

# Investment Insight

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## High Dividend and Income Equities: The Effects in an Expanding Economy

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A conversation with:  
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Fund Portfolio Manager and Senior Equity Research Analyst

### Highlights:

- Overall, for 2011, the High Dividend and Income strategy will have a continued emphasis on the stability and growth of the dividend which we feel is the best approach for the strategy in good markets as well as bad.
- We are looking forward to a more stable economic environment and are therefore more encouraged by the potential for steady and growing dividends, as supported by improved operating profits.
- There may be some shift in the various sectors of the HDI strategy. However, the core portfolio consisting of MLPs, REITs, utilities, consumer staples and telecom will likely be similar.
- We feel the economy is continuing to improve and a big part of this improvement is due to companies being in better financial health. In addition, we feel that there is an overall positive tax view and a manageable outlook on the movement of interest rates and inflation.

The following discussion, conducted on February 16, 2011, is moderated by Mac McCall, Sales & Marketing Associate – Rochdale Investment Management

**Q:** We have seen steady improvement in the market. In fact, on February 1st, we saw the Dow close at a post crisis high above 12,000. As the economy continues to improve, what can investors expect from dividend paying stocks in 2011?

**A:** I would like to highlight that our focus in 2011 is similar to what it has been in years past. There is a continued emphasis on the stability and growth of the dividend, which is the HDI mantra. HDI should be steadfast in achieving this, being that we are in an improved economy. It is better to invest in these companies for the dividend, in this phase of the economic cycle, while there are better debt and equity markets.

We will view our expected total return as the yield, plus the growth in the dividend, plus any profit growth in excess of the dividend growth. For instance, if you have a 6% yielding stock that can grow its dividend at 2.5% and there is some profit growth in excess of that dividend growth of 1.5%, then that should allow for an expected return of 10%, and that would be a nice return. However, I would like to point out that this is a year where HDI performance could lag behind broader markets such as the S&P 500, NASDAQ, Large cap growth, and various international indices. That would be especially true in the event of a strong bull market, or if our economy starts to accelerate faster than what is expected. It would be a great thing for clients and for investments in general, but it will be a little different in how HDI will perform versus years past.

In the past few years, HDI has performed better than the S&P 500, as well as many other domestic and international indices. You can see, that in the three- and five-year performance numbers. However, that is not the expectation in a strong bull market or a rapidly improving economy. We buy less risky, cash cow stocks that have a steady dividend component with lower growth than other companies. In this type of market, where things can accelerate rather quickly, some of the higher beta stocks tend to go up more.

I have often pointed out, in conference calls and/or meetings with clients that in a bull market (where the S&P is up 15% to 20%) HDI has a good chance of returning less. I want to align clients and advisors expectations with what I call the HDI norm or “base scenario”, which would be a steady return based on the dividend and the growth of the dividend. However, if we do get into a strong bull market, we are not going to be chasing high growth, riskier stocks. That being said, I remain a “bull” in the HDI strategy. I feel that the total return given the cash flow to the actual portfolio, the lower risk and equity participation, as well as the growing dividend component, which can be a hedge against inflation and interest rates, make it an attractive strategy. In the event of an economic kick-up, or if the U.S. starts to slow down, or if it is like last year where we had the debt crisis in Greece; all of these factors leave HDI well situated with less expected volatility.

**Q:** What do you see are the opportunities in the higher-yielding dividend stocks for the next year?

**A:** As previously mentioned, the focus is on the dividend and the growth of the dividend. Since this is a better environment it makes dividend growth, in aggregate, more steady and strong. That is a positive for the strategy. In an expanding economy, you may want to be in a few more cyclical names that could grow their dividend faster and could be more attractive than some of your very defensive dividend stocks.

The overall core portfolio which was quite balanced between MLPs, utilities, REITs, consumer staples, telecom and other names, will likely be similar as we see some value in all the various sectors. We feel that our current companies, and others that we may be interested in, can perform well in a steadier economy and we are encouraged by this.

