Bellwether CONSULTING

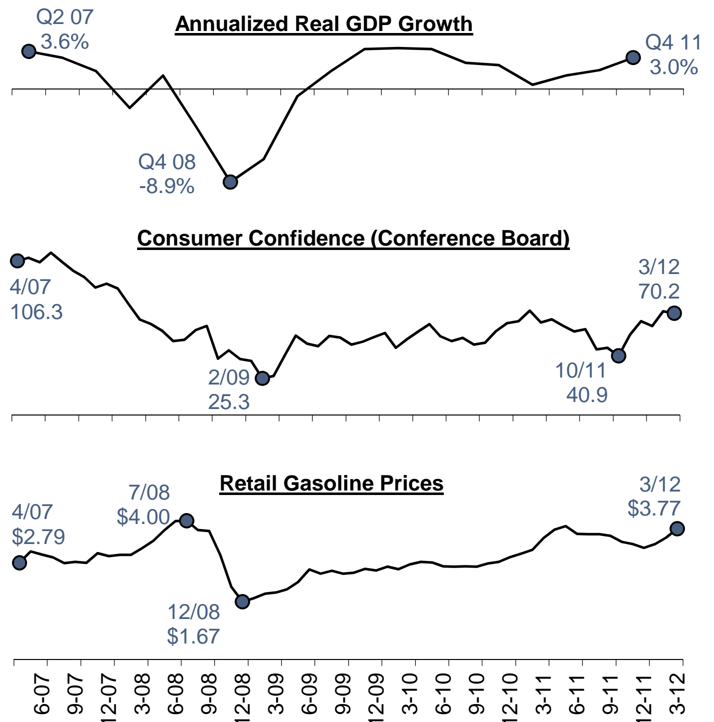
Your Quarterly Update on the Financial Markets
March 31, 2012

1st Quarter

MARKET Recap

The Economy: *"Professional Pessimism"*

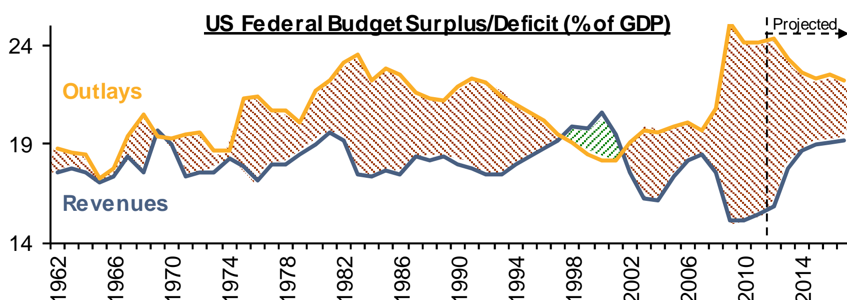
US economic growth accelerated in the 4th quarter of 2011 to a 3.0% annualized pace. Whether or not connected to the Federal Reserve's stimulus actions last fall, measurements of economic activity were almost uniformly higher. The few exceptions included a deceleration in nonresidential fixed investment, decreased federal spending, and increased net imports. Last quarter we discussed the lagged negative effect of the strengthening dollar (that is, the weakening euro and yen) on exports, although in the first quarter the dollar weakened against other currencies as the "flight to quality" associated with the euro crisis subsided.



Forecasting the performance of a complex economy is never easy, but the current environment makes it particularly awkward. As in most recoveries, incremental data points can be argued either way. Interestingly, consumer confidence continued to accelerate through Q1 to a post-crisis peak; this despite retail gasoline prices, which also achieved a post-crisis peak. Perhaps incremental good news on the employment front is the cause for cheer. Regardless, for the moment the "man on the street" is the most comfortable since the crisis began, and spending accordingly. Experts appear decidedly more guarded despite achieving a 3% pace which is, as we've recently discussed, key to driving down unemployment.

Confidence in the sustainability of this pace is low, in part because we were only able to sustain it following the 2008 recession for 3 quarters without massive additional stimulus. Further, experts look beyond the upcoming election and see a huge fiscal gap which must be closed, lest we face the fate of Greece. The White House budget (projected below) anticipates both tax increases and spending cuts which will be difficult to enact under any post-election scenario. More important, however, is that any projection of the fiscal gap relies on underlying economic growth assumptions. Fail to achieve the growth target, and even more austerity measures are needed – yet these actions are themselves counter-stimulative. Even the most hawkish of the 17 Federal Open Market Committee survey participants expects to maintain very low interest rates for the next 2 years, as their January 25th survey release indicates.

On March 26th Mr. Bernanke built a case for ongoing stimulus before the National Association of Business Economists. His comments are worth reading, because they illustrate the uncertainties which worry the experts. Fail to maintain monetary stimulus, and you risk recession if Congress delivers the cuts; fail to deliver the cuts, and you face a wall of inflation.



