

Searching for Growth

By Brian J. Sokolowski, CFA, Vice President and Investment Officer, 617-441-1422

2011 was a volatile year for equities, as markets digested a number of negative global events that included natural disasters, such as the Japanese earthquake and tsunami, widespread flooding in Thailand, and increased tornado activity in the United States (even in central Massachusetts!); popular unrest in the Middle East; a European sovereign debt and banking crisis which is threatening the future of the common currency; U.S. budget battles and associated uncertainty; and decelerating economic growth around the world, in both developed and emerging economies. The U.S. stock market has generally been resilient in the face of these issues – at least as measured by the S&P 500, which was roughly flat for 2011, or up 2% including dividends.

Although we recognize the risks listed above and have taken steps to protect client portfolios, times such as these often present excellent buying opportunities, especially for higher-risk assets. One such category is growth stocks. When markets sell off quickly, a greater portion of the correction is typically the result of contraction in valuation multiples, with a lesser portion coming from a reduction in earnings estimates, although there is almost always some of both. Because more of the value of growth stocks is embedded in future cash flow, these equities often correct more than value or higher-dividend-paying stocks during sharp market declines. However, since stock prices tend to track earnings growth over long periods of time, we regard the present as a great time to be looking for tomorrow's growth opportunities, as long as the investor can stomach the current volatility.

One way to balance near-term volatility and longer-term opportunity is through a diverse approach to growth. This approach means looking for a blend of emerging growth companies that tend to carry higher levels of market, competitive, and execution risk; more stable companies that are able to find growth in certain portions of their business; and new or accelerating growth themes that may influence a wide range of companies or industries.

In this issue of the TrustLetter, we present some of the emerging growth opportunities that we are finding in the software industry; the attractive growth being enjoyed by some larger multinational food and beverage companies in emerging markets; and the burgeoning growth potential for several U.S. industries (as well as for overall U.S. economic activity) created by the mini-boom under way in U.S. oil and gas production.

The software industry continues to drive productivity

There are a number of significant growth trends occurring currently in various sectors of Information Technology, including mobile computing, social computing, cloud computing, data analytics, and server and desktop virtualization, to name only a few. These technologies are at different points in their evolution and growth trajectory, but all still have significant growth runways ahead. The challenge in selecting attractive long-term equity investment candidates is in identifying those firms with sustainable competitive

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advantages in rapidly growing fields, as well as with stock prices that are trading at reasonable valuations relative to future cash flows. Two examples where we believe those factors are currently attractive are Ariba in the cloud computing area and Qlik Technologies in data analytics.

Ariba (ARBA) is a business-to-business commerce software company that delivers its products to the majority of its customers as a service (Software as a Service, or SaaS). The stock was a high-flyer in the dot.com era, reaching a market valuation of \$30 billion on only \$279 million of peak revenue. The stock fell from a high of \$818 in 2000 to a low of \$6 in 2005. The company went through the painful transition of down-sizing in the post-bubble technology landscape and spent most of the last decade, first, battling to stay in business, and then rebuilding its business to prepare for the next technology wave.

The groundwork was laid in mid-decade as Ariba noticed the coming shift to software being delivered over the internet as a service, instead of being installed on-site. This shift happened to fit Ariba's segment of the software world particularly well, as commerce is by its nature a collaborative or communicative activity. Ariba's solutions shifted from productivity tools to communication tools, and eventually to a network that links large commercial buyers with their suppliers – loosely described as an “eBay for business commerce.” Ariba's growth rate has been accelerating recently as its faster growing segments have become a bigger portion of the company, reaching a 20% growth rate in 2011 (with certain areas growing in excess of 50%).

The opportunity set in front of Ariba is very significant. Over the last twelve months, approximately \$200 billion of commerce was conducted over Ariba's network. The company believes that it can grow that figure towards \$1 trillion over the next five to seven years, as more business commerce is conducted online in the cloud, rather than over the phone, through email, or on paper. Ariba collects a very small fee (less than one-tenth of 1%) on the value of commerce conducted over its network. Because of the immense value of the commerce that it enables, the small fee percentage results in significant revenues and earnings. We believe that Ariba will continue to grow rapidly, the result of both increased commerce and higher fee rates as the company helps to drive productivity in business-to-business e-commerce.