**Q:** So it is pretty safe to say that you are bullish on HDI for the next 12 months?

**A:** Yes, I am absolutely a bull for those reasons.

**Q:** Let us talk about the various sectors that would be more cyclical in nature, which you may be focused on for this year.

**A:** It is notable that a couple of our sectors have some economic sensitivity and have rebounded fairly well, such as REITs. We had a defensive element to our REIT investments such as an overweight in the healthcare REITs, and we also had certain retail REITs that did very well through the downturn. We were invested in a diversified REIT based out of Washington, D.C. that had different properties, in probably the best real estate market in the U.S., especially through the downturn. I think overall, there is opportunity in REITs.

If there is more economic growth, the next stage could be industrial and warehouse REITs which were really beat up in the downturn and a lot of those stocks are still weak, but there could be opportunity there. There could also be opportunity in selected offices. Some office REITs have recovered and are probably overvalued, especially if they have exposure to some of the better markets. Right now, New York City and Washington, D.C. are better markets. Office REITs with that exposure have picked up, but there is still potential alpha in other various office investments.

Apartments are an area that are economically sensitive, but they have moved up. They moved up in a similar fashion to the REITs we own, so we did not miss an opportunity there, but I do not know if apartment REITs are quite as attractive right now. We are trying to weigh the line of having some defensive characteristics while maintaining possible growth in a better economy. For instance, going back to healthcare REITs, while they are defensive, they do have a very strong demographic (aging baby boomers) behind them. The New

York Times stated that, starting this year, about 10,000 baby boomers a day will turn 65. There has just not been the build out for the healthcare's needs. As a result, some of our REITs own healthcare properties and are very well poised, so you have the growth potential as well as the defensive characteristics.

Now lets move on to MLPs. We still like them and they have been performing great. We think that natural gas and its transport is a long-term secular growth story, but we would be a little careful in buying some specific companies. Though some have gone up and much of the good news is priced in, but we would not want to buy above a price that was our valuation criteria. We internally, and sometimes externally, call these valuation targets price limits. In other words, a limit price would be the price where you think the valuation makes sense. If it is above that price, we are not interested in buying the stock. Overall, MLPs have done great, and in some sense have earned that premium valuation.

Consumer staples would probably be an area that is more cyclical and because of food inflation we have to be careful on some of the food names. Will they be able to pass on all their pricing to the consumer, and will the input prices pressure their margins? Overall, we are seeing opportunity in consumer staples, but are open to other sectors as well.

Telecom is still very steady. Utilities are an area that can grow with increased electricity usage. When electricity fell in 2008 and 2009, it was the first time that had happened in back to back years since the great depression. It was primarily driven by industrial users. Electricity volumes can grow as the economy grows and act in a more cyclical way. Therefore, some of the names we are looking at are companies that may have a merchant energy business or a more market driven business. I think utilities are a very safe area. You will read about how utilities are going to underperform versus the S&P 500. That may be true if the S&P 500 is up say 18%; I tend to doubt utilities will be up 18% in such a market, but that does not necessarily mean it is not a good investment. A lot of the utilities we are buying are in the range of a 5% yield and are now in an environment where they can grow that yield.

I would like to mention that a few years ago we had invested in Canadian Income Trusts, which are basically Canadian high dividend stocks. They did not pay tax at the corporate level, which was true in the past. The Canadian government did away with that method of forming a business and the trust structure died. They all had to convert to regular corporations and that all had to happen by the beginning of this year. So now, all the former Canadian Income Trusts are just regular Canadian Common Stocks. They do pay a corporate tax, and the dividends are probably less because of that, but many of them are interesting. They had been battered as trusts and I do not think that they have recovered. As a result, I think there is some opportunity there, so those

would be some of the areas that we are also looking at.