FOMC Participants' Interest Rate Projections

Fed Funds (basis points)	Year-End 2012	2013	2014	Longer Run
401 - 500				9
301 - 400				8
201 - 300			4	
101 - 200		2	2	
26 - 100	3	4	5	
0 - 25	14	11	6	

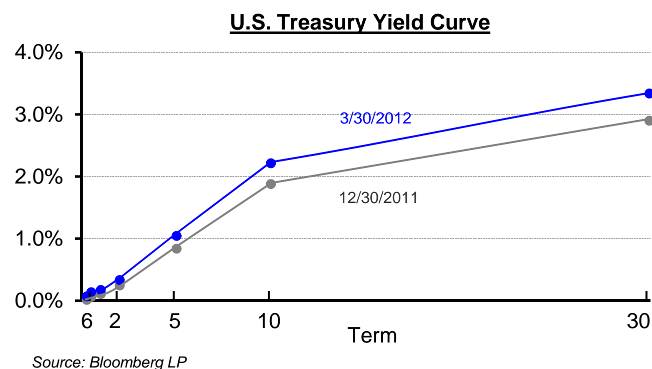
The US Bond Market

Bond Indices - Total Returns	
BarCap Aggregate	0.30%
BarCap Interm. Gov't	-0.38%
BarCap Long Gov't	-5.57%
BarCap Interm. Credit	2.50%
BarCap Long Credit	0.80%
BarCap High Yield	5.34%

The first quarter of 2012 closed with Treasury prices falling, pushing yields up. An improved economic outlook coupled with a European debt crisis that seemed less urgent gave many investors the confidence to move back to riskier assets, and emerging markets and high-yield bonds posted the best returns in the fixed-income sector. Money flooding into high-yield bonds allowed junk-rated issuers to sell bonds over the quarter with an average yield below 8%, and reports of hedge funds and other large investors selling the majority of their holdings of 2-year Treasury note futures circulated throughout the market in mid-March. However, in each of the past two years, investors began the year with higher-risk positions only to flee to the relative safety of Treasury bonds in the subsequent two quarters. With a slowing Chinese economy, many aspects of the European debt crisis still unresolved, and increasing oil prices, the possibility for another mid-year switch to "risk-off" strategies is not off the table.

Markets responded favorably to the Fed's indications after their March 13 meeting that they believed the economy was improving, with many anticipating the Fed would start raising interest rates in 2013. However, in the final weeks of the quarter, Chairman Bernanke emphasized the Fed's intent to stick with its accommodative policies into 2014. Further, with inflation controlled, he indicated that the central bank would consider additional stimulus, even though it had upgraded its economic outlook. With that, a March survey by Bloomberg News of the 21 primary dealers with the Fed forecasted the year-end yield on the 10-year Treasury at 2.49%, with three fourths of the respondents putting the odds of another round of quantitative easing at over 50%.

The benchmark 10-year Treasury was at 2.21% at quarter-close, up 33 basis points from the end of 2011. This included a 23 basis point uptick in March alone, the largest monthly gain since October, and a peak of 2.40% on March 20. Over the quarter, the yield curve steepened slightly, with the spread between the 2-year and 10-year notes widening to 188 basis points from 165 basis points at the end of 2011. The TIPS market hit a record low yield on March 22. Apparently incented by the improved economic outlook and the accompanying prospect of inflation, buyers accepted a negative payment for the second time in history on 10-year inflation-protected securities. Despite yielding -0.089%, investors bought $13 billion in 10-year TIPS, with the majority purchased by direct and indirect bidders – not dealers, who are required to purchase any excess issuance and who received one of their smallest allocations to date. In January, the securities sold at a yield of -0.046%.



Source: Bloomberg LP

Unfortunately, the uptick in Treasury rates did little to help beleaguered US corporate pension plan sponsors. While Treasury yields increased over the quarter, credit spreads decreased by an even greater amount, suggesting that the Treasury-yield uptick may have been driven by the hedge fund divestitures. For AA credit, spreads to Treasuries narrowed from year-end 2011 by 40 basis points for 10 years and 35 basis points for 30 years. For BB credit, spreads narrowed even more – over 70 basis points for 10 years and up. Since pension plan sponsors use corporate yields (not Treasury yields) to discount liabilities, pension liabilities increased again in Q1.

In March the delinquency rate on commercial mortgages posted its largest increase since October of 2010. According to Wells Fargo, the rise was driven by a decrease in resolutions of troubled loans. Loan servicers worked out $1.8 billion in problem debt in March, down from $2.8 billion in February. Analysts predict delinquencies will continue as borrowers face stagnant rents and persistent vacancies, particularly for office and retail buildings. In MBS, March saw a spike in the issuance of securities backed by new US home loans. According to Bloomberg, month-end transactions by Redwood Trust and Credit Suisse almost doubled the total issuance since 2008, bringing it to $2.4 billion. Issuance of non-agency home-loan bonds peaked at $1.2 trillion in 2006 before collapsing in the credit crisis. Recently, a shortage of highly-rated, high-quality assets for securitization has been driven by expanded limits on the sizes of loans eligible for government-supported programs and more capacity by banks to hold mortgages on their balance sheets, while demand for high-quality MBS has started to rise.

