

The Long View

2018 Edition, Issue 1



Investing
through
adversity



Investing through adversity

“I think the most important thing is to keep a long-term orientation. Trying to figure out what the market’s going to do today or even next week is an impossible task and one that I don’t think is helpful to creating long-term wealth.”

TIM ARMOUR
PORTFOLIO MANAGER

After a long, calm period of relatively strong returns, global equity markets gave way to a jarring bout of volatility earlier this year. The turmoil served as a reminder that markets can and will change, and that a measured, long-term approach to investing is paramount in today’s environment.

Overdue and not entirely unwelcome: That’s one way to look at the correction in the S&P 500 earlier this year. Although swift declines can be unsettling, they have long been part of the investment environment.

“We were overdue for some kind of correction,” portfolio manager Tim Armour says. “I am not overly concerned about this pullback. Markets do better over the long term when they experience corrections periodically; they can’t go up all the time.”

Tim says that generally solid economic data continues to provide a healthy backdrop for markets in much of the world. In the United States, corporate profit growth remains healthy, tax reform could boost gross domestic product (GDP) and consumer spending is relatively strong. Following strong growth in 2017, the Canadian economy remains in solid shape, and the unemployment rate matches the lowest level in decades.

Abroad, China’s GDP accelerated for the first time in seven years in 2017, and the economies of other emerging markets continue to show strength. Japan’s

economy is in its best shape in years, and Europe is on the rebound. Overall, the International Monetary Fund expects global GDP to hit 3.9% in 2018.

“We still feel good about the economic backdrop for corporate earnings, and we think there are plenty of opportunities to invest in companies that have the potential to reward investors,” Tim says.

Volatility also reinforces the value of diversification, and the role of bonds, Mike Gitlin, head of fixed income, says. “Investors need to stay balanced in their equity and fixed income weightings in their portfolios, especially during times like this. It’s important that investors focus on the four primary roles of fixed income in a balanced portfolio: diversification from equities, income, inflation protection and capital preservation.”

Some core bond strategies may not provide the diversification from equities that investors expect, and that could be a problem in a correction.

“That said, the current pullback may present a great opportunity for investors to upgrade their bond portfolios: that

means reallocating to bond funds that offer the potential for both solid income and diversification from equities,” Mike says.

Tim says the most important thing to do during periods of volatility may be one of the hardest. “You have to contain your emotions. It’s not easy to do on the way up, and it’s not easy to do on the way down, but it is the key to creating wealth over time. Sticking with the fundamentals, employing good asset allocation and maintaining a balanced portfolio with a long-term horizon is the best approach.”

Key Takeaways

- Markets periodically experience corrections that are part of the investment environment.
- The recent volatility has been jarring, but the global economy is largely supportive of corporate earnings and markets in much of the world.
- History shows that staying invested through periods of volatility has rewarded long-term investors.

Bull vs. Bear: Long-term gain beats short-term pain

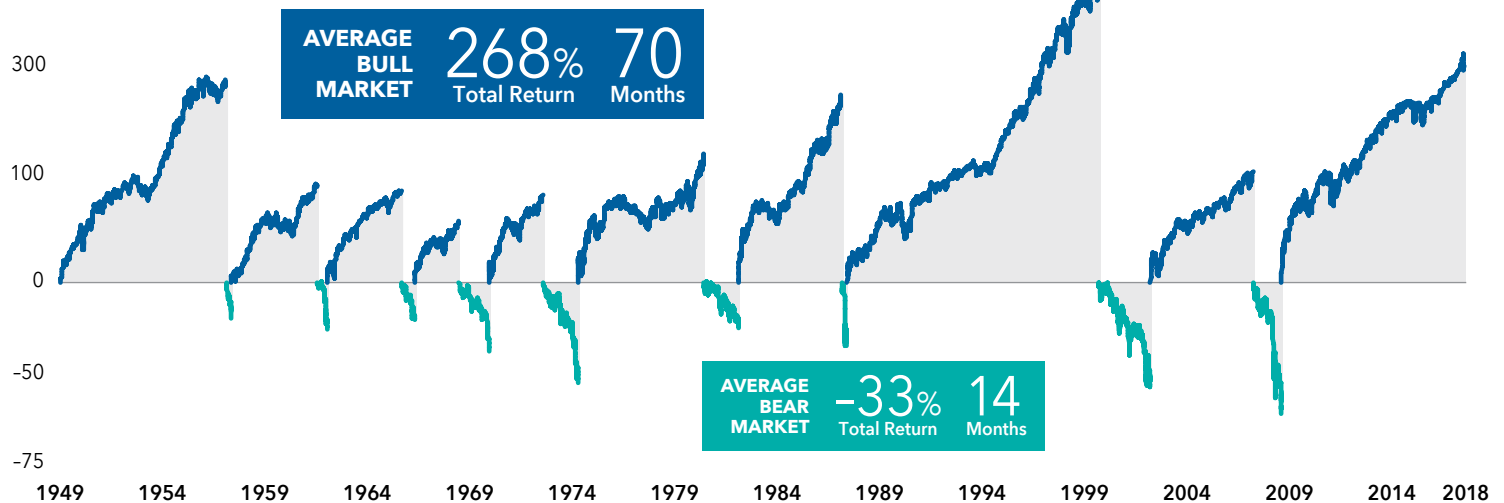
The downside looks less daunting with a long-term perspective

