RBC Wealth Management™

PRIVATE CLIENT EQUITY RESEARCH

RBC Wealth Management, a division of RBC Capital Markets Corporation, Member NYSE/FINRA/SIPC.

A Monthly Report of Equity-Income Recommendations

This Month: The Quarterly Sector Outlook

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For Important Disclosures, see pages 12-13.

Guided Portfolio: Prime Income
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Guided Portfolio: Prime Income

The Prime Income List has transitioned to Guided Portfolio: Prime Income. This strategy is designed for conservative equity investors who seek above average current income with relatively modest market risk. In selecting stocks for this Portfolio, we focus on well-established companies which, in our opinion, have low business and financial risk, attractive dividend yields, and some measure of capital appreciation potential. In addition, we emphasize consistency of dividends and potential for dividend growth. Such investments generally include utilities, Real Estate Investment Trusts (REITs), and Master Limited Partnerships (MLPs); but they may also include shares of any company with a relatively high current distribution yield and low relative risk. MLPs are not suitable for all investors and/or accounts. Due to tax regulations, MLPs are not recommended for qualified accounts because a portion of distribution income is return of principal (which is tax deferred), and distribution income of more than $1,000 could be taxable in qualified accounts due to unrelated business taxable income (UBTI). The Guided Portfolio: Prime Income is actively managed, based on research by RBC Capital Markets and/or our national sources.

Sifting Through the Noise: Our Top Ten List

The wealth of information that floods our desktops is always a challenge. One of the advantages of a bit of tenure in this business is experience tends to help when one tries to pick out the nuggets of "wisdom" from the white noise that is characteristic of this industry. Nearly three years ago, the stock market peaked, and the financial crises unfolded shortly thereafter. We've taken a thoughtful pause, and have highlighted our Top Ten List of key factors we monitor. Some items are very short term in nature, helping manage the minutiae that's part of the day-to-day process of stock selection, while other considerations are cornerstone of the view from 30,000 feet. While not all-inclusive, it may give you some insight into how we manage this Portfolio of conservative cash flow securities.

1. **The Current Market Move is Part of a Much Larger Cycle.** We believe social, economic, and political trends move in very large cycles that can span 60 to 80 years. One book we find helpful in this regard is *The Fourth Turning* by William Strauss and Neil Howe. Once the nature of these big cycles is better understood, investment strategy becomes easier, fears of uncertainty recede, and key sign-posts become easier to identify. Recently, another book we've added to our collection on this topic is *This Time is Different*, by Carmen M. Reinhart and Kenneth Rogoff. This book reviews nearly 800 years of financial crises, and, not surprisingly, the current environment is unfolding pretty close to historical precedent.

2. **The Contribution of Dividends to Total Returns is Woefully Underappreciated.** Most cocktail chatter on stocks revolves around a newly uncovered stock with dazzling potential to double or triple during the year. Yet, the power of dividend investing is met with yawns. Since 1900, dividends have contributed to 70% of total return in the United States and 72% in the United Kingdom. In periods of low growth, such as the period of time we currently occupy, dividends are even larger component of total returns. Corporations are expected to have accumulated nearly $2 billion on their balance sheets as we enter the fourth quarter, and the dividend payout ratio for the S&P 500 is currently 29%, well below the 48% average payout ratio since 1960. In our view, more of that cash will find its way into dividends because the payout ratio has plenty of room to expand.

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Guided Portfolio: Prime Income

