening in our markets right now. There's no paper rolling. Our markets are effectively closed. So nobody is refinancing their short-term loans."

You can imagine this additional information made all of us across the equity department take notice to work even more closely with our fixed-income counterparts to make sure we could help each other.

## How we strive to avoid common risk management pitfalls

Joseph Flaherty, Jr.  
MFS Chief Investment  
Risk Officer  
19 years with MFS  
27 years in industry



Let's consider some of the broad policies and practices that existed at some of the firms that failed, from a risk management perspective, during the financial crisis. I like to refer to these policies as the **five principles of risk mismanagement**.

1. Rely solely on quantitative models and methods that, while precise, are unable to handle some of the vulnerabilities and complexities of a new financial landscape.
2. Focus on what is most likely to happen based on history. Consider only what's happened in the past and focus only on the center of the distribution because that is the most likely outcome.
3. Take comfort in a single standard risk metric, like value at risk, without having done your own due diligence, without understanding the underlying assumptions and limitations, and assuming that because it's an industry standard, somebody else must have done that.
4. Incentivize risk-seeking behavior through short-term, asymmetric compensation schemes.
5. Take your risk management team, and in your quest to create independence, isolate them from the investment process and put them in a position where they don't understand what's going on with the investment side and have no ability to influence positioning and behavior.

At MFS, we are careful to avoid these pitfalls. When it comes to risk management, we believe **three things differentiate us from other firms: our philosophy, our structure, and our approach**.

### **Philosophy: Integrating risk management into the investment process**

Our philosophy is to balance risk and reward potential and budget risk to the areas where we think we have the greatest skill and the greatest likelihood of delivering performance.

### **Structure: Ensuring checks and balances**

Our structure is a balance between being integrated into the process and being independent from an oversight and monitoring standpoint.

### **Approach: Driving performance through security selection**

Our approach is a holistic blend of quantitative analysis and qualitative assessment. It is important to make sure that we actually align our risks with our global research advantage. It is not about eliminating risk. It's about identifying it, quantifying it, understanding and managing that risk, providing portfolio managers with flexibility to take advantage of opportunities in the marketplace, but at the same time sourcing value from the area where we think we have the greatest skill.



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to hear more from  
Joseph Flaherty.

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Five ways companies  
will invest their cash



Asset allocation  
during crisis



**Investment  
insights**

Five principles of  
risk mismanagement



Direct or indirect exposure  
to emerging markets?



Understanding  
investor needs



**MFS  
capabilities**

Global research  
platform



An illustration of a  
global team in action



Risk management  
in practice



No forecast can be guaranteed.

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