“None of us can predict what the market is going to do in the short term. But what we can do is identify good companies that we think are growing and will be better and bigger companies 10 years from now. If we get that right, through all sorts of market cycles, we are going to do well for our investors.”

TIM ARMOUR
PORTFOLIO MANAGER

Declines can be painful, but missing the upside could be worse

700% Cumulative price return for each bull and bear market



Results calculated in U.S. dollars.

SOURCES: Capital Group, RIMES and Standard & Poor's. Bear markets represent peak-to-trough price declines of 20% or more in the S&P 500. Bull markets reflect all other periods. Returns are shown on a logarithmic scale through February 14, 2018. Past results are not predictive of results in future periods.

Swift and dramatic change can take a toll on investors. When markets falter, some may be inclined to reduce their exposure to equities. Yet history shows that periods of turmoil and steep market declines have subsequently proven to be among the best times to invest. Recent volatility may have caused some investors to panic and head for the exits, but a long-term focus can help put bear markets into perspective. Since 1949 there have been nine periods of 20%-or-greater declines in the S&P 500. And

while the average 33% decline of these cycles can be painful to endure, missing out on part of the average bull market's 268% return could be even worse. The much shorter duration of bear markets (14 months on average), is also a reason why trying to time investment decisions can be difficult and is usually ill-advised. Rather than indiscriminate selling, investors who are nervous about heightened volatility may want to consider objective-based funds with the flexibility to invest in a broad investment

universe and a history of resilience during downturns. Investors should also re-examine their bond exposure for excess risk, as diversification from equities is one of the primary roles of fixed income in a balanced portfolio. Recent history, and the long-term record, show how rapidly the market can turn. The volatility of returns of the S&P 500 dating back about 60 years indicates that investors may be doing real damage to their long-term finances by trying to time the market.