The US Stock Market

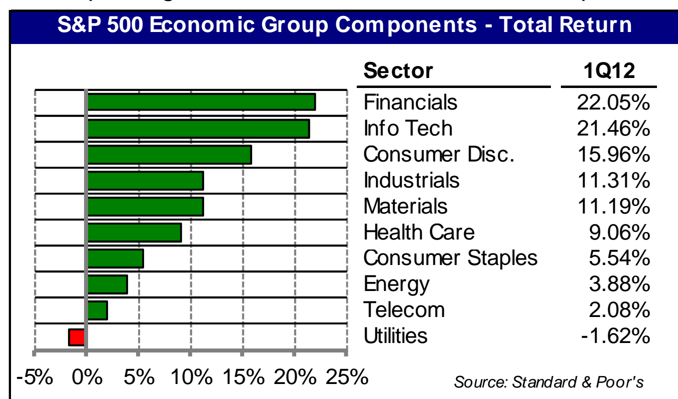
The stock market moved higher for the first quarter of 2012 due to a number of factors. The main drivers were cheap money, employment gains, improving consumer sentiment, and relative stability in the Eurozone.

Stock Indices - Total Returns			
Largecap Stocks		**Midcap Stocks**	
S&P 500	12.59%	S&P Midcap 400	13.50%
Russell 1000	12.90%	Russell Midcap	12.94%
Growth	14.69%	Growth	14.52%
Value	11.12%	Value	11.41%
Broad Markets		**Smallcap Stocks**	
Russell 3000	12.87%	S&P Smallcap 600	11.99%
DJ Wilshire 5000	12.76%	Russell 2000	12.44%
		Growth	13.28%
		Value	11.59%

Growth stocks rallied and outperformed value stocks by 369 basis points, measured by the broad-market Russell 3000 Index. Driven by increased risk appetite, investors moved into higher-risk growth stocks as market sentiment improved. The Fed's low rate policy is having its desired effect, forcing investors into riskier equities in order to earn a meaningful return.

At the sector level, the risk-on trade drove relative outperformance. Traditional high-beta sectors such as technology, consumer discretionary and materials posted strong quarterly gains. Apple returned 48.0% as the company reported strong revenues, guided future earnings higher, and declared a dividend and stock repurchase program. Cloud computing and data storage stocks also added to the technology sector's stellar performance with many companies experiencing robust growth in product demand and profits.

Since the 2008 crisis, financial stock volatility has persisted. The sector has reinvented itself over the years through government policy, most notably the repeal of the Glass-Steagall Act in 1999, opening the door for more capital risk taking. A top-performing sector for the quarter, large cap financial institutions benefited from positive results to bank stress tests and improving consumer credit demand. Due to positive stress test results, the Federal Reserve did not require any of the tested companies to immediately raise capital, and several large banks declared some combination of dividends and share buyback programs instead. (In this quarter's Focus Piece, we examine the dividend fallacy.) Mid- and small-cap financials did not participate as much in the rally, adding only 12.3% and 10.3%, respectively.

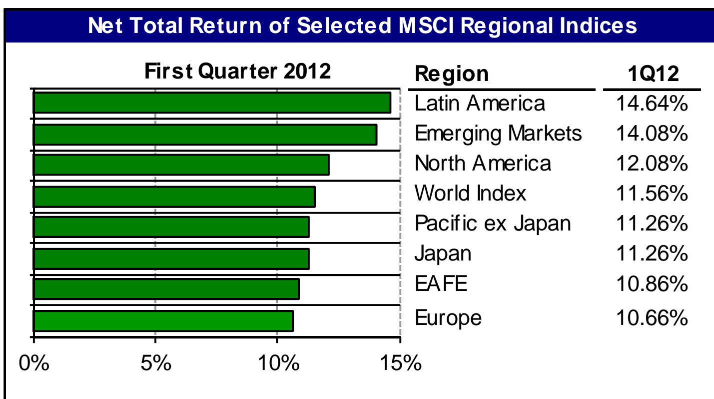


Investors shunned defensive utilities stocks, making them the worst-performing and only negative sector for the quarter. Due to their more stable earnings, investors prefer utility stocks during times of market uncertainty and volatility. The more conservative consumer staples sector also lagged the broader market.

Looking ahead, macro headline risk is likely to have a significant impact on US equity markets. While European leaders appear to have kept Greece's sovereign default orderly, other larger Eurozone country debts still loom. Domestically, corporate profit margins are at multi-year highs. Future margin mean reversion is likely, putting pressure on equities. Finally, negative real yields illustrate investors' inflation concerns. With a company's ability to pass higher prices on to customers, equities have benefited as an inflation hedge. The Fed's commitment to moderate steady inflation will likely be a positive pressure on equities going forward.