				Performance											
		Price	52- Wk.	Entry	Entry	LTD to	EPS (Calendar)			P/E		Annual	Div.	Payout	Cash Flow
Symbol	Company Name	9/30/10	Range	Date	Price ★	Capital	2009A	2010E	2011E	2010E	2011E	Div.	Yield	Ratio	Estimates
Consumer Staples															
MO	Altria Group Inc.	$24.02	24 - 17	11/02/07	$22.24	72.61	$1.75	$1.89	$2.01	12.7x	12.0x	$1.52	6.33%	80.0%	--
HNZ	H.J. Heinz Co.	$47.37	48 - 38	8/03/10	$45.30	64.70	$2.88	$2.99	$3.23	15.8x	14.7x	$1.80	3.80%	60.2%	--
LO	Lorillard Inc.	$80.31	83 - 70	1/29/09	$61.66	103.12	$5.76	$6.54	$7.17	12.3x	11.2x	$4.50	5.60%	68.8%	--
Energy															
CVX	Chevron Corp.	$81.05	83 - 67	8/29/03	$36.44	9.21	$4.84	$9.35	$9.87	8.7x	8.2x	$2.88	3.55%	30.8%	--
DO	Diamond Offshore Drilling Inc. @	$67.77	109 - 55	5/29/09	$84.28	29.03	$9.89	$6.93	$6.75	9.8x	10.0x	$0.50	0.74%	7.0%	--
SE	Spectra Energy Corp.	$22.55	24 - 18	6/18/10	$21.69	53.73	$1.18	$1.49	$1.70	15.1x	13.3x	$1.00	4.43%	67.1%	--
Financials															
BMO	Bank Of Montreal	$57.75	66 - 46	12/29/09	$52.74	17.65	$3.76	$4.74	$5.30	12.2x	10.9x	$2.64	4.57%	55.6%	--
Healthcare															
BMY	Bristol-Myers Squibb Co.	$27.11	28 - 22	2/13/09	$21.75	28.51	$1.85	$2.15	$2.32	12.6x	11.7x	$1.28	4.72%	59.5%	--
LLY	Eli Lilly & Co.	$36.53	38 - 32	1/29/09	$37.97	40.12	$4.42	$4.61	$4.44	7.9x	8.2x	$1.96	5.37%	42.5%	--
MRK	Merck & Co.	$36.81	42 - 30	9/28/09	$32.03	20.03	$3.25	$3.36	$3.81	11.0x	9.7x	$1.52	4.13%	45.2%	--
Master Limited Partnerships (MLPs)#															
ETE	Energy Transfer Equity LP	$37.12	38 - 27	5/25/10	$29.14	98.17	$1.98	$1.65	$1.97	22.5x	18.9x	$2.16	5.82%	93.7%	$2.32
EPD	Enterprise Products Partners LP	$39.67	40 - 27	11/13/03	$22.61	54.43	$1.61	$1.91	$1.99	20.8x	19.9x	$2.30	5.80%	73.7%	$3.08
KMP	Kinder Morgan Energy LP	$68.50	70 - 53	1/15/03	$35.45	59.41	$1.38	$1.61	$1.84	42.5x	37.1x	$4.36	6.36%	102.0%	$4.25
WPZ	Williams Partners LP	$42.40	49 - 22	2/20/07	$43.09	59.79	$2.88	$2.73	$3.24	15.5x	13.1x	$2.69	6.34%	65.3%	$4.12
Real Estate Investment Trusts (REITs)*															
NLY	Annaly Capital Management	$17.60	19 - 14	5/29/09	$13.94	5.83	$2.48	$2.56	$2.80	6.9x	6.3x	$2.72	15.45%	106.0%	--
CBL	CBL & Associates Properties	$13.06	17 - 8	5/25/10	$13.55	82.23	$2.52	$1.94	$1.88	6.7x	6.9x	$0.80	6.13%	41.2%	--
Telecommunications															
T	AT&T Inc.	$28.60	29 - 24	8/29/03	$22.46	36.91	$2.12	$2.32	$2.50	12.3x	11.5x	$1.68	5.87%	72.4%	--
BCE	BCE Inc.	$32.50	33 - 24	12/29/09	$27.17	37.44	$2.28	$2.73	$2.93	11.9x	11.1x	$1.78	5.48%	65.2%	--
VZ	Verizon Communications Inc.	$32.59	33 - 25	2/13/09	$27.62	55.82	$2.40	$2.23	$2.30	14.6x	14.2x	$1.95	5.98%	87.4%	--
Utilities															
D	Dominion Resources Inc.	$43.66	45 - 33	1/15/03	$27.85	55.31	$3.27	$3.34	$3.19	13.1x	13.7x	$1.83	4.19%	54.8%	--
DUK	Duke Energy Corp.	$17.71	18 - 15	2/28/05	$15.71	44.90	$1.22	$1.33	$1.34	13.3x	13.2x	$0.98	5.53%	73.7%	--
NST	NSTAR	$39.35	40 - 31	9/28/04	$24.52	54.74	$2.35	$2.52	$2.65	15.6x	14.8x	$1.60	4.07%	63.5%	--

Avg. Yield: 5.47%

	Year to Date Through 09/30/10	Last 12 Months Through 09/30/10	Since Inception Through 09/30/10
GPPI Cumulative Performance:	9.3%	22.7%	129.7%
S&P 500 Value Performance:	4.2%	8.7%	49.7%

Payout ratios for MLPs are based on 2010 distributable cash flow (DCF) estimates and not EPS.

@DO pays a two-stage dividend: a regular dividend of $0.50 annually and declares a special dividend quarterly, currently at $0.75; we believe the total for 2010 is likely to be $3.50/share combined. Inception date is January 15, 2003.

A stands for actual earnings, E stands for estimated earnings based on First Call Consensus estimates. Information regarding returns is presented as total return and therefore includes dividends as well as capital appreciation and presumes reinvestment of dividends. Return is calculated on an equal-weighted, total return basis, and includes dividends, which are assumed to be reinvested. Return calculations do not include commissions, interest charges or other expenses that would be associated with an investment in the securities mentioned. Return calculations for the Guided Portfolio Prime Income include securities that have been removed from the portfolio. Performance information on removed stocks is available upon request. Prices utilized for performance calculation purposes are closing prices one full trading session following additions to or removals from the Guided Portfolio: Prime Income. Past performance should not be viewed as an indicator of future results. Portfolio P/E ratios are derived from a simple average of individual stock P/E ratios. S&P 500 Value Index P/E ratios are based on First Call Consensus estimates, excluding figures that haven't been updated within 90 days. Dividend payout ratios are calculated as the annualized current dividend rate divided by the latest 12 months reported EPS, except where noted.

Source: FactSet and our national research correspondents.

