



Raging Bull



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Utilities Sector Overview

Defensive characteristics help now, but what about in a market recovery?

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Highlights

We recommend an underweight allocation to the Utilities sector.

Our underweight recommendation reflects our preference for early cyclical areas of the market.

Utility companies rely heavily on the credit markets, which impairs the near-term outlook but offers potential the sector may rally.

Valuations and yields are not compelling despite recent sector declines.

Exposure to commodity price fluctuations presents a risk to the independent power producers, though this risk has moderated.

Policy changes resulting as Democrats gain more control in Washington are likely to create a more challenging environment for the sector.

Within the Utilities sector, we favor the regulated utilities over the independent power producers.

We recommend an underweight allocation to Utilities, due in large part to our preference for early cyclical areas of the market that we expect to perform better as the economy stabilizes and the market rebounds. While this is the primary reason for our cautious outlook, several other factors suggest limiting exposure, including relatively less attractive sector yields, fair but not compelling relative valuations, and an increasingly challenging regulatory environment. Tight credit markets and downside risk to commodity prices also suggest caution.

On the flip side, the sector's high earnings visibility and defensive characteristics have helped relative performance during the market's recent slide, which could continue. Market interest rates may fall further, which could improve the relative attractiveness of the sector's dividend yields. Recent merger transactions suggest underappreciated value in the group. Natural gas prices may rebound and boost power prices. And if the recent improvement in the credit markets continues, the most leveraged sectors such as Utilities could benefit most, at least in the short run.

Within the sector, we favor the regulated utilities over the unregulated or independent power producers. Logically, the integrated utilities, which are a combination of the two, are rated neutral. Details to support these views can be found at the end of this report. Note that the S&P Utilities sector is less than 4% of the S&P 500.

UTILITIES SECTOR

Utilities Sub-Group	Recommendation/Outlook	Change from Prior
Regulated Utilities	Neutral to Positive	↑
Integrated Utilities	Neutral	↓
Independent Power Producers	Neutral to Negative	↓

Source: LPL Financial Research

Important Disclosure Information:

Please refer to the last two pages for important disclosures.



Our underweight recommendation reflects our preference for early cyclical areas of the market. Our sector recommendations are positioned to perform well in a rebounding market once the economy stabilizes and the market recovers. In this environment, the early cyclical areas of the market would likely outperform. As we have cited in previous editions of this publication, early cyclical sectors include Consumer Discretionary, Industrials, Technology and, to a lesser extent, Financials.

The Utilities sector, on the other hand, has historically been a defensive sector that performs better in lackluster market environments, when investors are looking for reliable income and wealth preservation. Accordingly, the sector typically behaves like a bond proxy, because investors in the sector are attracted to its above-average dividend yields. A slow economy tends to be accompanied by low interest rates and better bond and bond-like investment performance, though in the current crisis, the bond market has not quite followed this playbook.

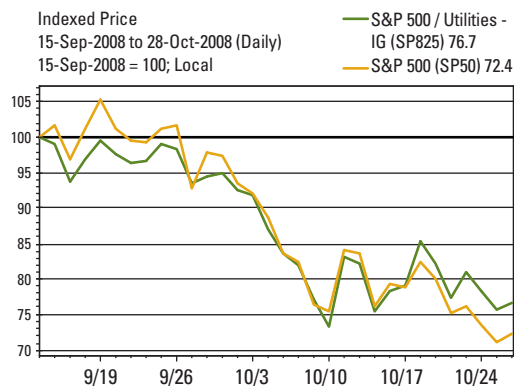
During the most recent market declines after Lehman Brothers failed on September 15, utility stocks sold off sharply along with the entire equity market. However, the sector has held up slightly better than the overall market during this period, outpacing the S&P 500 by about 400 basis points. The relative performance numbers are similar on a year-to-date basis. When we transition from market declines to a recovery, based on the 1990 and 1998 bottoms as a guide, we would expect the sector to lag the market.

The potential for rising interest rates is another source of concern in this sector. Historically, the dividend yields on utility stocks track market interest rates due to their bond-like characteristics. In addition, higher market interest rates reduce the present value of future dividends, which can be drag on stocks with bond-like characteristics such as Utilities. That means that rising market interest rates could pressure these stock prices, assuming dividend payouts don't increase much. Dividend yields can only rise for two reasons, either lower stock prices or dividend increases. In the current economic environment, dividend increases are less likely.

Utility companies rely heavily on the debt market, a near-term negative that provides the potential for a short-term bounce. The Utilities sector relies heavily on the debt markets. The average debt-to-capital ratio for the utility companies in the S&P 500 is .52. For comparison, the same ratio for the Technology sector is just .21. Accordingly, the ongoing credit crunch has more short-term impact on utility companies than technology companies, on average. Non-financial corporations overall have less debt than utilities as well.

