U.S. EQUITY FUNDS

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DWS Investments strategy insights: equities

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Equity holdings continue to be much lower than historical averages, despite encouraging fundamentals in Corporate America. In our opinion, investors can't stay underweight equities forever. Here are some ways to shape allocation decisions.

WHAT WILL TRIGGER EQUITY BUYERS?

Fund-industry statistics show that investors currently hold fewer equities relative to other asset classes than they have historically. As recently as 2000, equities — both U.S. and international — comprised nearly 80% of mutual fund allocations. That number dropped to just over 60% in 2003, climbed above 70% in 2006 and currently sits at about 55%, which is well below the 15-year average of 68%.[1]

It is tempting to assume these swings are due mainly to changes in the price of those equity assets, but the price levels of the S&P 500 Index have generally bounced between 800 and 1,560 since the late 1990s.[2] The price level of 1,200 in the fourth quarter of 2011, for instance, was also reached in December 1998, July 2001, February 2005 and May 2010.

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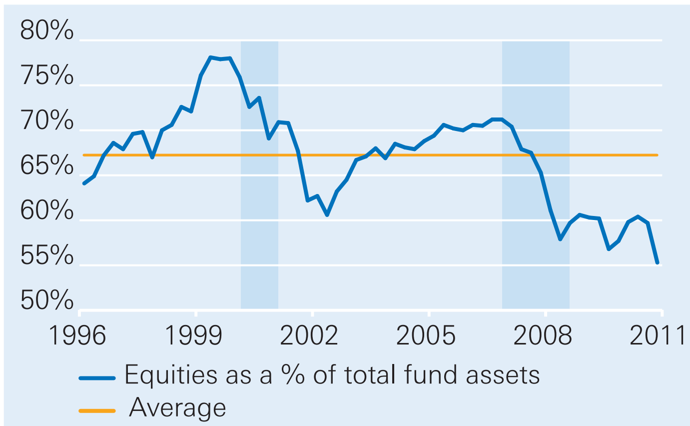
Part of the reason for lower equity allocations is the proliferation of newer specialty investment choices such as currency funds, unconstrained funds and managed futures. Over the years, many of the assets flowing into those types of funds have come from equity allocations.

Investors' appetite for equities has been challenged since the onset of the recession. And so the question remains, "What will trigger investors to move back into equities?"

EQUITY ASSETS ARE HISTORICALLY LOW



Source: Morningstar, the Federal Reserve Board and DWS Investments as of 9/30/11. Blue bars indicate recessions.

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FUNDAMENTALS ARE STRONG

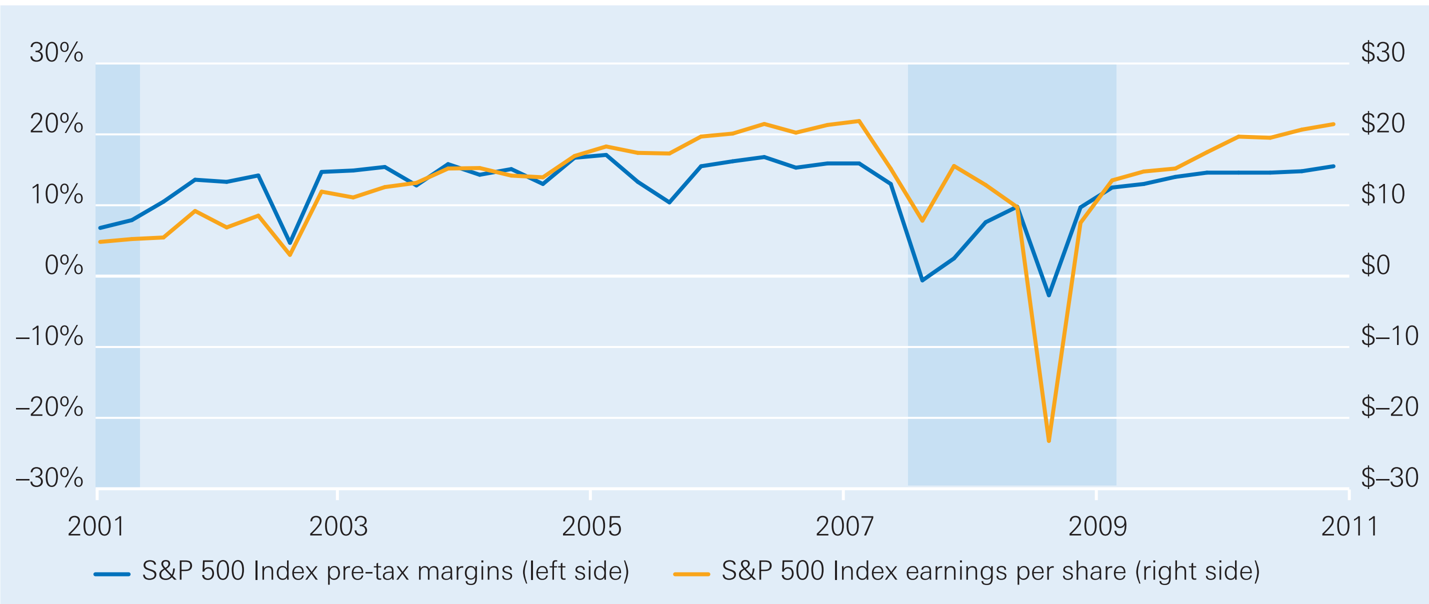
Looking at corporate fundamentals, investors should be very encouraged. Corporations adjusted aggressively to the recession and made changes that have created much leaner and more productive operations, on average, than those of pre-recession levels. They moved quickly, exited uncompetitive businesses, reduced excess headcount, leveraged cost-effective technology and figured out how to survive through the panic of the Great Recession. Then, when demand for their goods and services began to rise, corporations discovered they could continue to meet customer demands with leaner operations. While this helps profitability, it is detrimental to the national employment picture.