(continued from page 1)

3. **Quantitative Easing (QE) has Started in Japan, and the Fed Could Follow.** QE simply is a move by central banks to create money by purchasing securities in the open market through adding reserves to the banking system. The goal is to flood the market with liquidity to stimulate lending and more economic activity. On September 15, the Japanese government initiated QE by directing the Bank of Japan to purchase dollars to slow the appreciation of the yen. The move resulted in a 3% drop in the value of the yen, a 4% increase in the Japanese stock market, and as a result, made Japanese exports that much more competitive. A recent American Enterprise Institute report compared QE to an "experimental drug," an appropriate comparison, in our view. The global shortage of demand for goods and services is inherently deflationary in nature. In developed markets, overleveraged consumers and governments spend less, thereby slowing growth. In emerging markets, curbs are put in place to keep growth from spinning out of control and causing inflation. The net result is that we have too many factories, people, and general "capacity" compared to the true demand level required. Slower growth only serves to worsen the imbalance. Hence, the key is, at worst, to keep damaging deflation to periodic episodes through moves like QE. The CPI in the United States is currently 0.9%, but the month-to-month move was flat. QE remains a possibility by the Fed, since unemployment levels are poised to remain higher than usual for a longer period of time, in our view.

4. **Demographics Still Support the Underpinnings of United States Growth.** It may not seem like much in the near term, but the demographic trends have a powerful long-term impact on economics. In particular, two factors support the United States versus its peers:

   - The fertility rate (2005-2010) of 2.09 children per woman is the highest of the developed economies and closest to the replacement rate of 2.1 children per woman. Of all the demographic trends, this is the most key, in our view, and compares to Japan at 1.27 children per woman and Germany at 1.32 children per woman.

   - Working-age productivity, labor productivity, and real GDP growth exceed that of both Japan and Germany, countries the United States is most often compared to. The growth of this younger and more productive labor force should act as a driver of GDP.

5. **Mean Reversion is Absolute.** At the peak of the technology bubble in 2000, I remember getting a call from a Financial Consultant whose client wanted to sell several municipal bonds and buy the latest IPO, because he was "missing out" on this brave new world of technology. At the same time, on average, gold was trading at $279.00/oz., oil was trading at $27.39/bbl, and few understood or knew about energy-related Master Limited Partnerships. Over the course of the 2000s decade, we all know how much gold and oil rallied, and MLPs as a group rose 525%, while the average technology stock declined 54%. Bonds have provided superior performance for the past 30 years. The last time bonds had this kind of uninterrupted stretch of returns was from 1901 to 1932, when, according to work done by our national research source they then underperformed equities by 15% over the next 5 years. Regression to the mean is powerful. Demand for equities is low right now, but at some point, the risk/reward will become too compelling to avoid.

6. **Volatility Walks Hand in Hand with a Sideways Market.** The 10.7% rally in the third quarter was over-shadowed by the remarkable 10% move in September alone, the best September performance since 1939. According to our national research source, "we have averaged just five positive "ten percent plus" quarters per decade since 1950." What is particularly unusual is that the S&P 500 has risen or fallen by at least ten percentage points in six of the past eight quarters. It reminds us that broad intra-year moves are characteristic of sideways (or bear) markets. It's just one of the reasons we're big fans of dividend-paying stocks for the foundation of investor portfolios. The broad swings allow for tactical stock and sector moves for investors that are comfortable participating.

7. **Mega Cap Stocks are Inexpensive.** We are also believers in choosing stocks carefully and letting them work. In general, that often means buying good companies when they are out of favor with investors. Perhaps no other group of stocks is as out of favor as the mega caps, the growth stars of the 1990s. In general, we believe many of these companies, characterized by

cash rich balance sheets, attractive dividend policies, and dominant market share with premier product positioning, currently trade at valuations often reserved for their lower quality peers. Of note, large-cap tech stocks currently trade at the market multiple, the cheapest valuation since 1991 and well below its average valuation multiple since 1997 of 1.31x, according to a recent article in *Barron's*. Cisco just initiated a dividend policy, IBM recently raised its dividend 18%, and Intel is likely, in our view, to raise its dividend again in the next month. As we note in point five, regression to the mean is absolute—it's just a matter of time.

8. **Markets Historically Rally Ahead of Mid-Term Elections.** Our colleague, Phil Dow, highlights this data quite succinctly in his monthly piece: "Since 1942 the period post-midterm election has featured a positive stock market return. According to internet postings of a study performed by market historian Leuthold Group, in the 17 midterm elections since 1942, the S&P 500 gained an average of 2.6% in the 200 days leading up to the election and more demonstrably rallied 100% of the post-election 200-day periods to an average gain of 18.3%. History reminds us that whatever the zero sum political outcome, the removal of uncertainty has been a powerful stock market catalyst."
9. **Most Money Managers are Underperforming Their Benchmark to date.** Should mutual fund returns not approach benchmarks by year end, it could be like Desi used to say after one of the Lucy & Ethel escapades, "Lucy, you got some 'splainin' to do!" According to our national research source, 64% of all mutual fund managers were trailing their benchmark as of 9/27/10. A recent JPMorgan report noted that for the same period, nearly 30% of money managers were behind their benchmark by a full 5 percentage points. Should the market continue to rally, these investors will have no choice but to move into equities to try to make their year. Historically, laggards and cyclicals tend to be key beneficiaries of this kind of trade.
10. **While the Future may be Uncertain, Human Nature is Constant.** The core of behavioral finance is that human beings, due to our nature, will not always act in our best interest. We rely on both cognitive and emotional factors to help make investment decisions, factors that often put into use rules of thumb rather than logic. A belief that "someone else" is watching the store (i.e. risk factors) when making investment decisions can result in less than optimal choices after more logical evaluation. These factors, in our view, argue for reasoned and enforced regulation. As is generally the case, the pendulum often swings far in the other direction as rationality slowly resumes in the market. As the market regains its equilibrium over the next few years, we strongly believe that cash flow securities will remain an attractive option for investors willing to consider them.