Qlik Technologies (QLIK) makes data analytics software that enables its customers to improve decision-making and to drive productivity in almost any aspect of business by wringing more useful information from data in a faster and more flexible manner. Common functional areas addressed by the software include sales, marketing, supply chain management, manufacturing, and finance. Data has been expanding at an extremely rapid pace over the last decade and is even accelerating more recently as a result of new forms of interaction, such as social computing. Qlik estimates that global data storage doubles every sixteen months. Although the Business Intelligence (BI) software industry has been around for a number of years (and has enjoyed healthy double-digit growth rates), the traditional tools can be viewed as difficult to implement, as well as rigid and slow to use, and they often require significant assistance from technology staff within companies. Aided by notable progress in the development of technology hardware, such as faster and more nimble processing, Qlik has developed a proprietary analytics technology that puts powerful analytics tools directly at the fingertips of business users. This technology allows for fluid analysis in an intuitive fashion, is quick to implement and easy to use, and costs a fraction of the expense of traditional BI implementations. We believe that Qlik will continue to take market share from both traditional BI competitors, as well as from its fast growing and innovative peers. The result should be revenue, earnings, and cash flow growth above 30% for the next three to five years.

Multinationals are finding growth in emerging economies

Although large-capitalization multinational companies tend to grow at a slower pace than mid-cap technology firms, there are still places to find attractive growth rates within this group of companies. Company- or industry-specific drivers often aid growth for a period of time, or product cycles increase growth rates. For good reason, the rapid growth that multinationals are enjoying in emerging markets has attracted a lot of investor attention. For many U.S. and European companies, sales to emerging markets now typically comprise at least 20% and often significantly higher percentages of sales and profits. UBS estimates that emerging market sales for the S&P 500 companies average 12% in total. However, because that average percentage includes purely domestic firms, such as banks and railroads which drag down the average, the importance of emerging market sales for many

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companies is understatedⁱ. Three of the food and beverage companies that we own in client accounts (Yum! Brands, Nestlé and Anheuser-Busch InBev) have been enjoying rapid growth in emerging markets, and their stock prices are often driven by the results in these important markets.

Yum! Brands (YUM) operates the KFC, Taco Bell, and Pizza Hut franchises around the world. Yum! has been enjoying consistent earnings growth in the mid-teens over the last several years, despite sluggish revenue growth in its U.S. home market, primarily because of its excellent performance in China. Yum! has been in China for more than two decades and was successful early as a result of localizing its product offerings. China now accounts for almost 60% of the company's operating profit, twice the U.S. contribution of 30%. More importantly, almost all of Yum!'s growth is occurring in the emerging markets, led by China. Yum!'s same-store sales in China have averaged 8% growth per year over the past six years, and units have grown 20% annually over the last ten years. The result is that China alone has driven over one-half of Yum!'s growth rate, compared to less than one-tenth of the company's growth coming from the U.S., where same-store sales have been in the low single digits and the company is not adding stores.

While the company is thriving in China, Yum! is also building its presence in India for its next leg of growth – aiming to expand from the current level of 300 stores to 1,000 stores by 2015. Investors have voiced their approval of Yum!'s China and wider emerging-markets strategy, as the stock is up seven-fold since 2000 and trades at a 50% premium to the S&P 500 on a price-to-earnings basis.

Nestlé (NSRGY) has also been very successful in emerging markets, although in a more balanced fashion than Yum!. The portion of Nestlé's total earnings from emerging markets approaches 40%. The company's total revenue growth rate has averaged about 7% annually over the past five years, with 10%+ growth in emerging markets balanced by approximately 3% growth in developed economies. Similar to Yum!, over half of Nestlé's year-to-year growth is the result of its success in emerging markets. However, Nestlé's exposure is much more widespread than Yum!'s, as Nestlé derives only about 5% of its revenue from China. This difference is largely explained by its business model for packaged food, which requires a distribution system, but not brick and mortar stores, enabling a wider country-approach. Nestlé has been successful in emerging markets because of its Popularly Positioned Product approach, which attempts to

localize and sell products at low price-points in small package sizes, while still realizing healthy profitability.