Earnings and operating margins are very strong. In fact, margins of the Standard & Poor's (S&P) companies are higher now than any time since the 1980s (see chart below for details).

In terms of valuation, a debate rages on in the markets among those who say price-to-earning (P/E) ratios are very low, while others claim they are much higher.[3] The differences of opinion come from different assumptions and methodologies, but it is not a stretch to say that P/Es are reasonable, at the very least. P/E multiples are higher now than they were during the recession, as expected, but not so high as to concern us. Multiples certainly have room to climb, in our opinion.

Also, importantly, corporations are now operating with much less leverage than they did before the recession. They have reduced debt and begun to stockpile an impressive amount of cash that could be used for mergers and acquisition (M&A) activities, stock buybacks, dividend payments, re-investment into operations or whatever is viewed as the best use of that cash. From an investor-risk perspective, these high cash levels may potentially provide a significant buffer against the uncertainty of future earnings.

CORPORATE EARNINGS AND MARGINS ARE STRONG



Source: Ned Davis Research, Standard and Poor's and DWS Investments as of 3/31/11. **Performance is historical and does not guarantee future results.** Blue bars indicate recessions.

THE RELUCTANT EQUITY INVESTOR

Despite strong fundamentals, investors have been reluctant to move back into equities. Investors are frustrated, having been disappointed by equities more than once since 2000. To make matters worse, many investors moved assets out of stocks after the crash (realizing losses), and thereby failed to participate in the big rallies that followed (not realizing gains), leaving the total returns of their personal investment portfolios well below those of the broad equities markets.

Even without the whip-saw effect of poorly timed investment decisions, the broad stock market has caused some investors to feel like they are the subject of a cruel joke.

1. Since the 1990s, equity investment returns, in general, have been lower than historical averages. To the extent that investors have expected equities to keep up with historical averages, they have been disappointed.

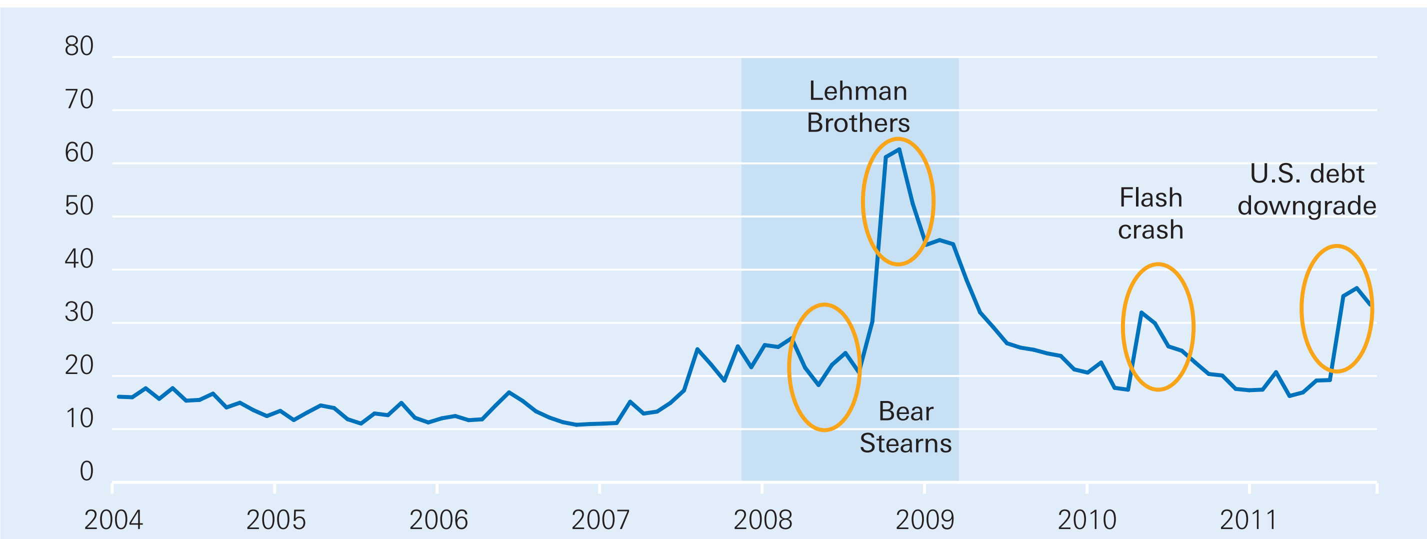
2. The volatility of equities has become gut-wrenching. The CBOE Volatility Index (VIX) has been elevated since 2007, including G-force-inducing spikes surrounding Bear Stearns, Lehman Brothers, the flash crash of 2010 and the U.S. government downgrade.[4]