Changes to the Guided Portfolio: Prime Income

We make changes to the Guided Portfolio: Prime Income based primarily on fundamental changes in the underlying business, such as balance sheet deterioration, declining cash flows, rising dividend payout ratios, or other changes that could negatively impact the company's ability to pay its dividend. We also take into consideration market activity and valuation. Removal from the list does not necessarily imply that investors should sell a stock. We state our justification for removal and immediately provide appropriate follow-up information via our internal communication systems.

Additions

There were no additions since the last publication of Guided Portfolio: Prime Income.

Deletions

There were no deletions since the last publication of Guided Portfolio: Prime Income.

Sector and Company Analysis

Consumer Staples Outlook

This sector contains some of the best-loved and most consistent growth businesses in the world with outstanding long-term dividend policies. With the economic recovery taking a bit of a breather, this group offers defensive growth, but the dramatic moves in currency, especially the move of the euro vs. the U.S. dollar, has caused swings in valuation for this group. The group rose 9% in September alone and is up 4% for the year. The concerns in the market that negative currency impact would greatly impact revenues and earnings seem to have abated since the euro remains a bit stronger than expected. Institutional investors currently have a fair amount of “love” for the sector, given its defensive growth, which tends to really shine during periods of slower economic growth. Value is king, in our view, and firms in this sector continue to rationalize the number and kinds of products they offer, support strong marketing spending—whether through advertising or through couponing—to catch the eye of consumers who look for that added incentive to select a certain brand. We believe the consumer remains value conscious since items categorized as a “need” have better pricing power than a “want.” In general, the sector is characterized by stable cash flow, attractive dividends, and a supportive commodity price environment. Should the market rally continue, we could see good entry points emerge in the group and would be a buyer on relative weakness to the market. For the long haul, we continue to view Consumer Staples stocks as core holdings in defensive portfolios.

In general, S&P estimates tobacco earnings could grow 11% in 2010 and 10% in 2011. The tobacco industry remains highly profitable, despite litigation and FDA regulation domestically. The long-standing commitment to a steady dividend policy makes it an attractive defensive growth sector where investors “get paid to wait.”

Consumer Staples Recommendations

Altria Group Inc. (MO)

Altria Group Inc. is the holding firm for subsidiary companies that primarily manufacture and market tobacco products. The company’s U.S.-based subsidiary, Philip Morris U.S.A., has more than 50% of the U.S. cigarette market share, with premium brands Marlboro, Virginia Slims, and Parliament, as well as discount brand Basic. The company also owns approximately 28.6% of SABMiller plc and 100% of Philip Morris Capital Corp.

Lorillard, Inc. (LO)

Lorillard, formerly a division of Loews Corporation, was spun independent in June 2008. The company is the third-largest U.S. tobacco company and a leading manufacturer and marketer of menthol cigarettes. Its leading menthol brand, Newport, represents 90% of cigarette volumes and holds a 10% market share in menthol cigarettes. The company also includes premium brands Kent and True and discount brands Old Gold and Maverick in its tobacco portfolio.

Energy Outlook

Energy stocks rose 9% in September, but are still down 1% year to date. The impact of the Macondo oil spill and slower economic growth has caused the driller and oilfield services segment to be particularly weak, while integrated oil companies in general are flat for the year. We believe the drilling moratorium in the Gulf of Mexico could be reconsidered after the elections, but for the drilling and oilfield services stocks, the slowdown and business interruption is already priced in. The Street has continued to shave expectations for both oil and natural gas prices for 2011. RBC lowered its expectations for oil and gas prices on September 15; oil is now expected to average $83/WTI (down from $85/WTI) and at $5.00/mcfe (down from $5.75/mcfe) of natural gas for 2011. We believe oil prices are likely to trade in a range of $60-$90/bbl WTI over the next several years, with a long-term benchmark of $85. Our new natural gas long-term price outlook is now $6.00/mcfe, down from $6.50. Despite low natural gas prices, natural gas drilling in regions with “wet” gas, or areas that have a high percentage of natural gas liquids (NGLs) as part of the reserve, have benefitted from strong processing margins, since NGLs are priced off oil.