**Q: You mentioned the hot button word: inflation. How do you think inflation would affect the HDI sector if we really do experience abnormal levels of inflation?**

**A:** There are two factors, inflation and interest rates, which are issues that affect all stocks but it is always a concern with HDI in particular. Interest rates are something we watch out for regularly. They have moved up quite a bit off their lows from what we saw last year. As a matter of fact, compared to the last five years, they are not too far out of the range. Interest rates are up from the very low rates of last year and that impact is already in the stocks. So, in talking about the 10 and 30 year rates (not so much the short rates) will they go up higher? They could, but as long as they go up in a gradual fashion, so that companies are able to earn more and increase their dividend, the impact should not be too much of an issue for investors. That dividend growth really is an offset to higher interest rates, and the most important driver of the stocks is their operating profits and dividend growth.

Inflation is the new worry and we are watching it very carefully. We are beginning to see a bit of food inflation and if you strip out certain segments of the Consumer Price Index (CPI), you will see some inflation there as well. We would be looking at companies that have pass-through pricing that can charge more in an inflationary environment without losing customers. For instance, if you have a 6% inflationary environment, you want companies that can increase prices by at least 6%. Their cost will go up too, but they should be able to get increased revenue, increased profit, and increased dividend growth at least at the nominal level. There will be some companies that have even better pass-through growth while some may have worse. There will be companies able to grow 10%, while others only grow 2% despite the inflationary environment.

It will be very important to look at companies that have that pricing power and that have assets that can be valued more in an inflationary environment. You may have an office REIT for instance, and if you are in a 6% inflationary environment you would hope that the asset values of the underlying offices would go up 6% as well, which will help to be a hedge. I think if we are in a moderate inflationary environment we should focus on companies that have assets that can go up with inflation and have pricing power. This way, they can at least get the increased revenue equal to the inflation rate and will be pretty well hedged against inflation. Right now, the market has likely not priced in the inflation risk but it is potentially out there. It is something you want to start looking at now and not wait another year when we are hit with inflation and then start scrambling for these names. We are doing the research now and starting to make portfolio shifts into the companies that do have that power of pricing.

**Q:** We are seeing in the headlines a lot of dividend growth. Across the market, corporations are again focusing and increasing their dividends. How do you think increasing dividends in the S&P will affect your HDI strategy?

**A:** Overall it is a positive. Think of it as a rising tide lifting all boats. I have some statistics that look at January and February for the past few years. In 2007, the change in dividends shows the S&P 500 up almost \$5 billion, while in the first two months of 2008, they were cut \$1.8 billion. Then in the first two months of 2009, we had \$30 billion in aggregate cut. In 2010, they were up \$3.3 billion and now, year-to-date through February 8th, they are up \$3.4 billion. So it is not just this year, but also last year, where the dividends are starting to come back, and I would like to say that it really did not affect the dividends of the majority of our stocks. For instance, REITs were an area where the dividends either got cut in half, cut to zero, or paid the stock dividend. We were not buying new REITs in 2008 or the first half of 2009, but the REITs we had, such as the healthcare REITs, all continued to pay their dividend in cash, and most of them have recently increased their dividend.

Even so, it is nicer to be in an environment where everyone is raising dividends and the aggregate is steadier. It is just a better environment overall. What we would like to see is our companies actually keep the spread between them and the other payers high, and have even better growth in their dividend.

**Q:** Let us switch gears and talk about the investment tax environment. We have been getting used to paying a 15% rate on qualified dividends. With the tax being extended at the end of the year for two more years, what do you think we should expect with regard to dividend taxation beyond 2012?

**A:** Last year was the year where the qualified rate on dividends of 15% was set to expire and jump to the ordinary rate. Plus the ordinary rates were set to go up from 35% to close to 40%. There was a lot of confusion, and a somewhat dysfunctional Congress did not help matters. What they ended up doing, and mind you it was not even the 11th hour, it was pretty much one minute to 12 o'clock that they did a two-year extension and not just for qualified dividends, but for all the tax cuts. Now the question is what happens in two years?