Anheuser-Busch InBev (BUD) is a Belgium-based company formed by the 2009 combination of InBev and Anheuser-Busch. Familiar products include Stella Artois, Beck's and Corona, in addition to the Budweiser family of products. BUD's most important emerging region is South America, which comprises more than one-third of its beer volumes and about 45% of its profits, roughly the same as North America on both counts. The beer markets in developed countries cannot be described as growth markets. The U.S. beer market has been declining slowly in terms of volume over the last twenty years, largely offset by strong pricing power held by the brewers. The case in emerging markets is quite the opposite. Brazil, BUD's second largest market after the U.S., has been averaging 7% volume growth since 2005 and revenue growth above 10% as a result of price increases. Rising incomes, combined with favorable demographic trends in emerging markets in general, and South America in particular, should result in continued double-digit earnings growth for the company. Almost 100% of that growth is likely to come from emerging markets.

Economic growth in emerging markets should continue to comfortably outpace growth in developed economies for the foreseeable future. We believe that client portfolios should include a strategic allocation to emerging economies, and we have achieved that goal historically through several investment vehicles, including multinationals, commodity producers, exchange-traded funds, and direct emerging market equities. Although we continue to retain exposure to a number of these vehicles, we currently favor the multinational approach because of elevated global risks and volatility.

The positive impact of a U.S. oil and gas boom

From 2000 to 2005, U.S. production of natural gas declined from 540 billion cubic meters to 511 billion cubic meters, according to the 2011 BP Statistical Reviewⁱⁱ. Analysts estimate that U.S. production will reach approximately 650 billion cubic meters in 2011, representing 4% compound annual growth from 2005 through 2011 - rapid growth in the world of energy production. The situation with crude oil is similar. U.S. production declined 11% from 2000 to 2005, remained fairly flat until 2008, and is expected to be up nearly 16% from 2008 through 2011ⁱⁱⁱ.

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A substantial portion of this production growth is due to the increased use of non-traditional recovery techniques such as hydraulic fracturing (“fracking”), which is controversial and carries both environmental and political risks. Those risks must be balanced by the positive implications of this boom, one of which is a meaningful decline in our dependence on foreign production. According to energy analyst Daniel Yergin, U.S. petroleum imports comprised 60% of total consumption in 2005. That figure has decreased to 46% in 2011^{iv}. Increased use of non-traditional recovery techniques also has a positive impact on a wide range of energy companies, including those involved in exploration and production, services, drilling, and refining. Another implication is the positive knock-on effects of this activity, including economic growth, job growth, and demand for adjacent goods and services. In this issue, we address briefly this latter implication, leaving a more in-depth discussion of the U.S. energy industry and fracking to a future issue of the TrustLetter.

Several companies outside the energy industry are enjoying benefits from the shale oil and gas boom in North America. According to a recent [Wall Street Journal](#) article, significant construction of new plants that depend on reliable supplies of low-cost natural gas is under way in the U.S., including in the chemical, fertilizer, and steel industries. PricewaterhouseCoopers estimates that these investments could create one million U.S. manufacturing jobs over the next fifteen years. Perhaps more importantly, the discoveries are attracting foreign investment to the U.S. For example, a Brazilian textile firm, Santana Textiles, is currently building a \$180 million denim plant in Edinburg, Texas partly because of electricity costs that will be 30% lower than in Mexico, where it originally considered building the plant^v. While we will continue to monitor this theme of foreign investment in the U.S. for more opportunities, a number of our current holdings, including Union Pacific and PNC Bank are well positioned to benefit from the low cost of natural gas in the U.S. Union Pacific (UNP) is the largest railroad in North America, operating a track network that covers the majority of the country west of the Mississippi River. Hauling coal is a traditional driver of rail earnings, and UNP participates in some fashion in the transportation of most other forms of energy, including moving wind blades and ethanol. In a general sense, UNP benefits from high activity levels – imports, exports and production are all positive for UNP. Because of more efficient transportation methods, imported oil and gas are less beneficial to UNP than other goods.

Domestically produced oil and gas from new sources are particularly positive for UNP because of the need to move infrastructure to the production regions to support extraction, and to help move the produced goods to market on the way out of the regions.

In the 3rd quarter 2011, UNP’s petroleum shipments increased 35% over the prior year, largely the result of increased shipments out of the Bakken and Eagle Ford shales. While this growth rate will likely moderate and eventually be partially replaced with pipelines, petroleum volumes from new regions where shale is produced should be a growth driver for the foreseeable future. UNP also brings in sand and other materials necessary in the drilling process. In the 3rd quarter, shipments of non-metallic minerals were up 40% over the prior year because of increased fracking sand shipments; steel shipments for energy exploration and production were up 13% over the prior year. With total rail volumes growing in the 1-2% range currently, the growth from new sources, such as unconventional energy production, is very important to UNP results.