Overseas Markets

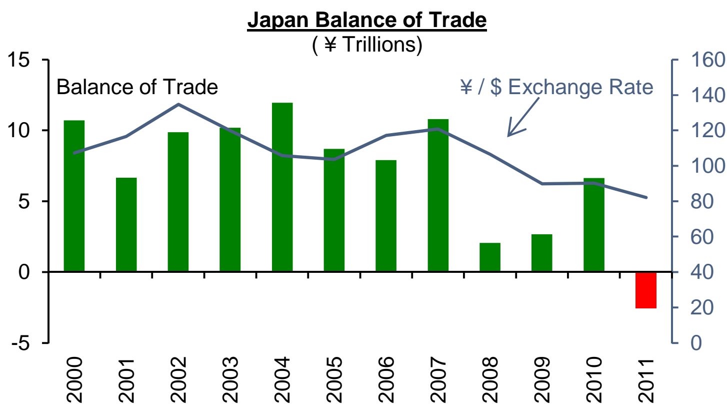
Compared to 2011, global markets calmed down in the first quarter. Investor focus remained on the Eurozone sovereign debt issue, but markets reacted positively to an assisted default for Greece. Yet concerns remain around other fragile Eurozone economies, slowing growth in China and rising oil prices. Even in this challenging environment, global market performance produced a second consecutive quarter of double-digit returns.



The year started off with the downgrade of a number of Eurozone countries and the ECB intervening in the bond markets, for a second time, to buy Spanish and Italian government debt. Yields jumped as investors lacked confidence in both countries' abilities to make good on their debt obligations. Through the Securities Market Program, the ECB has been a regular buyer of Spanish and Italian debt in the secondary market, attempting to keep yields in check. However, most of the focus in Europe remained on Greece and the question of whether the country could convince a meaningful percentage of its bond holders to take a significant haircut in order to affect a debt swap and facilitate another round of bailout funding. It appeared at various points that no

deal would be reached as voluntary participation topped out below the 90% requirement. Greece threatened to use collective action clauses, or CACs, that would let a majority of bondholders bind others to the agreement. A deal was ultimately struck with bond holders taking a 53.5% haircut on the nominal value of their debt holdings. The more interesting question, to us, was whether the event itself constituted a "default." The International Swaps and Derivatives Association (ISDA), in our opinion, rightly concluded that the use of CACs triggered a default as the clauses reduced bond holders' ability to receive payments. With a notional value of only about $3.2 billion in CDS outstanding, the decision appears not to have disrupted markets. However, there may be bigger implications if any of the larger peripherals (Italy or Spain) flirt with a default event, as this decision sets a precedent that may be used in a scenario where there are tens-of-billions of dollars of CDS outstanding protecting trillions of dollars of sovereign debt.

For the second time in less than 3 months, the ECB announced another round of lending intended to shore up Eurozone banks. The ECB revealed that 800 banks had applied for loans under the three-year program through its Long Term Refinancing Operation (LTRO). A total of €529.5 billion will be made available to banks. The loan program gives borrowing banks access to capital that can be repaid in three years at a 1% interest rate. This round of liquidity follows the initial offering in December where 523 banks borrowed €489 billion. The Bank's governing council left its key lending rate at 1%, matching its historic low. It also left the interest rate on its marginal lending facility unchanged at 1.75% and maintained the rate on its overnight deposit facility at 0.25%. Since Mario Draghi replaced Jean-Claude Trichet late in 2011, the ECB has made two 0.25% rate cuts, undoing rate hikes implemented under Trichet. In discussing the liquidity measures Draghi said, "The heavy take-up of the loans in December indicates that our nonstandard policy measures are providing a substantial contribution to improving the funding situation of banks, thereby supporting financing conditions and confidence." The improved sentiment was short-lived as the waning effects of previous bailouts and insurmountable debt loads have caused yields on Italian and Spanish bonds to rise. On the final day of the quarter, Eurozone finance ministers announced a €200 billion increase in the "crisis firewall ceiling," raising the total amount of loans that can be made by the two loan facilities to €700 billion.



Source: Japan Ministry of Trade

As the world economy continues to show signs of recovery, Japan is being left behind. After years of a combination of strong manufacturing and an export-driven economy, Japan announced that it had its first annual trade deficit since 1980 in the fourth quarter due in part to the lingering effects of last year's earthquake and tsunami. A number of disturbing trends were aggravated in the wake of the earthquake, which not only idled Japan's reactors and energy production, but also destroyed factory infrastructure and disrupted supply chains which have still not come back on line. External factors are also contributing to the problems as strong growth in emerging economies such as Brazil and China has driven up Japan's raw material and energy costs. This phenomenon does not appear to be abating, forcing manufacturers to confront the question of off-shore production in order to remain competitive. In the first 11 months of 2011 Japan reported a trade deficit of ¥2.3 trillion ($30 billion), compared with a surplus of ¥6.6 trillion for all of 2010. In addition, deflationary pressures remain high. Japan's GDP gap, the difference between productive capacity and demand, stood at -3.4% in the final quarter of 2011, compared with -3.0% in the third quarter. The negative figure means prices in Japan are expected to keep falling as productive capacity (i.e. resources required to produce goods and services) exceeds demand.