In general, our more bullish outlook for oil rather than natural gas is reflected in the stock selections for the list, with an emphasis on international integrated oil companies with strong cash flows. Additionally, we believe emerging economies will look for ways to use “black gold” to hedge their dollar holdings, and we would not be surprised to see sovereign wealth nations directly acquire reserves or oil companies to hedge their needs. We also prefer mid-range and deepwater drilling stocks that have drillships and rigs under contract with these cash-rich firms because they search for oil reserves in those “green field” deepwater locations. We believe drilling stocks could see a bottoming in day rates soon, with the potential for stronger day rates as we move into 2011.

Energy Recommendations

Chevron Corporation (CVX)

Chevron Corporation, through its subsidiaries and affiliates, is engaged in fully integrated petroleum operations, chemical operations, coal mining, power, and energy services. Chevron is the third-largest U.S. oil company and is ranked fifth globally in operations. It maintains a strong global footprint in refining, marketing, and transportation, with operations in the United States and nearly 175 other countries. Chevron’s production arm (22% revenues, 79% of profits) is the largest resource holder in Asia, the largest producer in the Caspian region, and also maintains a strong position in the Gulf of Mexico. It has more than 20 projects under development, with capital costs in excess of $1 billion and more than 40 projects with development costs exceeding $1 billion each.

Diamond Offshore Drilling, Inc. (DO)

Diamond Offshore Drilling, Inc. is one of the world’s largest offshore drilling companies. Formerly a wholly owned subsidiary of Loews Corporation, a 30% share went public in 1995; today, just over half of the company is owned by Loews Corporation. The company owns 46 mobile offshore drilling rigs, including 30 semisubmersibles (or “floaters”), 15 jackup rigs, and 1 drillship. Rigs operate in the Gulf of Mexico, the United Kingdom, the North Sea, South America, Australia, Africa, and Southeast Asia. In 2008, 59% of revenues came from outside the United States, while Petrobras accounted for 13% of revenues. Semisubmersibles accounted for 83% of revenues in 2008, drilling in water depths from 4,000 to 7,500 feet. DO shares were added to the S&P 500 in February 2009.

Spectra Energy Corp. (SE)

Spectra Energy Corp. is a pure play natural gas mid-stream company based in Houston, Texas. Spectra has a large network of North American natural gas-gathering and processing assets and 17,500 miles of interstate transmission pipelines, with associated storage and related infrastructure assets including retail distribution in Ontario, Canada. Its pipelines serve the high population density markets of the Northeast United States. Its 50% ownership interest in DCP Midstream gives it a sizable stake in one of the largest natural gas gatherers and processors in the United States.

Financial Services Outlook

The Financial Services sector currently represents 16.10% of the S&P 500 Index. For the year through September 30, the Financial Services sector was up marginally at 0.7% compared to up 2.3% for the Index. There are 20 sub-industries in this sector, with Diversified Financial Services making up the largest portion at 19.8%. Moderate economic concerns continue to weigh on the group in the second half of the year, but our research sources believe banks without excessive exposure to commercial real estate will do better, and banks that have large loan-loss reserves could potentially release some of those reserves. Our research sources believe the government’s new proposed banking regulations could impact the group’s profitability negatively and potentially lead to reduced valuations. However, they also believe this could lead to increased consolidation in the industry as stronger banks buy the weaker ones. Banks with the strongest balance sheets will do well in this environment. More importantly, our sources believe economic improvement will be the key driver for the group over the next 12 months. At this time, our focus is on Canadian financial services companies that came through the banking crisis in much better shape than many of their

U.S. counterparts due to the stricter Canadian banking regulations. Our current view of the Financial Services sector remains market weight.

Financial Services Recommendations

Bank of Montreal (BMO)

Established in 1817, Bank of Montreal is a diversified Canada-based financial services firm. Ranked the fourth-largest bank in Canada based on market capitalization, Bank of Montreal operates in the United States and 17 other countries. It also owns Harris Bankcorp based in Chicago, Illinois, as well as BMO Nesbitt Burns, a full-service broker-dealer. Its major business lines include personal and commercial banking in both Canada and the United States, which contribute about 50% to earnings; wholesale banking (35%), and wealth management (15%). Bank of Montreal has approximately 37,000 employees.

Health Care Outlook

Healthcare offers some of the best risk/reward opportunities in the market, in our opinion. The sector is rated Overweight by both RBC and our national research sources. In September, the sector rallied 9% on average, and is now -1% year to date. In a period of low growth, the defensive growth characteristics and low valuation/expectations offered by the sector hit the sweet spot for dividend investors. The forward P/E multiple for Health Care is now at 10.7x, below that of the S&P 500 (or about 12x). The stocks we select for this Portfolio are pharmaceuticals. According to our national source, the group is pricing in just 6% earnings growth and 2% revenue growth for the next few years. In general, we expect M&A activity to remain strong into 2010 as biotechnology firms and pharmaceutical companies work to fill pipeline gaps and seek economies of scale. Unlike the transformative mergers seen in the sector in 2009, we believe niche acquisitions or joint ventures in other Health Care sub-sectors will mark 2010. We believe these companies once again will work to leverage the distribution and relationships pharmaceuticals have with insurance firms and hospitals. As a result, we expect pharmas to broaden their product footprints into other health care sub-sectors, similar to the moves made recently in biotechnology and generic-drugs companies. The Guided Portfolio: Prime Income Investment Committee continues to focus on pharmaceutical companies that have made transformative mergers to build their product pipelines and extract costs, which supports better earnings growth and, over time, should lead to better dividend growth.