PNC Financial Services Group (PNC) is the leading bank in Pennsylvania and the second largest bank in Ohio. These two states, which are covered by the Marcellus and Utica Shales, are at the center of the U.S. shale energy boom. According to a Pennsylvania State University study, Pennsylvania citizens will collect \$250 billion in royalties from the energy industry, in addition to \$8-\$15 billion annually spent by the industry on drilling^{vi}. This increase in activity is especially important in a region that has seen a massive decline in manufacturing activity over the last twenty years. A general acceleration in economic activity should be a positive for the region’s banks, including PNC. Although this activity has not had a significant impact on results to date, we expect that energy production in PNC’s footprint will play an increasingly important role in the coming years. At a recent conference, a PNC executive stated that the “boom for the region is just getting going” and it will be “a lift for that area for a bunch of years”^{vii}. When most U.S. banks are struggling to show positive loan growth and Rust Belt banks in particular have been hit by years of manufacturing and population declines, a U.S. energy resurgence can be a meaningful contributor to stock prices, even more so given cheap valuations (less than book value in many cases).

UNP and PNC are two specific beneficiaries of the unconventional energy boom in the U.S. The benefits will be more far-reaching, however, driving economic growth and employment. Precise measurement of the number of jobs

2012 Contribution and Deductibility Limits for Retirement Plans

By *Laura C. McGregor, Vice President and Trust Officer, 617-441-1434*

An important part of an individual's financial plan is preparing and saving for retirement. Retirement savings may be optimized through various vehicles, including a Traditional Individual Retirement Account (IRA), Roth IRA, Simplified Employee Pension (SEP-IRA) plan, and a 401(k) plan. Two advantages of these plans are the deferral of income taxes and a source of cash flow at retirement. To be eligible to make contributions to such plans, an individual must have compensation. The term "compensation" includes earned income such as wages, alimony and, for self-employed individuals, net earnings from self-employment.

2012 Contribution Limits

Each year the Internal Revenue Service (IRS) determines the contribution limits for each type of plan. The 2012 contribution limits are as follows:

Traditional IRA: Contribution limits remain unchanged from the limits in 2011, which are \$5,000 for an individual under age fifty in 2012 and \$6,000 for an individual over age fifty or attaining the age of fifty in 2012. The \$1,000 difference based upon age is known as the "Catch-up Contribution" amount. Individuals over the age of 70 ½ are not eligible to make contributions.

Roth IRA: Contribution limits remain unchanged from the limits in 2011 and are the same as for Traditional IRAs. However, an individual's ability to make a contribution to a Roth IRA depends upon the amount of that individual's modified adjusted gross income (MAGI). For 2012, the yearly contribution that can be made is phased out for single filers with MAGI from \$110,000 to \$125,000 and joint filers with MAGI from \$173,000 to \$183,000.

SEP-IRA: This type of plan is used primarily by small businesses or self-employed individuals. Generally, the maximum 2012 SEP contribution that can be made by a self-employed individual is the lesser of 20% of net self-employment income after one-half of the self-employment tax deduction or up to \$50,000. For employees, the contribution amount is the lesser of 25% of wages or up to \$50,000.

401(k) Plan: This type of plan is a qualified plan through an employer. Changes for 2012 are in the amount of the elective

deferral contributions made by the employee. The maximum contribution amount has increased to \$17,000 from \$16,500 in 2011 for an individual younger than age fifty in 2012. For an individual who is age fifty or older or attains age fifty in 2012, the maximum contribution is \$22,500, an increase from \$22,000 in 2011.

Deductibility

The deductibility of a contribution to a Traditional IRA depends upon whether or not an individual or an individual's spouse is an active participant in an employer-sponsored retirement plan. When an individual is an active participant, the amount of the deductible IRA contribution depends upon the individual's adjusted gross income (AGI) and filing status. An individual is considered an active participant if he or she is eligible to participate in a plan even if he or she elects not to do so. The range for 2012 AGI phase-out limitations for single filers who are active participants in a retirement plan is \$58,000 to \$68,000; for joint filers, this range is between \$92,000 and \$112,000. If only one spouse is considered an active participant, the phase-out range is between \$173,000 and \$183,000 of AGI. Individuals subject to these limitations may make non-deductible contributions to a Traditional IRA up to the contribution amounts; however, the tax advantages of funding a Roth IRA instead should be considered before making such contributions.