3. Consumers—whose spending makes up a significant portion of gross domestic product (GDP) growth—currently have dismal confidence and sentiment levels (as measured by the Conference Board and University of Michigan, respectively).[5] Confidence remains significantly below pre-recession levels. What this implies about commitment to equities is not encouraging.

4. Additionally, the unemployment picture is grim. Not only is the official unemployment rate high, but the average duration of unemployment is longer than any time in several decades. Employees concerned about job security generally are not likely to invest in an asset class that has disappointed them in recent years.

5. As if all that weren't enough of an explanation of the tepid investor sentiment toward equities, boomers, as a demographic of society, are inching toward retirement. This means they naturally tend to bias their investment allocations toward less risky, income-producing assets.

VOLATILITY HAS BEEN HIGH



Source: CBOE, the Federal Reserve Board and DWS Investments as of 9/30/11. **Performance is historical and does not guarantee future results.** Blue bars indicate recessions. Volatility is represented by the CBOE Volatility Index (VIX).

AMERICAN HOUSEHOLD REDUCED DEBT

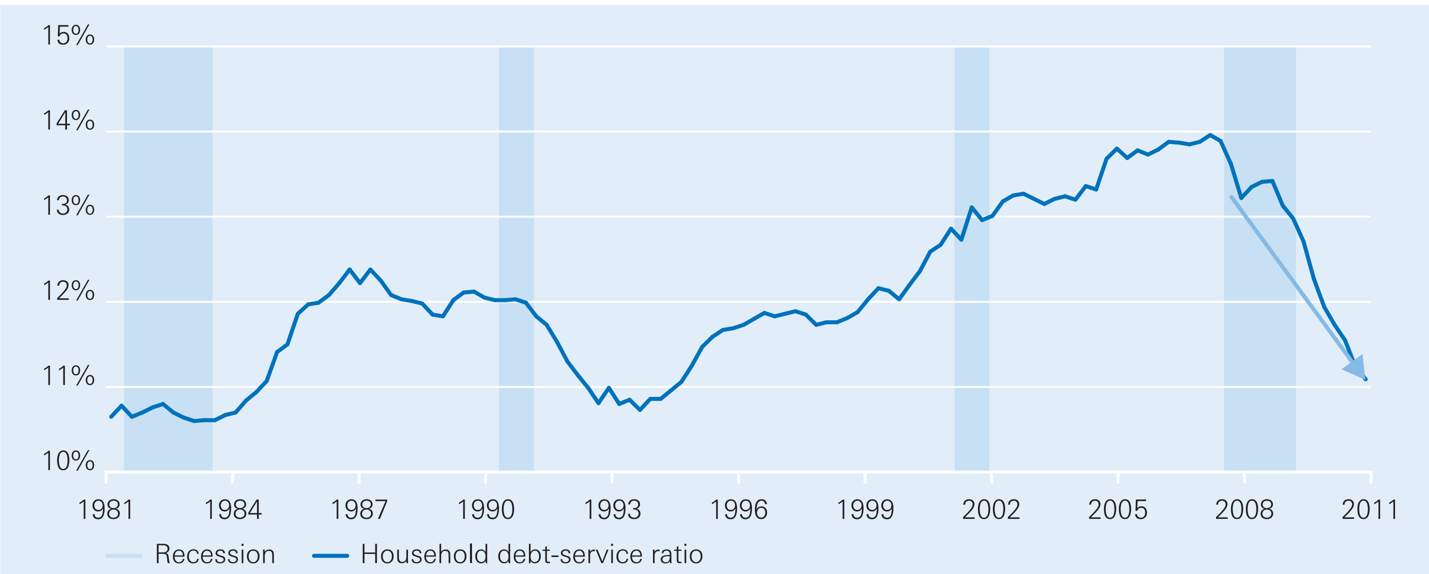
Lower allocations to so-called risky assets are consistent with the larger trend of households paying down debt and increasing savings.

