

# Quarterly Portfolio Update

## Pioneer Funds – U.S. Mid Cap Value

### 30 December 2011

Equity

## Review

US double-dip recession risks were largely dispelled in the fourth quarter, with employment, business profits and confidence all showing strength. The European-debt crisis is far from resolved, but interest rate cuts and liquidity injections from the European Central Bank eased immediate pressures on markets.

Treasury bond yields declined modestly (the 10-year yield declined from 1.95% to 1.86%) and credit spreads narrowed in the fourth quarter, helping the BarCap US Aggregated Bond Index return 1% for the quarter (and 8% for the full year).

The Russell 3000 Index, a broad measure of the US stockmarket, recouped the majority of its third-quarter losses with a 12% fourth-quarter gain, ending up 1% for the full year.

The US continued to perform well relative to other global equity markets, reflecting both better economic growth and a strengthening currency: the MSCI EAFE international developed market and emerging markets equity indexes returned 3% and 4%, respectively, for the quarter: each was down more than 10% for the full year.

Smaller-cap stocks, which tend to be more volatile and economically sensitive than larger-cap stocks, outperformed in the fourth quarter: the S&P 500 Index returned 12%, while the small-cap Russell 2000 Index returned 15%; for the full year, the S&P 500 returned 2% (all from dividend income: its price-only return was 0%), while the Russell 2000, unable to recover all the ground it gave up in the third quarter, returned -4%.

Defensive names and groups had been favoured over cyclically-sensitive investments in the third quarter correction; that pattern was reversed in the fourth quarter rally. Within the S&P 500, the economically sensitive Energy (up 18%), Industrials (16%) and Materials (15%) sectors led, while the defensive Telecom Services and Utilities sectors (each up 8%) lagged.

In terms of fourth quarter sector results, all but one of the ten sectors of the Russell Mid Cap Value Index finished

strongly positive. Materials and Energy were up 23% and 22%, followed by Industrials (+16.5%), Consumer Discretionary (+15.9%), Financials (+13.7%) Information Technology (+10.9%), Utilities (+10.4%), Consumer Staples (9.4%) and Health Care (+5.8%). Telecommunications, the lone laggard, was down 6.3%.

## Performance Analysis

Pioneer Funds – U.S. Mid Cap Value (Class A, non-distributing, USD units in USD) returned 11.28% in the fourth quarter, compared to 13.37% for its benchmark, the Russell Mid Cap Value Index. Returns for the year were -7.62% and -1.38%, respectively.

Portfolio underperformance in Q4 was primarily driven by sector allocation decisions, in which overweights to the Health Care and Telecommunications sectors, and underweights to the Consumer Discretionary and Materials sectors were factors. Stock selection in the Industrials, Consumer Discretionary, Materials and Utilities sectors also detracted.

Positive relative performance came from superior stock selection in Health Care and Financials (where four of the portfolio's top ten contributing holdings resided), as well as Information Technology, and Consumer Staples, helped by an underweight to the Utilities sector.

In the Consumer Discretionary sector retailer Kohl's, underwear maker Hanesbrands, and auction house Sotheby's underperformed, although that impact was partially offset by strong returns from upscale hotel company Wyndham Worldwide and home builder Toll Brothers.

Kohl's shares, following a 33% run-up between early September and mid-November, pulled back sharply following lower-than-expected same-store sales in December. We continue to own Kohl's but are actively analysing the position at present. Hanesbrands, a smaller position, declined in sympathy as one of its competitors, Gildan Activewear (not a holding) cut earnings guidance early in the month. We added to the position because we believe that the sympathetic downdraft was unwarranted and due to the company's different business mixes.

Auction house Sotheby's was off due to choppiness in the art market. We continue to hold the stock given that its discounted valuation has a favourable long-term outlook for the art market. Homebuilder Toll Brothers contributed positively to performance, driven by early signs of a recovery in the housing market.

In Healthcare, strong performance by Salix Pharmaceuticals and Humana added to performance. Salix outperformed after the FDA ruled for more stringent hurdles for the development of generic competition to its primary drug Xifaxan. Humana, a managed health care company, benefited from strong earnings guidance driven by a benign outlook for cost inflation. Baxter International, which specialises in products for blood disorders, fell on concerns about increased competition and economic softness in Europe.

In Financials, insurer Aflac and regional bank KeyCorp, were solid performers. Aflac's shares gained on sales momentum and higher margins. We like its strong capital levels, "de-risked" investment portfolio, sales momentum, and discounted valuation. KeyCorp performed well on signs of life in its lending and continued credit improvement.

In Telecoms, NII Holdings, a Latin American mobile phone company, detracted from performance as greater competition and foreign exchange rate movements caused downward earnings revisions. We exited the position.

## Portfolio Strategy

In fourth quarter trading, the biggest change made to the Portfolio was our reduction in exposure to the Health Care sector, cut by approximately 5%. We eliminated medical device company Zimmer on pricing and a slowdown in hip and knee procedures, its primary market. We also exited our position in hospital owner Tenet, as low utilisation and poor patient mix continue. In addition, we exited Baxter and life sciences company, Thermo Fisher.

In other trading, we increased our weighting in the Consumer Discretionary sector adding four new names, while eliminating two. We added Hanesbrands given its deeply discounted valuation and our expectation for strong second half earnings driven by price increases and lower cotton costs. We also added speciality retailer Guess and motorcycle manufacturer Harley Davidson. We exited media company CBS on stock price appreciation.

At the end of the year, our largest overweights relative to the benchmark were Information Technology (10.2% vs.

8.1%), Industrials (12.1% vs. 10.4%) and Financials, (32.6% vs. 30.1%). Our largest relative underweights were Utilities (8.7% vs. 14.6%) and Health Care (5.5% vs. 5.9%).

## Outlook and Positioning

Continued improvements in unemployment and company fundamentals, low inflation, low interest rates and moderate equity valuations leave us encouraged regarding equity prospects in 2012. In some sectors, such as Housing and Banking, we see stabilisation or slowly improving fundamentals coupled with discounted valuations. We are concerned with the US consumer but expect an improving employment market to help improve the outlook for this sector. We continue to like Industrials, although we expect margins may begin to stabilise due to rising commodity prices (oil), and less cost-cutting going forward. Our biggest concern is economic slowdowns in Europe and Asia, which could drag on the US economy.

Our investment approach emphasises higher quality companies with generally higher returns and margins, superior balance sheets, defensible market positions, and good managements. We also look for low valuations and a long-term strategy for improving the business, and sometimes a controversy or concern that we believe will prove unfounded.

Clearly, the global economy is dealing with a difficult period with regard to economic growth and may remain challenged for some time. As such, we think a portfolio with these characteristics should perform relatively well.

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