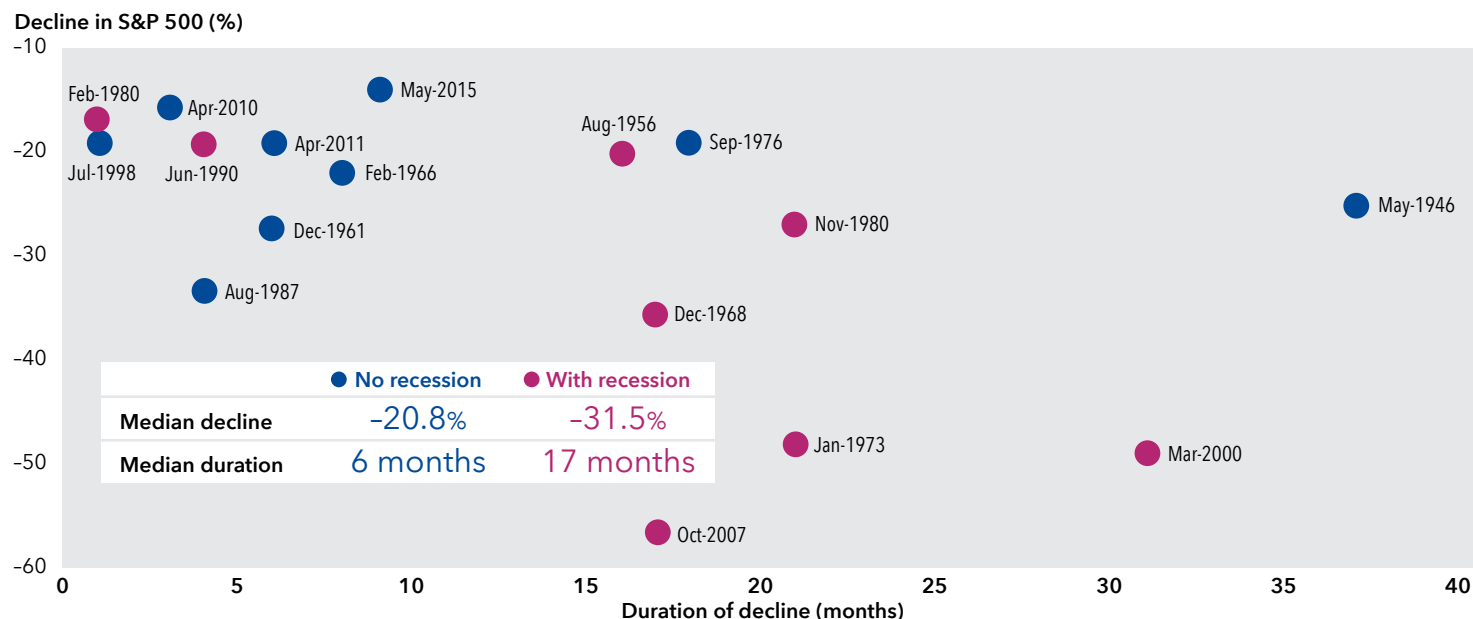
Why are some declines steeper? It's the economy

Some of the most severe declines are associated with recessions

"The U.S. economy has been in an expansion for a while now, but I think it still has a ways to go. There doesn't appear to be anything systemic, or any big imbalances, that we think are of a significant size and nature, that would push the U.S. economy into a recession within the next 12 to 18 months."

DARRELL SPENCE
ECONOMIST

Short, and not that sharp: Since 1945, nearly half of the declines have lasted less than eight months



Results calculated in U.S. dollars.

SOURCES: Capital Group and Standard & Poor's. Dates for declines shown represent market peaks. Peak-to-trough dates are as follows:

May 1946 - June 1949, August 1956 - December 1957, December 1961 - June 1962, February 1966 - October 1966, December 1968 - May 1970, January 1973 - October 1974, September 1976 - March 1978, February 1980 - March 1980, November 1980 - August 1982, August 1987 - December 1987, June 1990 - October 1990, July 1998 - August 1998, March 2000 - October 2002, October 2007 - March 2009, April 2010 - July 2010, April 2011 - October 2011 and May 2015 - February 2016. May 2015 is not an official decline. More severe declines are those associated with recessions beginning within 12 months of the market peak.

Every decline is different. A look back at stock market history since World War II shows that retreats have varied widely in intensity and length. But many declines during that period share a common pattern. In fact, nearly half of the declines since 1945 lasted less than eight months. And, in nearly one-third, the market was back at a new high less than 10 months after it peaked. One important factor in determining whether a decline is major or minor is what's happening in

the economy at the time. The median decline in the S&P 500 during retreats associated with a recession is 10.7% greater than those not associated with a recession, while the duration of the decline is substantially longer. The reason? Earnings fall much more dramatically around major pullbacks than around minor bear markets. Those declines in the lower centre of the chart are among the most serious and have all been associated with a recession.

In relatively recent times, the financial crisis and the tech bust have both had significant impacts on investor sentiment. Market crises are traumatic and costly. But ultimately, the market has not only survived, but thrived. For more than a century, the U.S. market has endured wars, recessions, assassinations, bubbles and busts. And each time it has come back. Through it all, the market has demonstrated a remarkable strength and resiliency in the face of challenges.