Health Care Recommendations

Bristol-Myers Squibb Co. (BMY)

Bristol-Myers Squibb is a global health care company with dominant franchises in pharmaceuticals and nutritional products. Prescription drugs comprised 81% of revenues in 2007, followed by its nutritional division, Mead Johnson (Enfamil) at 13%, and medical devices at 6%. Its key disease focus is on cardiovascular, anti-cancer, anti-infectives (including HIV/AIDs), and the central nervous system. Plavix, its largest-selling drug through a joint venture with Sanofi-Aventis, generated $5.9 billion in revenues in 2008. Bristol-Myers finalized its spin-off of its Mead Johnson Nutritionals interest in December 2009. Research and Development represents 17% of sales, with more than 50 drugs in the development pipeline. Bristol-Myers seeks to broaden its pharmaceutical reach by developing drugs with strategic partners; recent deals were signed with ZymoGenetics and Exelixis.

Eli Lilly & Co. (LLY)

Eli Lilly & Co discovers, develops, manufactures, and sells pharmaceutical products for humans and animals. The company's products are sold in countries around the world. Lilly's products include neuroscience products, endocrine products, anti-infectious drugs, cardiovascular agents, oncology products, an anti-ulcer agent, and animal health products.

Merck & Co. (MRK)

Merck & Co., Inc. is one of the largest global pharmaceutical companies, with strong franchises in asthma, allergies, diabetes, and hypertension. Merck is also a leader in vaccines, which accounted for 15.5% of sales in 2009. The company also participates in a number of product joint ventures with Johnson & Johnson, AstraZeneca and Sanofi-Aventis. Merck closed its acquisition of Schering-Plough in late fall, 2009, for a combination of cash and stock. Foreign sales approached 44% in 2009.

Merck’s research and development spending totalled almost 20% of sales in 2009, and is projected to be almost 19% of sales in 2010.

Master Limited Partnerships

MLPs are similar in almost every way to publicly traded companies but have several advantages because of their unique partnership structure, regulatory, and tax laws, including favorable tax treatment for investors and tax benefits for sponsors. Unlike corporations, whose profits are taxed by the federal and state governments, partnerships do not pay tax on their income and may, therefore, pass the full amount of their cash flows to their unit holders, thereby avoiding the “double taxation” to which corporations are subject. Capital gains and losses, amortization and depreciation, and all other credits and deductions are included in an individual’s allocation of income and are passed through directly to the unit holder.

Investors need to remember MLPs are partnerships—and not stocks—and are treated as such by the IRS. The tax burden falls completely on the unit holder. Instead of receiving a 1099 form for tax purposes, investors receive a K-1 form, which usually arrives in late February or early March and means MLPs may not be totally appropriate for investors wishing to file their taxes early. Some MLPs operate in several states, and filing these state taxes can be cumbersome. When we use the phrase “tax-advantaged distribution” regarding MLPs, we are referring to the fact that the distribution contains a high percentage of “return of capital,” which serves to offset the cost basis in the underlying unit. Please consult with your tax advisor on issues that may pertain to Master Limited Partnerships.

Master Limited Partnerships Outlook

The MLP stocks have been among the best performing group in 2010, delivering 18.3% as measured by the Alerian MLP Index (AMZ), after returning an outsized 76.23% in 2009. Despite this strong relative move, we believe MLPs strike at the investor sweet spot because they provide above-average, growing cash flow with relatively lower risk. The demand for safe yield in a market where the 10-year treasury yields less than 2.6%, we believe is one reason for the strength of the group. The other reason is the outlook for acquisitions and projects remains strong, because drilling activity is robust for both oil and natural gas. This level of drilling activity and massive discoveries in the oil and gas shales in North America have increased the demand for infrastructure to support these growing regions. For investors seeking above-average cash flows from conservative business models, we caution that most of the return in the year may come primarily from yield.

MLPs remain popular with high net worth investors due to their defensive growth and above-average, tax-advantaged yields. Debt and equity capital offerings have been largely well received by investors. While we believe valuations are not extended, shocks to the credit markets could rattle the group, providing attractive entry points. The group could also take a “breather” as the market absorbs the additional units and monitors projects and demand for infrastructure. The profitable spreads for processing natural gas liquids (NGLs) remain, supporting growing cash flow for many of the securities we have on the Portfolio. While the risk/reward remains attractive over the long term, we prefer to add partial positions as prices pull back.