China's leadership focused on preventing an economic "hard landing." The People's Bank of China (PBOC), using its preferred policy tool, cut the reserve ratio requirement on large banks by 50 basis points in February to 20.5%. The move injects credit into the economy by loosening the amount of cash reserves banks must hold on their balance sheets. In addition, China's target interest rate has been on hold at 6.56% since mid-2011. Inflation continued to moderate in the first quarter, allowing the PBOC to take a more simulative stance on future monetary policy. With China viewed as one of the BRICs that will lead future global growth, investors are heavily focused on its economic data releases. Annualized GDP has fallen from a two year high of 11.9% in the first quarter of 2010 to 8.9% as of the last quarter of 2011. Recent data out of the National Bureau of Statistics of China shows a housing bubble may be looming and would likely unwind at an accelerating pace. In the first two months of 2012, floor space under construction by real estate enterprises increased 35.5% year-on-year while the floor space of commercial buildings sold decreased by 16.0%. The National Development and Reform Commission of China responded to the weakening economic data and foreign investment outflows by boosting the amount of foreign borrowed funds that foreign banks can bring into the country. The total figure of $24 billion is a sharp increase from last year's quota of less than $5 billion dollars. In a move to further integrate the yuan globally and make it more internationally convertible, regulators are expanding its use in cross-border trade and investment settle-

ments. Under the current proposal, the existing trial program would increase from 20 billion yuan ($3.2 billion) to 50 billion yuan ($7.9 billion).

With investor risk appetite increasing, Far East markets enjoyed significant gains during the first quarter. Strong economic numbers and stock market-friendly government policies helped push indices higher. The MSCI Thailand Index gained over 21% as it continued to recover from debilitating flooding. An array of moves including a cut in interest rates, an increase in foreign investment, and positive government stimulus measures has the Thai central bank president optimistic about future growth. Another top performer, the Philippines benefited from an interest rate cut and strengthening fiscal position. The Philippian Finance Secretary believes there is room for further credit rating upgrades as the government increased tax revenues without increasing the tax rate. Inflation remains acceptable and the Philippian's central bank remains open to further rate cuts if European and US consumer demand falters. An adverse change in Indonesia's investment rules caused investor concerns making it the worst performer in the Far East with the MSCI Indonesia Index up only 4%. The new rule, requiring foreign investors to reduce stakes in mining assets to 49% is deterring some investors from risking capital in the region.

Strong growth underpinned by accommodative monetary policies helped major Latin American markets move higher. Chile's economy increased 6% for 2011, driven by retail commerce, construction and personal services. Colombia's economy followed suit, growing at 5.9% due to a boom in its oil and mining industries. The growth rate is a 4-year high and highlights the resilience of its economy. Although Brazil's unemployment rate edged higher during the quarter, it was expected as companies dismiss workers after the busy year-end holiday season. Wages also increased, underpinning Brazil's struggle to bring inflation rates in line. For 2011, inflation registered 6.5%, a top reading for the government's acceptable range. Brazilian policymakers expect inflation to moderate to 4.4% by the end of 2012.

Focus On: *The Dividend Fallacy*

An investment that pays a steady income stream is a recipe to calm investor nerves in a volatile market. Add equity participation, near zero short-term interest rates and investor peace-of-mind, and it's no wonder why dividend stocks have a renewed interest among investors. The popularity of dividend stocks was illustrated in a recent episode of Jim Cramer's Mad Money where he devoted an entire show to reviewing rock-solid "sleep-well-at-night" dividend stocks.

In the first quarter of 2012, Apple agreed to accommodate investor demands of a dividend payout. Previously, Steve Jobs passionately believed the company should keep excess cash reserves on Apple's balance sheet in the event of an attractive company project or acquisition. His successors, being more open to the idea of transferring a portion of the company's $100 billion cash position to investors, announced a 2% dividend and $10 billion stock repurchase program. The news emphasizes the hot topic of dividends in today's low rate environment and the strong investor demand for any meaningful rate of current income on invested capital.

As investment managers race to advertise their dividend income funds (or create new ones), we pause to consider whether the dividend yield is in fact a sound basis for an equity investment strategy. Read the popular press and it clearly is – but in preview, we are skeptical.

The Dividend Fallacy

"Since 1926, dividends have contributed nearly a third of total equity return while capital gains have contributed two-thirds," stated the introduction of the S&P 500 Dividend Aristocrats Index methodology sheet.

We have heard many famous analysts repeat the same claim. Did these returns come from dividends, or are these professionals falling into the same trap which ensnared the Beardstown Ladies? In 1996, this investment club from Beardstown, Illinois gained fame by publishing a book claiming that their simple, no-nonsense investment approach had considerably outperformed the market. It was soon discovered that their performance claims were simply incorrect. Their innocent mistake, one made by countless amateurs when trying to calculate investment returns, was to confuse the concepts of *investment returns* and *capital flows* by counting their contributions to the club pool as investment returns. The club's actual annualized performance since their founding in 1983 amounted closer to 9%, not the index-crushing 23% originally claimed.

