THE Equity View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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When Looking for Yield, Remember the Three Ps

Pay-out, Participation, and Protection

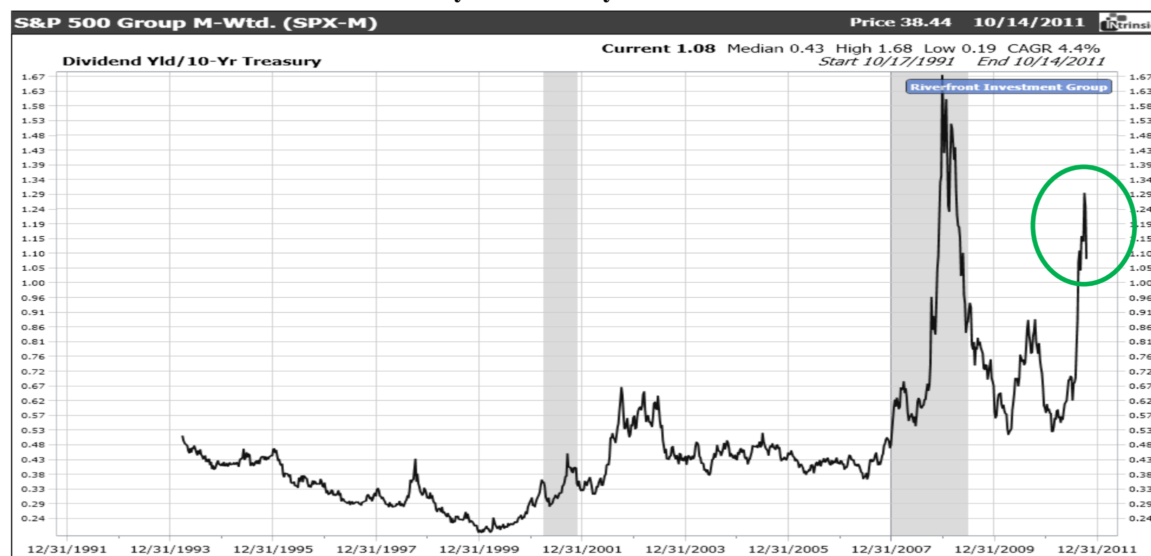
An environment in which money markets yield next to nothing and 10-year Treasuries return around 2%, forces investors to shop for yield in non-traditional places, such as the stock market. In our opinion, this is a good time for income investors to consider stocks, since valuations are low and dividend yields are attractive. However, just like bonds, we don't think stocks should ever be chosen solely for their dividend yield. We recommend income investors adopt the "3P Approach" when selecting stocks – maintaining a proper balance of what we believe are the most important characteristics of income stocks: Pay-out, Participation, and Protection.

Pay-out: Stocks With Attractive Yields Are Plentiful

Since multiple asset classes and products are constantly competing for income investors' attention, a minimum yield is often required for a security to be included in an investor's portfolio. Therefore, our first "P" of income investing is Pay-out, which describes the level of income that is paid out each year. The S&P 500 Index of US equities currently yields approximately 2.5%, significantly exceeding comparable rates on short-term credit instruments, such as money markets or CDs, even exceeding yields on some longer-term instruments, such as the 10-year Treasury Note. The top and bottom panels of Chart 1 illustrate that S&P 500 stocks currently offer yields that are attractive relative to their historical relationship with Treasuries. *Dividends are not guaranteed and are subject to change or elimination.*

Chart 1

S&P 500 Dividend Yield Versus the 10-year Treasury Yield



S&P 500 dividend yield versus 10-Year Treasury yield: The relative yield of the S&P 500 to Treasuries is approaching a multi-year high. Historically, high stock yields relative to Treasury alternatives have been positive for future stock performance.

Past performance is no guarantee of future results. © Intrinsic Research

With the average dividend yield of the S&P 500 exceeding yields found on longer-term Treasuries, it is not difficult to identify stocks with pay-outs greater than those of bonds. For example, as of 10/14/11, 25% of the S&P 500 offered a dividend yield exceeding 3%, and 45% of the S&P offered yields above 2%. Importantly, dividend yields are also worth more to individuals in higher tax brackets than bond interest, since dividends are taxed at favorable rates — an advantage that can equate to an extra 50-75 basis points ("bps" = $1/100^{th}$ of 1%) of return for individuals who reside in the highest tax brackets. Table 1 displays the dividend yield for equities adjusted to compare the after-tax yield with that of taxable bonds under a number of potential tax-rate scenarios.