Master Limited Partnership Recommendations

Energy Transfer Equity L.P. (ETE)

Energy Transfer Equity (ETE) is the General Partner of Energy Transfer Partners (ETP), L.P., an energy Master Limited Partnership. Through this structure, ETE owns the 2% general partner interest and a 37% interest in the limited partner units of ETP (62.5 million units). ETE recently announced the purchase of the general partnership interest in Regency Energy Partners, L.P. from GE Capital in a two-step transaction. Through these ownership positions, ETE receives incentive distribution rights (IDRs) from these partnerships, which result in a leveraged way to participate in the growth of the cash flows. The ETP businesses are focused in the following areas: intrastate transportation and storage; interstate transportation; midstream services, and retail propane. Regency Energy Partners, L.P. (RGNC) focuses on the following business areas: transportation and gathering & processing midstream services. We estimate distributions will have 80% tax deferral for new investors.

Enterprise Products Partners, L.P. (EPD)

Enterprise Products is one of the leading midstream energy service companies in North America, providing complete services of processing, fractionation, transportation, and storage to producers. The partnership serves the largest producing basins of natural gas, crude oil, and natural gas liquids in the United States, including the Gulf of Mexico, Rocky Mountains, San Juan Basin, Permian Basin, Texas and Louisiana Gulf Coast region, East Texas, and Mid-Continent. Enterprise Products believes it is a leader in the development of midstream infrastructure in the deepwater Gulf of Mexico. The partnership has an estimated tax deferral of 90% for new investors. In late 2009, the company completed its acquisition of Teppco Partners L.P.

Kinder Morgan Energy Partners, L.P. (KMP)

Kinder Morgan Energy Partners, L.P. owns and operates one of the largest product pipeline systems in the United States, along with CO_2 and natural gas pipelines. With the acquisition of the Vancouver Terminal and drop down of the Trans Mountain assets, its footprint is now expanding into Canada. Its general partner, Kinder Morgan, Inc., was recently taken private in 2007 by a consortium including principals from Goldman Sachs and key shareholders. We estimate the tax deferral for the partnership is 95% for new investors.

Williams Partners, Ltd. (WPZ)

Williams Partners Ltd. holds a diversified portfolio of energy midstream assets. With the acquisition of its sister MLP, Williams Pipeline Partners, it holds intrastate and interstate natural gas pipelines that service primarily the Pacific Northwest. With the $12 billion drop-down of assets from its general partner, Williams Companies, WPZ is now the third-largest MLP in the industry. It also holds sizable assets in gathering and processing assets, critical to the production of Natural Gas Liquids. Williams Companies, which owns the general partner, now also own 80% of the outstanding L.P. units. Tax deferral is estimated at 80%.

Real Estate Investment Trusts (REITs) Outlook

We remain selective when considering REITs for inclusion in the Portfolio. The group struggled with less-than-visible cash flow and high debt levels in 2009. This resulted in reduced dividend payments or, in some cases, part cash/part stock dividend structures being declared by many of the equity REITs (hard assets). The REIT group as a whole continues to rally into 2010, but returns in the REIT sub-sectors have been mixed, consistent with trends in the Financial sector. Opportunities at this time appear to be in the higher-quality mortgage REIT space due to their above-average yields. These REITs have high-quality mortgage portfolios, proven management teams, and conservative balance sheets. We find valuations attractive in the mortgage REIT space because several high-quality companies are valued at or just above their NAV and utilize lower-than-average leverage. We remain selective and focus on what we view as a timely opportunity to acquire great business models. We continue to monitor the property REIT space for investment opportunities. As we head further into 2010, we expect the more favorable operating environment we saw in the first half of 2010 will continue, resulting in returns on equity remaining very attractive for the group. We expect interest rates will remain low for the rest of the year, with the potential for a Fed rate tightening being pushed out to the second half of 2011 at the earliest. We believe this interest rate environment and the lower borrowing costs will continue to be beneficial for mortgage and equity REITs, but continued improving economic conditions will be the real driver for the equity REIT space.

REIT Recommendations

Annaly Capital Management. (NLY)

Annaly Capital Management owns and manages a portfolio of high-quality agency, mortgage-backed securities. The company’s principal business objective is to generate net income for distribution to stockholders from the spread between the interest income on its mortgage-backed securities and the cost of borrowing to finance its acquisition of mortgage-backed securities. Annaly does not originate mortgages. The company also operates a fixed-income investment management subsidiary, FIDAC, which currently holds net and gross assets under management of $12.1 and $18.8 billion, respectively. Annaly is organized as a real estate investment trust (REIT) for tax purposes.

CBL & Associates (CBL)

CBL & Associates owns, operates, manages, develops, redevelops, and acquires primarily regional malls in addition to community and neighborhood centers. CBL owns 163 properties, including 88 regional mall/open-air centers in 27 states, totalling 87.8 million square feet of gross leasable area. CBL & Associates' properties are located primarily in the Southeast and Midwest regions of the United States. The company focuses on the middle markets where it can be the dominant retail landlord. CBL generates revenue predominately through long-term leases to retail merchants and recovers most property operating expenses from its tenants through contractual agreement. Tenants include major department stores and other retailers.