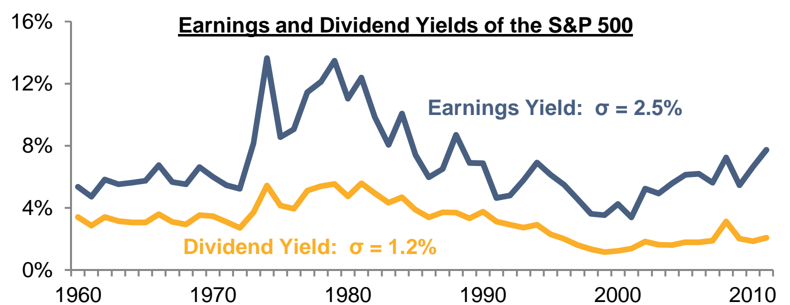
Consider a simpler scenario -- you decide to transfer $1,000 from your checking account to your savings account. Glancing casually at your next savings account statement, you're tempted to think that you are wealthier by $1,000. Are you? Of course not – you simply transferred money from one account you own to another account you own. No investment return occurred. Rather, you now own a larger savings account and a smaller checking account. In fact your checking account is now "riskier" than it was prior to the transfer, since the smaller account is now easier to overdraw.

That's not to say there's never a good reason to transfer money between your accounts. Perhaps your savings account pays a better rate of interest or offers lower fees. Maybe you find it easier to budget for long-term purchases this way. Maybe you're very comfortable that the remaining balance in your checking account is large enough to prevent an overdraft. But it would be wrong to think of the transfer itself as a value-generating event – and it would be very wrong to build a savings and investment strategy based on transferring money between accounts.

Similarly, the *dividend fallacy* occurs where investors mistake dividends for investment returns. Key to understanding this is to recognize that, as a stockholder, you already own the assets of your company – including the cash that is used to pay the dividend. Payment of a dividend is simply a transfer from one account that you own (the company) to another account that you own (your brokerage cash account). The value of the latter grows, while the former decreases. Importantly, the company is marginally riskier after payment of the dividend, since the reduction in shareholder equity means the company's capital profile is more leveraged.

It follows that dividends on the S&P 500 "contributed" nothing to the return of the index, any more than the Beardstown Ladies' club dues contributed anything to their returns, or the $1,000 account transfer contributed anything to your wealth. The returns of the S&P 500 were "contributed" by the earnings generated through the productive activities of each underlying company and by the forces of supply and demand for each company's stock that set its price. To express this as a yield, divide the earnings (not the dividends) per share of the company by the price per share of the stock. This "earnings yield" measures the return generated by each dollar invested in the company at its current market price.

If you prefer, you can flip the earnings yield fraction to express it as a multiple instead of a yield, the famous "P/E Ratio." It's interesting that we are so much more comfortable thinking in terms of multiples when valuing stocks, but we turn to yields when valuing real estate or bonds. Yet the earnings yield of a stock is every bit as useful as the "yield to maturity" of a bond or the "cap rate" of a real estate investment. Like a bond yield or cap rate, the earnings yield reflects the return on your investment, not the return of your investment.



Why are people so tempted by the dividend yield? Because, we suspect, that dividends are much more stable than earnings. Looking at the dividend and earnings yield for the S&P 500 over the last 50 years, we find that the earnings yield on the index has been more than twice as volatile as the dividend yield. Focusing on the dividend yield creates the illusion that stocks are less risky than they actually are. Could that also be why so many Wall Street pundits are enamored with dividends, since their cash registers tend to ring when people invest more in stocks?

If Markets are Efficient, Dividends are Irrelevant

The checking/savings account example may be simple, but do not be too quick to dismiss it. This line of thinking underlies the theorem of capital structure irrelevance advanced by Franco Modigliani and Merton Miller, which holds that in the absence of taxes and transactions costs, and if markets are efficient, then capital structure decisions such as dividend payout rates or stock repurchases have no impact on the underlying value of a company. For this and other achievements, they were each awarded the Nobel Prize in Economics (Modigliani in 1985, Miller in 1990).

	Pre-Dividend			Post-Dividend		
	Cash	Debt	Quick Ratio	Cash	Debt	Quick Ratio
Company ABC	$100 mm	$100 mm	1.00	$90 mm	$100 mm	0.90
Company XYZ	$100 mm	$100 mm	1.00	$100 mm	$100 mm	1.00

For instance, Company ABC and Company XYZ have identical capital structures: $100 million in cash and $100 million in short-term debt. Their quick ratios, a measure of a company's ability to use current assets to cover current liabilities, are both 1.00. Company ABC declares a $10 million dividend and Company XYZ does not. The post dividend effect on Company ABC adversely affects its quick ratio and ability to meet short term financing needs.