Table 1: After-Tax Yield Comparison -- Dividends Versus Taxable Bonds

	Potential Dividend Tax Rate (%)					
Dividend Yield	**15.00**	**20.00**	**25.00**	**30.00**	**35.00**	**39.60**
2.00%	2.49	2.39	2.29	2.19	2.09	2.00
2.50%	3.12	2.99	2.87	2.74	2.62	2.50
3.00%	3.74	3.59	3.44	3.29	3.14	3.00
3.50%	4.36	4.19	4.01	3.84	3.66	3.50
4.00%	4.98	4.78	4.58	4.38	4.18	4.00

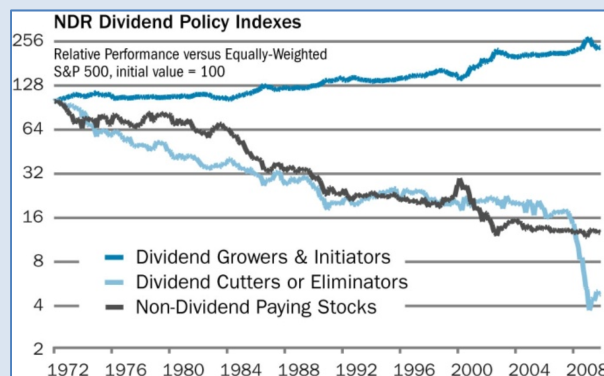
Source: RiverFront Investment Group; RiverFront is not a tax advisor.

Participation: Dividend *Growth*, Not Just Overall Yield, Is The Name Of The Game

The second "P" of income investing is Participation, which we define as an investment's ability to participate in the inherent growth of equities. This growth can take a couple of forms -- dividend growth and/or share price growth. In our view, Participation is paramount, since it is the only compensation an investor receives for leaving the bond world, where principal and interest payments are considered relatively safe. In our view, it makes little sense to leave the "safe" world of bonds to buy the stock of a company that never raises its dividend. We often view companies that pay stagnant dividends as "bonds in disguise," and we think they only make sense if the dividend yields exceeds the bond yield by an amount significant enough to justify accepting a less senior claim on the company's assets.

Dividend Growers Outperform

Stocks that have grown their dividends have historically outperformed over the long term. The equally weighted dividend policy indexes, calculated by Ned Davis Research (NDR), are derived from the component stocks in the S&P 500. Their performance is then plotted relative to an equally weighted version of the S&P 500. Companies that had grown or initiated dividends over each prior 12-month period outperformed the S&P 500 by 33% since 1972. Those that have cut or eliminated their dividends have underperformed by 95%, and non-dividend payers underperformed by 87%.



Source: Ned Davis Research and RiverFront Investment Group
Past performance is no guarantee of future results.

Dividend Growth Can be Meaningful

Unlike the coupon on most bonds, the dividend on a stock can change. Dividends tend to grow in line with a company's normalized earnings growth and, in our view, can be expected to grow at a 5-10% rate in the future for the average stock. Faster growing companies, such as those in the Technology, Healthcare, Industrials, or Consumer Discretionary sectors, may experience significantly faster growth. Table 2 shows that a 3% initial dividend could grow to a nearly 5% yield after five years if a company can maintain a 10% dividend growth rate.

Table 2: Future Yield of 3% Dividend under Various Growth Secarios*

	Years					
Growth Rate	**1**	**2**	**3**	**4**	**5**	**10**
5%	3.15	3.31	3.47	3.65	3.83	4.89
10%	3.30	3.63	3.99	4.39	4.83	7.78
15%	3.45	3.97	4.56	5.25	6.03	12.14
20%	3.60	4.32	5.18	6.22	7.46	18.58
25%	3.75	4.69	5.86	7.32	9.16	27.94

** Yield on Original Investment*

Source: RiverFront Investment Group
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Dividend Growth in Unconventional Places

An income-seeking investor with a strategy emphasizing consistent dividend growth would likely have avoided some of the pitfalls (i.e., banks, real estate investment trusts, government sponsored enterprises, telecom stocks) experienced by many yield-focused strategies in 2008. In fact, based on 10-year dividend growth rates, three of the historically highest yielding sectors – Financials, Telecommunications, and Utilities – are ranked at or near the bottom of the S&P's ten sectors. Leading dividend growers can be found in non-traditional areas, such as semiconductors, retail, fast-food, pharmaceutical, and personal care products.

Sector	3-Year Median Dividend Growth Rate Equal-Weighted	5-Year Dividend Growth Rate Equal-Weighted
Technology	9%	13%
Industrials	8%	10%
Staples	8%	10%
Healthcare	7%	10%
Discretionary	5%	9%
Materials	3%	9%
Energy	3%	8%
Telecommunications	2%	5%
Utilities	3%	4%
Financials	-2%	1%

Source: Intrinsic Research and RiverFront Investment Group
Past performance is no guarantee of future results.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Protection: Diversify Outside Traditional "Yield" Industries

Protection, our third "P" of income investing, describes an investment's ability to protect the investor from extraordinary risks. Income investors tend to have lower risk tolerances than other investors because they generally have fewer years to make up for mistakes and cannot afford a significant drawdown on their principal. The best way to protect against those kinds of risks, in our view, is to not put all of one's eggs into a single basket; we recommend diversifying. Unfortunately, diversification[1] can be an unknown concept for many income investors, who have historically crafted non-diversified portfolios either by building a bond portfolio from the new issue calendar or building an equity portfolio from a list of the highest-yielding stocks.