Telecom Services Outlook

We are marginally positive on the group because we believe the encouraging effects from consolidation, combined with low valuations and above-average dividend yields, represent opportunity for equity-income-oriented investors. While wire-line voice losses will continue for the group due to outside competition, the consolidation within the Regional Bell Operating Companies (RBOCs) brings reduced competition in the business and wholesale marketplace as regional concentration increases. The growing mix of wireless, plus continued rollout of services, such as Internet Protocol Television (IPTV) and broadband, should support steady volume growth while reducing churn. The blend of reduced competition and improved mix of services should mostly offset a downtrend in pricing. As regional concentration increases due to mergers, the RBOCs benefit from the cost advantage inherent in owning the majority of their regional network access assets. As a result, their margins should improve and earnings grow, albeit in low-single digits, increasing free cash flow and supporting above-average dividends and potential dividend growth. Year to date through September 30, this sector was up 5.9% compared to 2.3% for the S&P 500. Telecom, which is more defensive in nature, did better through the summer months as investors moved to more defensive investments amid the economic concerns in Europe and concerns of a potential double-dip recession. While economic growth remains slow, we don't believe we will have a double-dip recession. With that said, we believe this sector still provides attractive dividend yields for equity-income investors.

Telecom Services Recommendations

AT&T Inc. (T)

AT&T Inc. is one of the world's largest communications companies and is the largest in the United States. Operating globally under the AT&T brand, AT&T companies are recognized as the leading worldwide providers of IP-based services to business and as leading U.S. providers of high-speed DSL Internet, local and long-distance voice, directory publishing, and advertising services. With the acquisition of Bell South, AT&T Inc. holds a 100% ownership interest in AT&T Wireless, the No. 1 U.S. wireless service provider, with more than 52 million wireless customers.

BCE Inc. (BCE)

BCE, Inc., founded in 1880, is the largest diversified telecommunications firm in Canada. Telecom services, including wireline, wireless, video, and internet access are provided through its wholly owned subsidiary Bell Canada. The company also holds ownership interests in several telecom firms: Aliant (45% ownership); Telestat (100%); BCE Globemedia (20%); and Bell ExpressVu (100%). BCE and its subsidiaries provide telecom services to close to 70% of Canadians, with primary concentration in Ontario and Quebec. The company reinstated its dividend plus a share repurchase plan shortly thereafter. In July 2009, BCE acquired the outstanding 50% ownership interest in Virgin Mobile Canada.

Verizon Communications Inc. (VZ)

Verizon Communications, Inc. provides wireline voice and data services, wireless services, and internet services. The company also provides network services for the federal government, including business phone lines, data services, telecommunications equipment, and pay phones. The company has operations worldwide.

Utilities Outlook

We believe utilities will prove to be a solid long-term holding for very conservative equity-income investors, and we expect low- to mid–single-digit total returns in 2010. Year to date through September 30, the sector was up 1.8% for the year compared to the S&P 500, which was up 2.3%. Utilities offer investors conservative low–to-mid single-digit earnings and dividend growth potential. We believe this sector will eventually price in the anticipated economic and housing market recoveries in their service territories. However, this recovery will most likely lag the broader market. We continue to focus primarily on the plain vanilla utilities with strong regulated businesses for our conservative equity-income investors. We also see opportunity in diversified natural gas utilities that have the ability to leverage the growing need for infrastructure in the energy industry. We view the economic recovery as a “long and winding road.” As a result, we would selectively buy utility stocks when valuations are at compelling levels—such as they are now. This sector, which is more defensive in nature, has under-performed since investors look for sectors and companies more leveraged to an improving global economy. All things considered, we believe this sector still provides attractive dividend yields for equity-income investors.

Utility Recommendations

Dominion Resources, Inc. (D)

Dominion Resources is a diversified utility holding company that generates, transmits, distributes, and sells electric energy in Virginia and Northeastern North Carolina. The company produces, transports, distributes, and markets natural gas to customers in the Northeast and Mid-Atlantic regions of the United States.

Duke Energy Corp. (DUK)

Duke Energy is one of the largest electric power companies in the United States, supplying and delivering energy to approximately 3.9 million U.S. customers. The company has nearly 37,000 megawatts of electricity-generating capacity in the Midwest and the Carolinas and provides natural gas distribution services in Ohio and Kentucky servicing 500,000 customers. Duke has more than 4,000 megawatts of electricity generation in Latin America and is a joint-venture partner in a U.S. real estate company.

NSTAR (NST)

NSTAR is an energy delivery company with revenues of approximately $3 billion and assets of $6 billion. NSTAR serves 1.4 million customers in Massachusetts, including approximately 1.1 million electric customers in 81 communities and 300,000 gas customers in 51 communities. NSTAR also conducts non-utility, unregulated operations. Its non-utility segment engages in steam distribution, telecommunications, an energy IT company, and five real estate trusts.

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			Investment Banking Services Provided During Past 12 Months	
Rating	Count	%	Count	%
Buy (TP/O)	642	49.61	191	29.75
Hold (SP)	588	45.44	123	20.92
Sell (U)	64	4.95	9	14.06

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An analyst's “sector” is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector, but does not attempt to provide the analyst's view of how the stock will perform relative to: (i) all companies that may actually exist in the company's sector, or (ii) any broader market index.

Ratings:
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Outperform (O): Expected to materially outperform sector average over 12 months.

Sector Perform (SP): Returns expected to be in line with sector average over 12 months.

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