An individual investing in Company ABC pre-dividend identified an investment dollar amount and risk tolerance for the investment. By paying a dividend, the company increased its leverage and transferred 10% of its capital back to the investor. Now the investor is presented with the issue of a riskier investment and identifying another investment for the cash dividend. Reinvesting the dividend in Company ABC would further increase the investor's risk in a more-leveraged company. So, a rational investor with a predetermined risk tolerance would instead hold more cash and a more-levered Company ABC or select another investment option altogether.

In an efficient market with no transaction costs or taxes, investors decide how much leverage risk they will tolerate. Investors in Company XYZ can create a "dividend stream" of their own by selling a portion of their stock holdings, replicating ABC's dividend payout. Or, they could create a personalized dividend stream by liquidating shares during times when cash is needed and keeping capital invested otherwise. Conversely, an investor in Company XYZ can simply buy more shares, on the margin if necessary, to create a leveraged position similar to that of ABC with the dividend reinvested.

Since investors can create their own personal dividend stream or leverage, it follows that they should not pay more for ABC simply because it pays a dividend. If the market assigns more value to ABC because of its dividend yield, an investor could create an arbitrage by purchasing XYZ and shorting ABC, while adjusting their cash exposure to account for the dividend. Arbitrage activity would drive up the price of XYZ, and force down the price of ABC, until parity is restored.

If Markets are Inefficient, Do Dividends Matter?

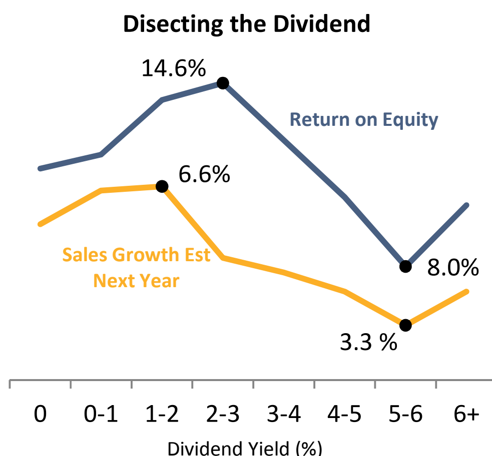
Modigliani and Miller's main arguments assume markets are efficient and investors are rational. In the real world, there are transaction costs and investor psychology that can impact investment returns and volatility. Proponents of dividend-focused strategies argue that higher dividend yields show prudence in a company's management, provide "information content" about future earnings, and are desirable to a specific investor profile.

First, a decision to provide a dividend shows judiciousness in a company's management. Once a company matures in a developed market, the "low hanging" growth projects are complete. Then executives must weigh the risks and rewards of taking on new projects to make business processes more efficient or attain new customers, for instance. At some point in a company's life, the risks of the next endeavor outweigh the rewards. In these situations, it can be tempting for management to take on the next project to enhance their staff resources or otherwise benefit themselves.

Second, there is "information content" in a company's dividend policy. The management team responsible for determining whether to declare or increase a dividend has an insider's view into the company's financial standing and future profit projections. When management decides to declare a quarterly dividend, they communicate to the market their confidence in consistent future net income and cash flows. Just as the market rewards stocks of companies that declare a dividend, it penalizes companies that lower their dividend because the decision communicates to investors that management is concerned with the company's future growth and ability to meet dividend payments.

Third, dividend stocks provide the desirable combination of current income and equity participation for a specific investor profile. Known as the Clientele Effect, dividend stocks meet the needs of a group of investors that prefers current income in their investment options. If only 20% of stocks offer dividends and 80% of investors desire stock dividend payouts, a premium is placed on dividend stocks. Hence, the Clientele Effect will have varying effects on asset classes based on aggregate investor preferences. As Baby Boomers retire, the theory goes, dividend stocks will be increasingly preferred.

These arguments hinge on the notion that markets are not efficient. We would largely concede the point – in our view, market inefficiencies exist, but the magnitude and duration of those inefficiencies decrease every day. However, it is not so clear to us that dividends are a reliable signal of intrinsic value.



In theory, companies pay dividends when management believes there are no attractive projects remaining to generate positive returns. Instead they pass excess cash on to investors to decide where to allocate the cash. Key company fundamentals illustrate this theory. The universe of all US public companies with market caps greater than $1 billion was separated into groups based on their dividend yield. The data suggest that beyond a certain point, as a company's dividend yield increases, its growth estimate and profitability decrease. Developed companies in mature markets with high barriers to entry, such as utilities, have repeatable margins year after year with little or no growth. Instead, they choose to pay higher dividends. Return on equity (ROE) illustrates a similar picture as investors are willing to take lower dividend yields from companies with higher ROEs and growth prospects.

Does the lack of marginally profitable investments indicate management quality, or does it simply mean the company is out of opportunities? As noted above, Apple recently declared its first dividend after a meteoric run-up in its stock value. Presuming the decision by management was a sound one, is Apple stock a better investment now that it has given up on reinvestment at the margin, or was it a better stock at the steep point of its growth curve?