Some sectors can provide a measure of protection

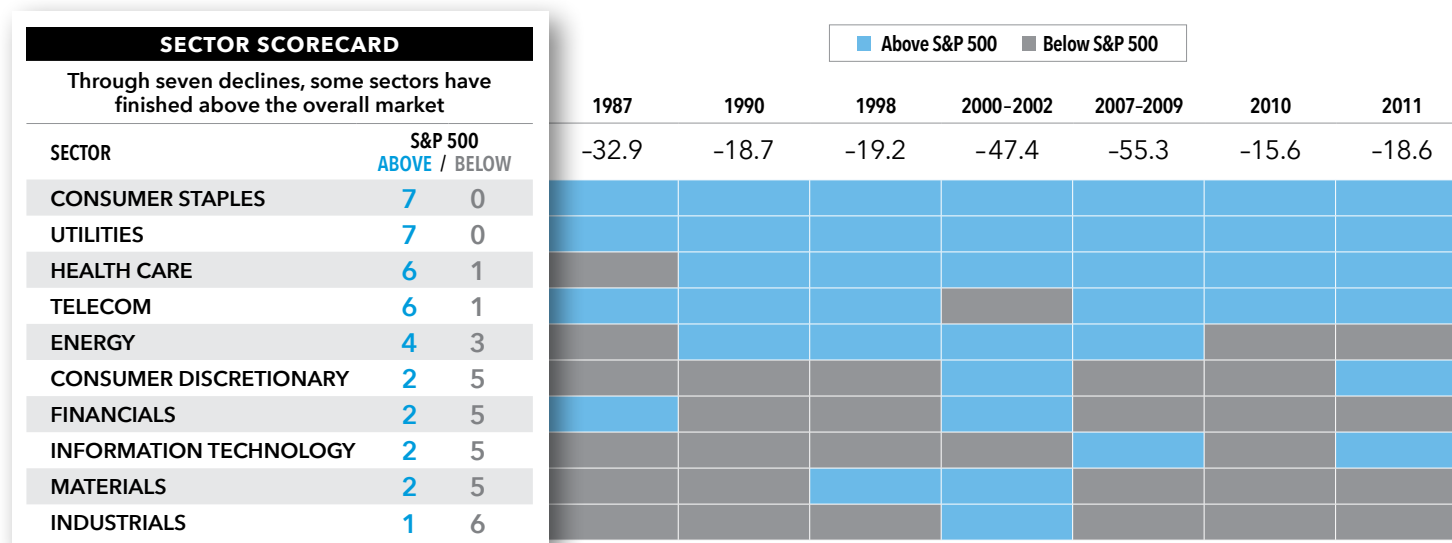
Security selection and diversification can play a role when markets retreat

“The recent volatility has served as a reminder that markets can and will change, so we’ll continue to take a measured, long-term approach, with capital preservation very important in security selection and portfolio construction. I believe that in this environment, our ability to add value will come primarily through security selection backed by fundamental research.”

HILDA APPLBAUM

PORTFOLIO MANAGER, CAPITAL GROUP
GLOBAL BALANCED FUNDSM (CANADA)

Index return doesn’t tell the whole story – some sectors have outpaced the market



Results calculated in U.S. dollars.

SOURCES: Capital Group, FactSet, RIMES, Standard & Poor’s and Thomson Reuters. Sector returns for 1987 are equally weighted, using index constituents from 1989, the earliest available data set.

During the financial crisis that jolted the markets a decade ago, there was nowhere to hide. From its peak on October 9, 2007, to its low on March 9, 2009, the S&P 500 dropped 55.3%. Every sector in the index suffered a serious setback, with the financials sector losing 81.7% of its value. But some sectors held up better than others. Consumer staples, for example, retreated about 29%, while health care dropped 38%. Small comfort, but still relative outperformance.

One of the consequences of the market’s decline during the financial crisis was that many investors questioned the value of diversification. During periods of instability, however, it’s important to maintain perspective, balance and flexibility. A portfolio that has the ability to nimbly explore evolving opportunity sets, using both allocation and security selection, can add value by investing in the right stocks and bonds based on a fundamental, valuation-based approach.