We see significant problems with both of these strategies. First, investors could potentially end up concentrated in the "product of the day," such as bank preferred stocks or closed-end income funds, leaving them susceptible to changes in confidence regarding these products. Second, a portfolio could become overly concentrated in one or two sectors, such as Utilities or Financials, which might inhibit its ability to participate in the growth potential of stocks. This phenomenon is what led to the severe pain many income investors experienced in 2008 when the big banks, like Citigroup (C-N) and hybrid financial companies like Fannie Mae (FNMA.OB) plunged. We see sector concentration issues today in one of the most well-known proxies for income stocks -- the Dow Jones Dividend Index.

Dow Jones Dividend Index	
Utilities	**35%**
Consumer Goods	**22%**
Industrials	**13%**
Financials	**9%**
Basic Materials	**5%**
Consumer Services	**5%**
Oil & Gas	**4%**
Health Care	**3%**
Telecommunications	**3%**
Technology	**2%**

RiverFront Moderate Growth & Income Portfolio*	
Utilities	**1%**
Consumer Goods	**12%**
Industrials	**7%**
Financials	**12%**
Basic Materials	**3%**
Consumer Services	**12%**
Oil & Gas	**10%**
Health Care	**10%**
Telecommunications	**7%**
Technology	**22%**

***Domestic equity percentages only**

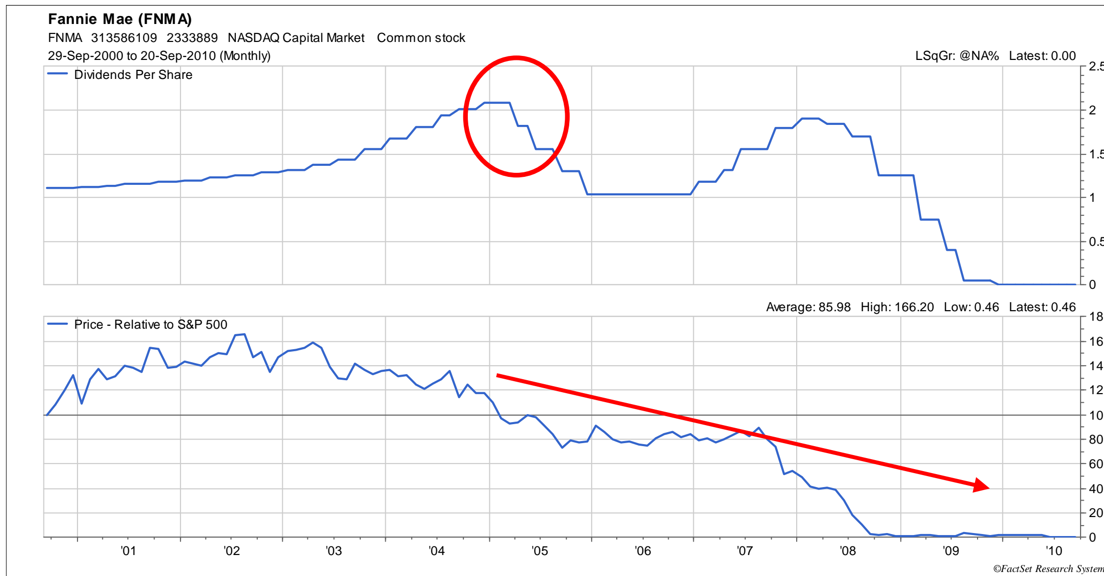
The Dow Jones Dividend Index (left table) is highly concentrated in four sectors — Utilities, Consumer Goods, Industrials, and Financials — which make up more than 75% of the index.

We believe the index is growth challenged due to its 3000 bp Overweight to the historically slow-growth Utility sector and 2500 bp Underweight to the faster growing Technology and Healthcare sectors.

Source: iShares website, as of 10/14/11, RiverFront Investment Group, as of 10/17/11
Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

[1] *Diversification does not ensure a profit or protect against a loss. Please see the end of this presentation for additional important disclosure information.*

In addition to appropriate diversification, investors can protect their portfolios against principal loss by avoiding "dividend mirage" stocks. These stocks lure yield-hungry investors with their high dividends, only to cut them at a later date. We believe an analysis and understanding of the balance sheet and business model of a company can aid investors in avoiding dividend mirages. High dividend payout ratios often signal companies whose dividend policies may not be sustainable, while companies with spotty track records of maintaining a dividend are often the first to cut dividends during tough times. Companies such as Fannie Mae, Ford (F-N), Thornburg Mortgage (THMRQ.PK) and Nokia (NOK-N) foreshadowed their 2008 dividend cuts by cutting at least once in the five years prior to the credit crisis.



We are generally suspicious of a company that cuts its dividend. After it has been cut once, we think it's more likely that it will be cut again. Fannie Mae presaged its dividend elimination in 2008 by cutting the dividend in 2005. The stock performed poorly relative to the S&P 500 around the dividend cuts (bottom panel). We think this is fairly typical for stocks of companies that have cut their dividends.

Data courtesy of FactSet Research Systems

Bottom Line: Building a diversified portfolio with income objectives is not just about looking for stocks with high dividend yields; it requires a delicate balance of the Three Ps, without an overemphasis on any one factor. However, we believe careful effort will be rewarded, as dividend-growing equities are attractive and well-positioned for a decade of outperformance, in our opinion.

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