And of course, this assumes management sets dividend policy based on business opportunity. In the real world, a moral hazard arises. Once management believes that a high dividend yield drives up stock prices, they are incentivized to con-

tinue paying or raise dividends, even to imprudent levels. For example, several major banks recently increased their dividends and instated share buyback programs. These same banks were on the brink of bankruptcy in 2008 and received large bailout funding; at present they rely on free interest from excess reserves cheerfully supplied by the Fed. Are they paying dividends now because they have too much capital, or are they simply desperate to drive up the price of their badly battered stocks? How much "information content" can you derive from a management team that's paid with stock?

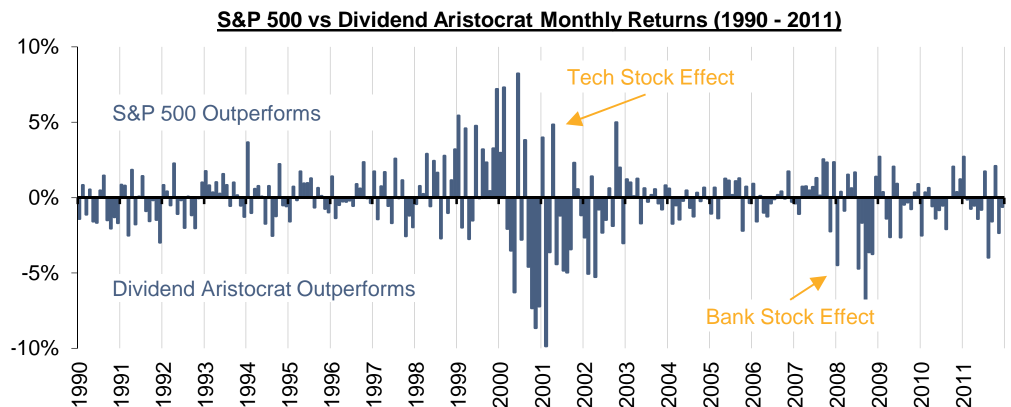
Finally, how significant can the Clientele Effect be today? In the past, it was expensive and inefficient to sell shares of stock to generate a living income stream. Today's no-load mutual fund investors can dial up their managers and redeem fractions of shares, without a fee, and even have an income stream paid to them automatically.

So there are secondary arguments which suggest that dividend yields may be indicative of quality, and counter-arguments for each. This raises the questions of the day: Can dividend yield be used as a "rule" in a naive investment strategy (e.g., an index strategy) to outperform the broad market? And, failing that, can dividend yields be used by active managers to add skill-based return?

Evaluating Naive and Active Dividend Strategies

There are few dividend-focused indices with lengthy track records to evaluate, and each has some sort of unique twist. Consider two popular dividend indices, the Dow Jones US Select Dividend Index and the S&P 500 Dividend Aristocrats Index (illustrated). The former focuses on high dividend-paying stocks and has a large allocation to a traditional dividend-paying sector, utilities. The latter includes companies that have increased their dividends for 25 consecutive years and, as a result, has a lower yield and smaller allocation to utilities.

At a glance, there are clearly periods of time where dividend-paying stocks outperform the broad market, and periods where they underperform. Over the last 30 years, 2 anomalies come to the fore – the tech stock bubble and collapse of 1998-2003, and the credit crisis of 2008. Otherwise, the difference in returns between dividend indices and the broad market looks like noise. More formally, a statistical t-test on monthly total returns comparing the S&P 500 to the two dividend indices in question yielded no statistically significant difference in returns, when run over the entire period including the anomalies. This is consistent with predictions of theory – dividend yield is not, in fact, predictive of returns.



Even the anomalies themselves are suspect, due largely to industry tradition. High-growth tech stocks do not tend to pay dividends, whereas banking stocks traditionally do. However, the collapse of tech stocks was not caused by their dividend policy – nor was the collapse of banking stocks (which caused banks to omit their dividends, eliminating them from the dividend indices). That suggests to us that understanding the opportunities and threats of a particular industry is more important than evaluating the dividend policies of constituent companies.

If naive strategies cannot be expected to outperform, what about active strategies? When we search for dividend-focused managers on behalf of our clients, we start with the premise that the strategy should be actively-managed. The key is to make sure that the manager is selecting quality companies that happen to pay high and stable dividends, rather than implementing a naive strategy with high fees. Our most effective way of getting to the essence of a dividend strategy is to have the manager thoroughly explain their investment strategy without once using the word "dividend". If a manager cannot do that, chances are they are following a naive strategy, and have little chance of realizing alpha. On the other hand, if they are thoroughly and independently evaluating each company's capital structure with full knowledge that the incentives of company management are not always aligned with the shareholders, then perhaps they can add value. Said differently, the manager's approach should be compelling even if it were applied to stocks which do not pay dividends.

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