The benefits of diversification may have been lacking in 2008 and early 2009, but generally the principle remains fundamentally sound. Diversification through a strategic allocation to stocks and bonds around the world remains the hallmark of a portfolio that can help investors pursue their objectives in the long run. Such a portfolio can also help investors maintain a long-term perspective and place short-term drivers of the market into perspective.

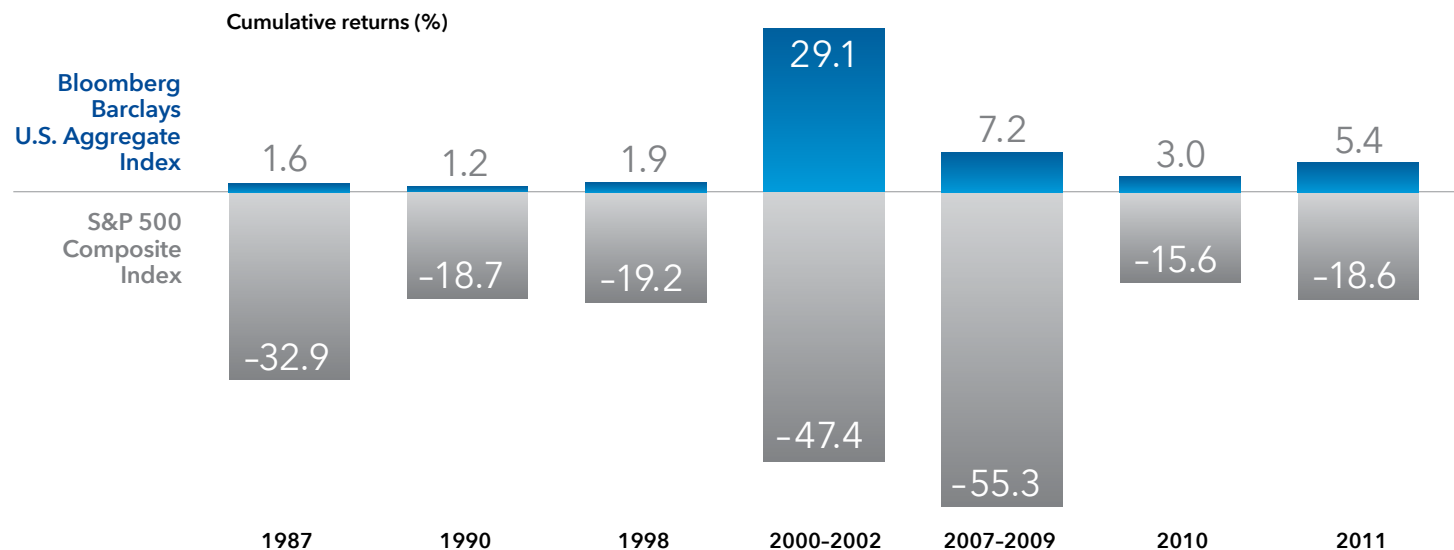
Buffers: Bonds can provide resilience when equities decline

Bonds can help mitigate volatility and provide balance in a diversified portfolio

“There are four roles of fixed income in a diversified portfolio: diversification from equities, income, inflation protection and capital preservation. Nowhere in there does it say, ‘Try to be as equity-like as possible.’ That’s not the fifth role.”

MIKE GITLIN
HEAD OF FIXED INCOME

Bonds have provided a measure of capital preservation in periods of market turbulence



Results calculated in U.S. dollars.

SOURCES: Bloomberg Index Services Ltd., RIMES and Standard & Poor’s.

Bonds play a variety of roles in a diversified portfolio, including providing income, capital preservation and inflation protection. They also help mitigate volatility. When equities are volatile, bonds typically provide balance to a portfolio. The chart shows that in market declines of at least 15% during the past three decades, bonds have provided relatively significant positive returns. That’s one of the reasons to invest in bonds, even in a rising rate environment.

The U.S. Federal Reserve raised interest rates three times in 2017 and once in 2018 to a range between 1.5% and 1.75%. Looking ahead, the U.S. Fed is expected to raise rates several times in 2018, but the Fed has indicated that rate hikes will be gradual, which can moderate the impact on the value of bonds. Investors who take a broadly diversified approach in their fixed income allocation and avoid excessive credit risk shouldn’t feel a dramatic impact from U.S. Fed policy.