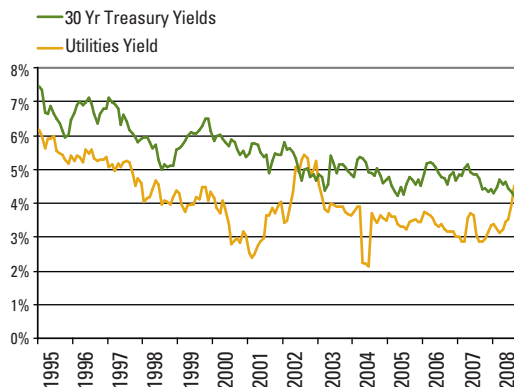
The counter-argument here is that the earnings streams of utility companies is typically more predictable during challenging economic environments than it is for more cyclical companies. As a result, once credit becomes more available, these heavily leveraged companies should trade on their earnings rather than on the availability of credit. Even in that scenario, we believe any relative outperformance from this sector on a credit relief rally would be short-lived.

1 Utilities Held Up Slightly Better than the Market Since Lehman Brothers Failed



Source: FactSet, LPL Financial Research

2 S&P 500 Utilities Yield vs. 30 year Treasury Yields



Source: FactSet, Bloomberg, LPL Financial Research

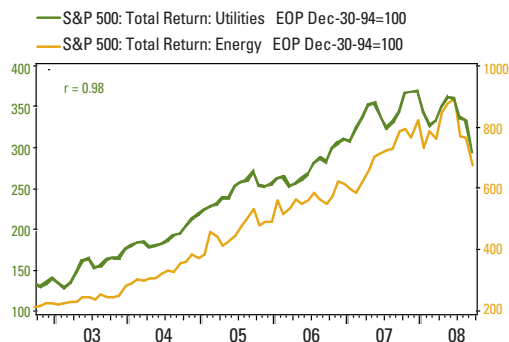


Another way the lack of available credit is negative for the sector is by dampening merger and acquisition activity. Despite the recently announced takeover bid for NRG by Exelon, the acquisition premiums these stocks enjoyed when credit was flowing are gone. While the Exelon bid and Warren Buffett's recent purchase of a power producer are positive developments, additional deals are likely to be few and far between. We believe Buffett's purchase was a unique situation and not indicative of a pending buyout wave.

Exposure to commodity price fluctuations presents a risk to the independent power producers, though this risk has moderated as prices have fallen. In recent years since the industry was deregulated, utility stocks have become more tied to the prospects for commodity prices and the Energy sector. Accordingly, we believe the sector still carries some downside risk associated with potential commodity price and energy sector weakness. The unregulated independent power producing utilities benefit from higher energy prices, mainly natural gas, by passing higher rates on to consumers and selling power inventory at higher prices.

A look at the correlation between the S&P 500 Energy and Utilities sectors illustrates this point. In fact, the correlation is nearly perfect over the past five years for the two sectors, at 0.98, and higher than the correlation between Utilities and any other sector. The Utilities sector is also highly correlated to the S&P 500, but not as much as to Energy.

3 The Utilities & Energy Sectors are Highly Correlated



Source: Standard and Poor's / Haver Analytics, LPL Financial Research
10/28/08

While we expect energy prices to go sideways or fall, we do acknowledge that in an Energy-led rally, if oil and gas prices rise, Utilities will get a lift. Energy and Utilities have performed relatively well on recent up days, a trend that we do not expect to continue as the market transitions from defensive, late cycle investments to the early cyclicals that are likely to beat the market in a recovery.

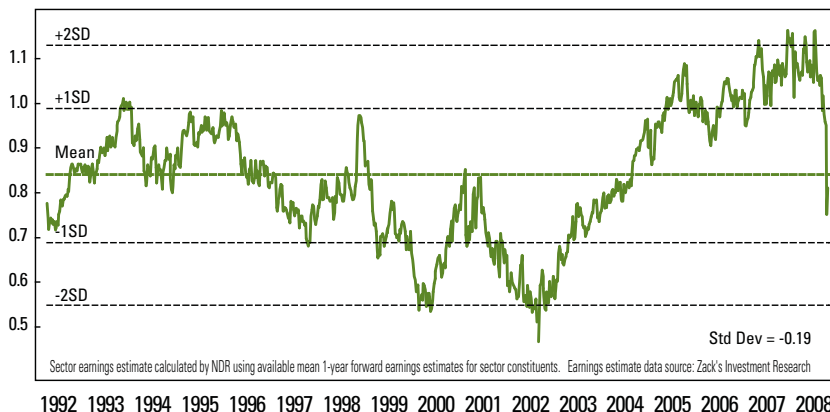
Valuations and yields are not compelling despite recent sector declines.

