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MAINTAINING PURCHASING POWER THROUGH HIGH QUALITY DIVDEND GROWTH

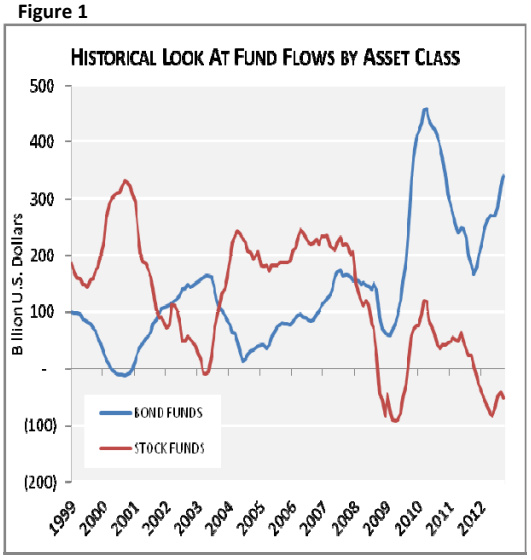
We remain committed to our theme of owning high-quality dividend-paying stocks. Ever since the Federal Reserve demonstrated it was serious about fighting inflation in the early 1980's, bonds have exhibited stellar returns. Unfortunately, we think we are very near the end of this high return period, as we will demonstrate here.

As evidenced by mutual fund flow data, investors still perceive bonds to be a safe haven from volatile equity markets. Over the last year alone, $340 billion has been invested in bond and income funds while $52 billion has left equity funds.

Figure 1 illustrates the secular fund flow shift into bonds and away from stocks since the financial crisis. Note that the opposite phenomenon occurred at the peak of the equity bubble in 2000. The money flowing into bonds has driven yields on fixed income investments to historically low levels so that bonds now seem quite expensive. This bond "over-valuation" can be illustrated using the stock concept of price-to-earnings (P/E) ratio, with bond earnings being the yearly coupon that the bond owner receives. Figure 2 shows the historical stock market P/E ratio and an equivalent P/E ratio for the 10-year Treasury, which is just the bond price divided by the yearly coupon payment. Note that this equivalent bond P/E has spiked to approximately 60 compared to a stock market peak P/E of approximately 30 at the turn of the century.

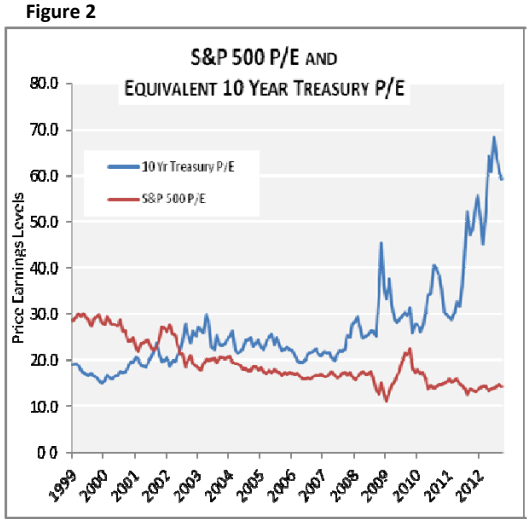
The fund flow data and valuation data are telling a story of bonds that are now very popular and expensive relative to equities that are now under-owned and reasonably valued (current S&P 500 P/E is around 13). This dynamic has caused us to be concerned about future bond returns and optimistic on future equity returns as the following will show.

Figure 1



Source: Janney ISG, ICI, Bloomberg

Figure 2



Source: Janney ISG, Bloomberg

The 10-year Treasury recently traded with a coupon of 1.625%, and the most recent CPI reading was 2.0%. This produces a real yield of -0.38% (actual or nominal treasury yield minus inflation) compared to the long-term average real yield of 2.58%. This means an investor in the 10-year Treasury is actually receiving a negative real rate of return and is not able to maintain the purchasing power of his portfolio (more on this later).

The Federal Reserve is also doing its best to provide low interest rates until housing and labor markets show significant improvement. These efforts to "re-flate" the economy are gaining some traction, as evidenced by improvements in housing conditions. We think the Fed will ultimately be successful at reviving the economy (assuming our newly elected politicians can agree to a budget deal in the near future). Once the Fed and our politicians are successful, bond yields will rise to more normal levels. Investor fund flows may also eventually leave this expensive market, just as they left equities in 2000. This may plausibly coincide with the normalization of economic conditions.

An example best illustrates the impact rising interest rates can have on bond values. Assume you bought a current 10-year Treasury with a 1.625% coupon at a par value of $1,000 and held it for one year. If interest rates were flat, you would get your 1.625% coupon and be able to sell the bond for $1,000. If interest rates went up 1.0% to 2.625%, you would still get your 1.625% coupon, but your bond would be worth only $920. This represents a portfolio loss of about 6.7% and demonstrates a key concept that many investors are ignoring: bond prices move opposite to bond yields. If rates move up to 3.625%, the bond would be worth only $848 and the portfolio would experience a total loss of over 14%. To get a return higher than the 1.625% coupon, an investor in the 10-year Treasury would need to see interest rates drop. If the yield dropped all the way to 0.625% (a 1.0% drop), the price of the bond would go up to $1,087 for a one year return of about 9.8%. This data is summarized in Table 1 and shows that the risk attached to bonds may be skewed to the downside.

Bond Price vs. Yield Change for Current 10-Year U.S. Treasury Bond

Date	Yield Change	Actual Yield	Bond Price	Total Return
11/15/12	-	1.625 %	100.00	-
11/15/13	+2.00 %	3.625 %	84.76	- 14.4 %
11/15/13	+1.00 %	2.625 %	92.03	- 6.7 %
11/15/13	-	1.625 %	100.00	+ 1.3 %
11/15/13	-1.00 %	0.625 %	108.74	+ 9.8 %

** assumes coupon reinvestment rate of 0.28%*

Source: Janney ISG, Bloomberg

Meanwhile, we have a very different set of dynamics taking place with high-quality dividend-paying stocks. Let's use the 16 highest-credit-rated companies in the S&P 500 for our analysis. We believe these stocks are in a much better position to maintain long-term portfolio purchasing power. These 16 stocks have an average yield of 2.8% which provides much better current income than the 10-year Treasury discussed above. These companies also have a long history of substantially increasing their dividends, with an average 10-year dividend growth rate of 9.4%. And all but two companies were able to raise their dividends through the financial crisis. Even these two, GE and PFE, are now substantially increasing their dividend.

Increasing dividends go a long way toward maintaining and increasing investor purchasing power. This is best illustrated by comparing CPI inflation of 2.7% over the last 10-years to the 9.4% dividend growth rate. Because of inflation, you need $1.31 today to maintain the purchasing power of $1.00 from 10 years ago. The dividend growth of the high quality stocks would have provided $2.45 of purchasing power, assuming you started with $1.00 of dividends 10-years ago (remember also that the bond coupon remains constant). Obviously, the dividend purchasing power has actually been substantially increased over the last decade. These companies also have very strong balance sheets and strong cash flow, so they are well positioned for future dividend increases.

These high quality stocks are also reasonably valued, especially when compared to Treasuries. The average stock price to forward earnings ratio is just 13.5, and the equivalent ratio for the bond example above is 61.5 ($1000 bond price divided by $16.25 yearly coupon). Because these companies also possess strong brands and real assets, the stock prices should continue to go up as the economy heals and interest rates normalize.

Compare the choices: On one hand, increasing dividends and potential for stock price appreciation. On the other hand, low constant coupons and potentially falling bond prices as interest rates normalize. The choice seems clear for an investor with a long-term time horizon.