The U.S. household debt-service ratio has been falling.[6] This ratio is an estimate of payments for outstanding mortgage and consumer debt relative to disposable personal income.

We realize the U.S. household has had a dismal history reducing debt during the past decade. As a nation, the proliferation of over-levered households with zero or negative savings rates came to characterize the nation (and much of the developed world). It may not be a great accomplishment that the nation's savings rate is now something modestly north of zero, but it's a step in the right direction.

Since households are lowering their debt burdens, they have a higher ability to take risk in the investment markets than in recent years. Yet their willingness to take risk remains low.

HOUSEHOLDS HAVE AGGRESSIVELY REDUCED DEBT



Source: The Federal Reserve Board and DWS Investments as of 6/30/11.

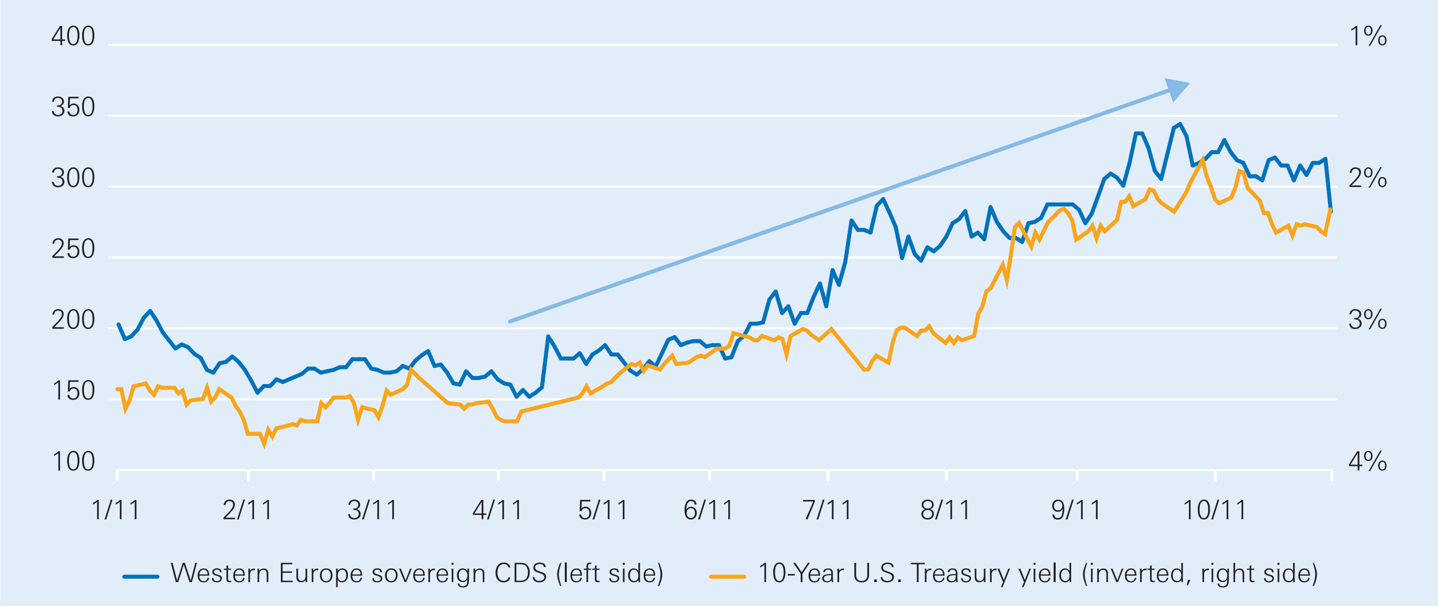
PENT-UP DEMAND

We believe there is pent-up demand for equities, due to the low yields on other asset classes (cash and fixed income) and attractive valuations. The bulls and bears each have strong convictions and, as the old saying goes, "disagreements are what make markets." From a top-down perspective, there are many concerns, creating headwinds for the broader stock market. From a bottom-up perspective, there are many reasons to be excited about individual stocks.