Contributions made to a Roth IRA are never deductible; however, withdrawals are generally free from income tax.

For SEP-IRA plans, a special computation must be made to figure the maximum deduction for annual contributions made by a self-employed taxpayer. Generally, the deduction limits are based in part on the compensation paid to eligible employees participating in the plan.

Contributions made to a qualified plan such as a 401(k) are made on a pre-tax basis and are often matched up to a certain percentage by an individual's employer.

The rules governing retirement plan contributions and deductibility are comprehensive and complex. As always, it is important to consult with a financial planning professional or tax accountant regarding the establishment, requirements and tax implications of the various types of retirement plans.

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supported by a particular industry is a difficult task because of categorization inconsistencies and multiplier effects. The task is even more difficult in the case of controversial industries such as shale energy, where there are politically motivated adjustments on both sides of the issue.

We can, however, at least present some rough estimates. On the high side, the economic forecasting firm Global Insight (commissioned by the gas industry) estimates that net new jobs supported by shale gas alone could reach 270,000 by 2015, bringing the total number of U.S. jobs supported by shale gas drilling to 870,000 from the current 600,000^{viii}. Adjusting for an economic multiplier effect that is used to estimate the indirectly supported jobs would still indicate creation of around 70,000 direct new jobs resulting from shale gas by 2015. On the other end of the spectrum, the environmental group, Food and Water Watch, estimates that allowing full drilling in New York would only add 6,000 new jobs^{ix}. Estimating the exact impact is impossible, but it is logical to assume that increased shale energy exploration and development is additive to job creation on a net basis. North Dakota, home of the Bakken Shale, which has been under development for the last decade, may be instructive. The state's unemployment rate is 3.5%, energy jobs have tripled in the past three years, and total employment has grown 10% since 2002, versus flat employment for the U.S. as a whole^x.

A more comprehensive way to look at the impact of shale is simply by looking at total economic activity created by new shale activity. According to the Global Insight report, gas shale drilling alone will add \$118 billion to economic growth

over the next four years. Although this drilling would only add 2/10ths of a percent per year, it is additive to growth (and not insignificant, considering an economy that is expected to grow only about 2% in 2012). Another way to look at the impact is the dollars that otherwise would have been sent outside the U.S. to import natural gas. Despite the strong growth in natural gas production, the U.S. is a net importer of natural gas, importing about 15% of annual consumption, according to the Energy Information Agency^{xi}. The 27% growth in U.S. production over the past six years has both reduced the amount of imports and helped push prices down to below \$3.00 per million BTU, from above \$12 per million BTU in 2008. According to Daniel Yergin, the lower price, combined with fewer imports that otherwise would have been necessary, results in up to \$100 billion dollars not being sent abroad each year^{xii}.

Conclusion

We are not expecting the recent market volatility to end anytime soon and have attempted to preserve capital in client portfolios by retaining larger cash balances and reducing position sizes in higher-risk stocks that have appreciated in value. However, we are also beginning to deploy cash into promising areas, including various opportunities across the growth spectrum. We believe that a balanced approach to portfolio construction includes companies with different risk and growth profiles and that this strategy will allow portfolios to enjoy the success of some emerging growth firms, while also limiting the downside when financial markets are under stress.

ⁱ "What's the Emerging Market Exposure of the S&P 500?", UBS Investment Research; April 4, 2011

ⁱⁱ 2011 BP Statistical Review and www.eia.gov

ⁱⁱⁱ *ibid*

^{iv} "America's New Energy Security", *Wall Street Journal*; December 12, 2011

^v "Shale Gas Boom Spurs Race", *Wall Street Journal*; December 27, 2011

^{vi} "Heard Off the Street: Marcellus Shale Boom Hits Banks", *Pittsburgh Post-Gazette*; March 6, 2011

^{vii} William S. Demchak, Senior Vice Chairman, PNC; at the BancAnalysts Association of Boston Conference, Nov 3, 2011

^{viii} "Shale Gas Drilling to Add 870,000 jobs by 2015, Report Says", December 6, 2011, Bloomberg.com

^{ix} *ibid*

^x www.bls.gov

^{xi} www.eia.gov

^{xii} "America's New Energy Security", *Wall Street Journal*; December 12, 2011

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Cambridge TrustLetter *Editor – Laura C. McGregor*

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