The ability to provide resilience in periods of equity market corrections should be one of the goals of short-, intermediate- and core-bond strategies. Funds that provide diversification from equities can be good building blocks to help create durable portfolios. They also allow investors to rebalance their asset allocation at an appropriate time in market cycles. This approach can help investors achieve long-term investment and savings goals.

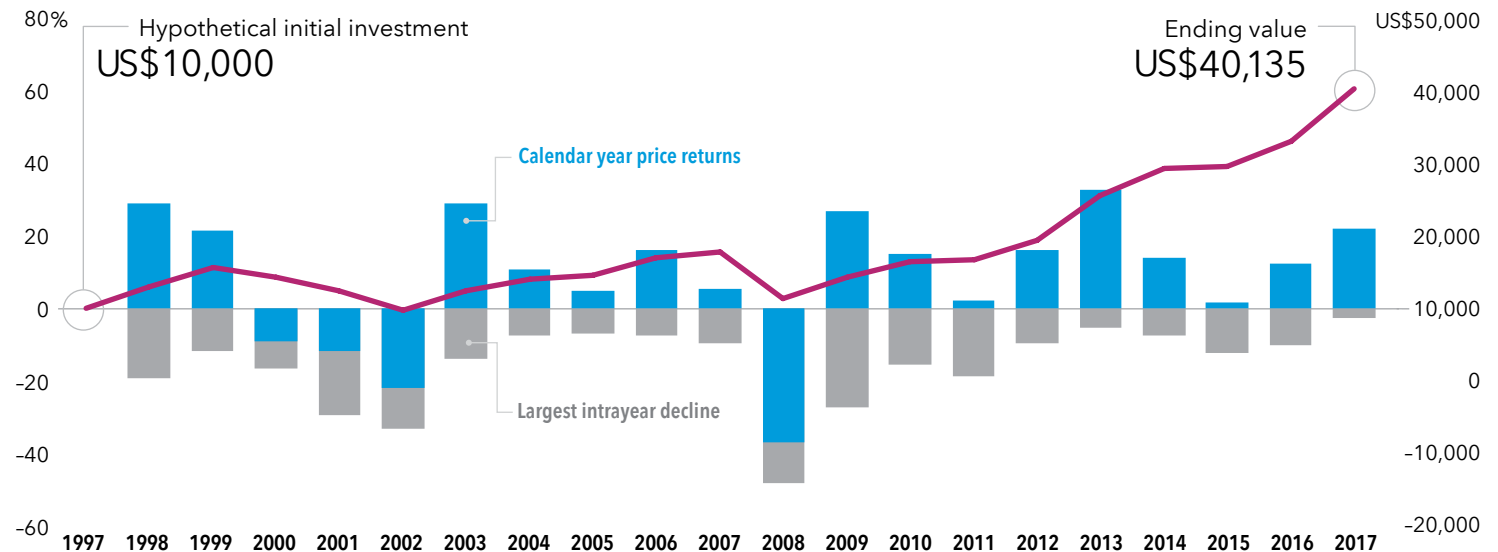
Long-term investors have weathered market declines

Don't let intrayear declines derail long-term investments

"We've recently been through a volatile and, in some ways, surprising period. When we go through times like this, it's easy to respond by focusing on the short term. But I think the right thing to do in such an environment is to push your time horizon. You need to be thinking for the long run."

CARL KAWAJA
PORTFOLIO MANAGER, CAPITAL GROUP
GLOBAL EQUITY FUNDSM (CANADA)

Avoid the urge to time the market



Results calculated in U.S. dollars.

SOURCE: Capital Group. Intra-year gain and decline reflect largest price changes within each year. S&P 500 annual returns are based on the price index only and, as such, exclude dividends. The index is unmanaged and, therefore, has no expenses. Investors cannot invest directly in an index. Past results are not predictive of results in future periods. This hypothetical illustration is for informational purposes only and is not intended to provide tax, legal or financial advice. For illustrative purposes only; please consult your financial and/or tax advisors regarding your individual situation.