At first glance, one might conclude that the Utilities sector is dirt cheap at a forward P/E of about 10. Earnings are likely to grow at or near a double-digit rate during the next 12 months, if analysts' forecasts are accurate. This valuation is clearly attractive in absolute terms, and we do expect the sector to trade higher over the next 6 to 12 months. However, relative valuations and relative performance are more telling; and on that basis, the sector does not look especially compelling. The discount to the S&P 500 on a forward P/E basis is about 20%, which is only marginally below the sector's average over the past 16 years.



Relative Valuations are Fair and Improving, but not Especially Compelling

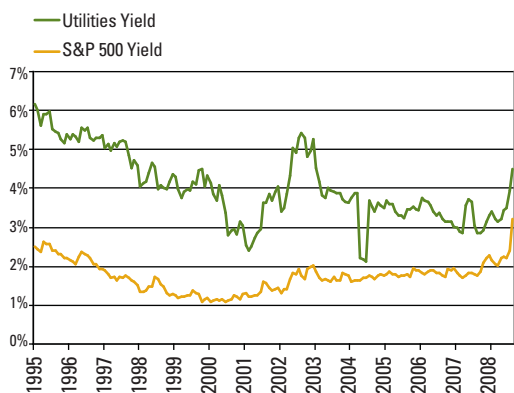
Ratio of S&P 500 Utilities Sector Forward P/E to S&P 500 Forward P/E
10/17/2008 = 0.8



Source: Ned Davis Research, LPL Financial Research

Utilities valuations are also commonly evaluated by their relative dividend yields, because so many investors own utility stocks for income. Relative to long-term Treasury yields, the sector's current yield of about 4.5% looks good. As shown in the previous chart, the two yields are right on top of each other. However, the spread between Utilities yields and the yield on the S&P 500, now at 3.2%, is only 130 basis points. As shown in the accompanying chart, that spread is as narrow as it has been since 1995. The prospects for greater capital appreciation in the broad market, we believe, offset the slim relative yield advantage. So while yields near 5% are attractive in a low interest rate environment, and financial company dividends are less certain, the relative income from the sector is not especially compelling, in our view.

4 Utilities Dividend Yields vs. S&P 500 Yields Since 1995



Source: FactSet, Bloomberg, LPL Financial Research

Policy changes resulting as Democrats gain more control in Washington are likely to create a more challenging environment for the sector. More Democrats in control in Washington will likely bring a more challenging regulatory environment for utility companies. For one, increasingly tough and costly environmental regulations are likely, including mandated use of renewable energy sources as well as carbon footprint limits. A focus on climate change will increase support for alternative energy. Moreover, the tax rate on dividends is likely to increase, perhaps retroactively in 2009. Given the importance of dividends to utility investors, this consideration could weigh on the group more now that the election is just days away.

Within the Utilities sector, we favor the regulated utilities over the independent power producers. The cleaner the better! Within the sector, we favor the regulated utilities over the independent power producers. We rate the integrated, or multi-line utilities neutral, which is logical given that these utilities are a blend of regulated and non-regulated businesses. Our preference for less commodity price risk and higher predictability of earnings is the primary reason for our preference for the regulated and multi-line



utilities over the unregulated power producers. The ability of regulated utilities to recover their costs associated with providing cleaner power positions them well for a Democrats' regime in Washington. Substantial investment is required not just for environment controls and renewable energy, but also to upgrade the grid for basic transmission and distribution. For those advisors investing in individual utilities, we would focus on the cleaner gas-powered and nuclear utilities over dirtier coal.

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Alpha: Incremental return due to non-market factors. A positive alpha indicates that the portfolio has produced returns above the expected level at that level of risk. Alpha measures a fund's risk-adjusted performance. It represents actual returns less the fund's risk adjusted performance as measured by beta, and is expressed as an annualized percentage.

Capital Ratios: a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.

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

P/B Multiple - Determined by dividing current stock price by shareholders equity for the most recent quarter.

PTB - Stock price divided by shareholders equity per share.

Book Value - A company total assets minus intangible assets and liabilities, such as debt. A company's book value might be higher or lower its market value.

Forward P/E- Price/earnings ratio, using earnings estimates for the next four quarters. Book value yield - is the ratio of a company's shareholders equity to its market capitalization.

DESCRIPTION OF INDICES

Indices are unmanaged and cannot be invested into directly.

Prepared and published by Dow Jones & Co. It's one of the oldest and most-widely quoted of all the market indicators. The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries, and widely held by individuals and institutional investors. These 30 stocks represent about a fifth of the \$8 trillion-plus market value of all U.S. stocks and about a fourth of the value of stocks listed on the New York Stock Exchange. It is not possible to invest directly in an index.

The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S. based common stocks listed on The Nasdaq Stock Market. The Index is marketvalue weighted. This means that each company's security affects the Index in proportion to its market value. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index. It is not possible to invest directly in an index.

Relative Strength is a technical momentum indicator that compares the magnitude of recent gains to recent losses in an attempt to determine overbought and oversold conditions of an asset.

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