Well it remains to be seen and since Congress is a messy place right now, my view is that we have a reasonable chance of that 15% rate on qualified dividends, as well as capital gains becoming permanent. However, there was an interesting budget that was issued on February 14th at 10:30am by the Office of Management and Budget, which is an arm of the Executive Branch. It is a couple of hundred pages, but in the summary table of the document, it has all the proposed tax increases and/or tax cuts. The idea is to get the taxes on

ordinary income back to that 39.6% rate.

However, in his budget, Barack Obama proposed a 20% rate for qualified dividends and net long-term capital gains. That has been his proposal since he was running for President. It was in last year's budget and the budget before that. He has been sticking to that 20% rate. My view is that 20% is a worst-case scenario. It is very unlikely, given the present make up of Congress, that they would actually go higher than that. They probably all want lower than 20%, but that puts it at a cap so to speak. Certainly, you could say that the minority party in the House would probably like it to be higher, but they will have no influence on that number.

My view is if 20% was proposed by President Obama and 15% is what we have now, it will probably be somewhere in between. Obviously, 15% is better than 20%, but if ordinary rates go back up to 40% you still have that advantage versus the ordinary rate. I think that from a regulatory and tax point of view, it is still a green light on the HDI strategy. I think if we were to look forward two years from now we would still be looking at a favorable outcome.

**Q:** What do you think would happen to the HDI strategy and to the market if we were to experience out of bounds expected inflation?

**A:** I have received a few questions like that in prior years. In addition, I often hear questions like, will these companies go out of business, will they cut their dividends to zero, and also a lot of volatility questions. In the past year, there were a lot of questions on interest rates, but this year seems to be the inflation question. There is a lot of liquidity out there in terms of the monetary system, and you are seeing a lot of commodity and import inflation not just in food but in everything. I would say if we get into an environment like the late 1970s where there was high single-digit (close to double digit) inflation, which is not a favorable environment for any market, whether it is an equity trader's market or credit market, that would be a big concern and would become a primary focus for our research.

In fact, that would be a situation where the entire research team would have to meet. Look at the whole investment process and really think through a major revamping of how we want to protect our clients from that type of environment. However, I do not think that is the likely scenario. I think the Fed, before they increase rates, can pull back a lot of liquidity very quickly. I think Ben Bernanke is our guy. His focus was on how to fight deflation and while he may not be an inflation hawk, he understands inflation, and I have confidence that he would pull things back before it spun out of control.

The idea of 4% to 5% inflation is likely, and that is what we focus on when choosing dividend stocks. Can they atleast get 4% to 5% pricing and hopefully even more. Even though they are going to be feeling it on their inputs, maybe they are

only getting 3% to 5% on the inputs and they try to get 4% to 6% on the revenue, and actually get some excess earnings growth out of that. It will be a focus. What we do not want to do is get stuck in a stock that pays a high dividend but does not have pricing power and the opportunity to grow that dividend. One thing about inflationary environments is that there are companies that are able to raise prices in line with inflation, while there are others that actually see price decreases. It is the aggregate sum of everything being 5%. There are going to be a few companies that are at 12% and some may be at -1%.

That will be a focus and these are items that we are in the process of looking at now and that we will be monitoring. If we do get into that very high level it would certainly be a concern, but it will be an overall firm-wide concern, which would entail some high level meetings on how to battle it best.

**Q: Is there anything else you would like to add before we close?**

**A:** I want to keep people aware that we are in a good, improving environment and it is a better economic environment than we have seen the last two years. That will be good for HDI stocks too, but we will not necessarily be chasing every high beta stock out there to stay in line with the S&P 500 if it is not prudent to what our clients are looking for. I am optimistic on the environment from a tax point of view, from the companies operating point of view, and from the current interest rate and inflation point of view. It is all looking pretty positive.

With inflation and interest rates possibly going up just over the horizon, I would like to reassure everyone that these influences are on our radar. We will be doing the kind of research that attracts the right stocks to the portfolio. You can continue to feel confident in the HDI strategy and we are certainly thankful to be in an improving year rather than where we were in the past couple of years. 2011 is really shaping up to look like a positive year for HDI.

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