Declines happen, and it's not easy to keep calm and carry on. Indeed, there is a natural human instinct to make changes, including portfolio adjustments, based on what one thinks will happen. This impulse isn't confined to periods when stock prices are falling – it's equally tempting when stocks are rising. Just as some investors are inclined to reduce equity exposure following a market decline, others are reluctant to maintain stock investments during a

rising market because they worry that a correction might occur.

And the market provides plenty of opportunity to make changes. The S&P 500 has had intra-year declines every year for the last 20 years. But while the market has its declines, it also goes up. Overall, the market has gone up 16 out of 20 calendar years since 1997. As a result, a hypothetical initial investment of US\$10,000 in the stock market, as represented by the S&P 500, would have

grown to an ending value of more than US\$40,000 as of December 31, 2017. During the past several years, the world's equity markets have demonstrated a very low level of volatility. Volatility could be returning to more normal levels, which can represent an opportunity for long-term investors with a systematic investing plan. Regular investing does not ensure a profit or protect against losses. Investors should consider their willingness to keep investing when share prices are declining.

Investment professional biographies



Hilda L. Applbaum is a portfolio manager at Capital Group and a portfolio manager of Capital Group Global Balanced FundSM (Canada). She has 31 years of investment experience and has been with Capital Group for 23 years. Earlier in her career, as an equity investment analyst at Capital, Hilda covered global convertible securities. Before joining Capital, she was a principal investment officer and director of research for the California Public Employees Retirement System, and a research analyst and economist at Federal Farm Credit Banks Funding Corp. in New York. Hilda holds a master's degree in economics from New York University and a bachelor's degree in economics from Barnard College of Columbia University graduating magna cum laude. She also holds the Chartered Financial Analyst[®] designation. Hilda is based in San Francisco.



Timothy D. Armour is chairman and chief executive officer of Capital Group; chairman and principal executive officer of Capital Research and Management Company, Inc., part of Capital Group; and chairman of the Capital Group Management Committee. He is also an equity portfolio manager. Tim has 35 years of investment experience, all with Capital Group. Earlier in his career, as an equity investment analyst at Capital, he covered global telecommunications and U.S. service companies. Tim began his career at Capital as a participant in The Associates Program. He holds a bachelor's degree in economics from Middlebury College. Tim is based in Los Angeles.



Michael C. Gitlin is a partner at Capital Fixed Income Investors, part of Capital Group, with primary responsibility for leading the fixed income business. He is chair of the Fixed Income Management Committee and also serves on the Capital Group Management Committee. He has 24 years of investment industry experience and has been with Capital Group for three years. Prior to joining Capital, Mike was the head of fixed income at T. Rowe Price, and earlier its global head of trading. Before that, he was head of U.S. equity sales for Citigroup Global Markets, where he also served as head of Asia-Pacific sales trading, head of Asia-Pacific cash equities, and head of international cash equities. He also served as head of Asia-Pacific trading for Credit Suisse Asset Management and traded Japanese equities and bonds for George Weiss and Associates. He holds a bachelor's degree from Colgate University, graduating cum laude. Mike is based in Los Angeles.



Carl M. Kawaja is an equity portfolio manager at Capital Group and a portfolio manager of Capital Group Global Equity FundSM (Canada). Carl has 31 years of investment experience and has been with Capital Group for 26 years. Earlier in his career, as an equity investment analyst at Capital, he covered global household products and U.S. personal care companies, along with Canadian companies. Before joining Capital, Carl was a security analyst for Gabelli & Company in New York, as well as an equity analyst for Lévesque Beaubien in Montreal. He holds an MBA in finance from Columbia Business School and a bachelor's degree in history from Brown University graduating magna cum laude. Carl is based in San Francisco.



Darrell R. Spence is an economist at Capital Group. He has 25 years of investment industry experience, all with Capital Group. He holds a bachelor's degree with honours in economics from Occidental College graduating cum laude, and is a member of Phi Beta Kappa and Omicron Delta Epsilon. He also holds the Chartered Financial Analyst[®] designation and is a member of the National Association for Business Economics. Darrell is based in Los Angeles.

Years of experience as of December 31, 2017.

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