Pent-up demand for equities should be released with the resolution of some macro uncertainties, in our opinion. The largest among these uncertainties is the current state of affairs in Europe. Debates continue surrounding the details of restructuring European sovereign debt (whether the process is labeled a "default" or not), but defaults in and of themselves are not the big concern. The big concern is whether restructuring of debt has consequences that are contained (like Argentina in the early 2000s) or creates a shock that produces wider systemic risk (like a Lehman Brothers 2.0).

The relationship between the situation in Europe and investor risk aversion is illustrated in the chart below by plotting credit default swap prices (which represent credit protection on a basket of European sovereign bonds) and 10-year U.S. Treasury yields (which we inverted for comparative purposes, so numbers fall vertically instead of rise).[7] As you can see, the two lines follow each other very closely. The translation: Concerns about Europe have caused investors to seek safety in the form of U.S. Treasuries, and that has driven their prices up and their yields down.

MARKETS ARE BECOMING MORE RISK-AVERSE



Source: Bloomberg, the Federal Reserve Board and DWS Investments as of 10/27/11. The CDS is represented by the Markit iTraxx Western Europe sovereign five-year CDS.

CONCLUSION

Progress has been made in the three years since the stock market hit its low due to the credit crisis. The leverage on corporate and household balance sheets has been significantly reduced, and although the federal government's balance sheet has assumed some of this aggregate leverage, the cycle is nevertheless maturing.

We believe the economy continues to face significant challenges, however that doesn't mean that there are not opportunities in the market. As the worrisome macro issues move toward resolution, we expect the number of opportunities to increase.

RECOMMENDATIONS FOR ASSET ALLOCATORS

Company fundamentals are compelling, but macro uncertainties are too great to advocate overweighting equities relative to historical averages.[8] Since trying to find the absolute bottom has proven to be a flawed strategy, we would recommend investors begin to allocate towards equities.

We advise investors to determine if their current equity allocations reflect their long-term needs. Then, formulate a plan that includes:

1. Establishing the optimal allocation to equities, fully considering their specific investment time horizon (the longer the time horizon, the better suited to volatilities associated with equities), and

2. Establishing a timeline for rebalancing toward that optimal allocation. If the current allocation is 20% and the optimal allocation is 50%, determine how much time is needed to get there. This approach takes advantage of dollar-cost averaging, giving exposure to some growth in the interim while avoiding the risk of going "all in" at once.

Also consider more defensive equity strategies, including income producers and low-beta vehicles.[9]

Once the plan is set, stay disciplined, and don't focus too much on the day-to-day headlines. Current events may appear more daunting than they actually are. Over-reacting could perpetrate the common mistake of getting in too late, getting out too late, and perennially underperforming the broad market.

Asset allocation neither assures a profit nor guarantees against loss.

IMPORTANT INFORMATION

[1] Source: Morningstar as of 9/30/11.

[2] Source: Standard & Poor's. The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market.

[3] Price-to-earnings ratio (P/E) ratio compares a company's current share price to its per-share earnings.

[4] The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

[5] Gross domestic product (GDP) is the value of all goods and services produced by a country's economy.

[6] Household debt-service ratio is an estimate of the ratio of debt payments to disposable personal income; debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.

[7] A credit default swap obliges the seller of the CDS to compensate the buyer in the event of a loan default.

[8] Overweight means a higher weighting in a given sector or security than the benchmark.

[9] Beta measures a security's sensitivity to the movements of the fund's benchmark or the market as a whole. A beta of greater than one indicates more volatility than the benchmark or market, while a beta of less than one indicates less volatility.

Index returns do not reflect fees or expenses, and it is not possible to invest directly in an index.

The opinions and forecasts expressed herein are those of the authors, do not necessarily reflect those of DWS Investments, are as of 9/30/11 and may not come to pass.

IMPORTANT RISK INFORMATION

Investments in mutual funds involve risk. Stocks may decline in value. Bond investments are subject to interest-rate and credit risks. When interest rates rise, bond prices generally fall. Credit risk refers to the ability of an issuer to make timely payments of principal and interest. Investing in derivatives entails special risks relating to liquidity, leverage and credit that may reduce returns and/or increase volatility. Investing in foreign securities, particularly those of emerging markets, presents certain risks, such as currency fluctuations, political and economic changes, and market risks. There are additional risks associated with investing in commodities, high-yield bonds, aggressive growth stocks, non-diversified/concentrated funds and small- and mid-cap stocks which are more fully explained in the prospectuses. Please read the prospectus for more information.

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