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Digging for Dividends



A conversation with David J. Abella, CFA, Fund Portfolio Manager and Senior Equity Research Analyst

Highlights:

- Any potential changes to tax treatment for dividends are not likely an issue until after the 2008 elections, although we continue to monitor.
- After outstanding performance in 2006, opportunities still exist to build a good portfolio of high dividend equities, and we are capturing some gains and moving proceeds into stocks with more attractive valuations.
- The current stable interest rate environment is good for the high dividend strategy.
- High dividend equities, with a total return and volatility profile in between the broader equity market and bonds, can be considered a defensive positioning in the event of a significant market correction.

Standardized returns for the quarter ended 12/31/06 are as follows: Average Annualized Total Return at NAV (Net Asset Value) for 1-year, 3-year, 5-year, and since inception: 22.10%, 12.85%, 5.31%, and 4.16%, respectively; Average Annualized Total Return at POP (Public Offering Price, reflecting maximum front end sales charge of 5.75%) for 1-year, 3-year, 5-year, and since inception: 15.09%, 10.65%, 4.07%, and 3.35%, respectively. Prior to 6/27/03, the Rochdale Dividend & Income Portfolio invested as the Rochdale Alpha Portfolio, with a different investment objective and an aggressive mid- and small-cap strategy.

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A fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other information about the investment company, and it may be obtained by calling 800-245-9888, or visiting www.rochdale.com. Please read the prospectus carefully before investing. RIM Securities LLC, 570 Lexington Avenue, New York, NY 10022.

The following discussion is moderated by John T. Fulgham, AIF®, Senior Vice President of Rochdale Investment Management.

Q: Can you enlighten us a little bit, particularly for those that are new to the call, as to what the high dividend and income strategy is designed to do for an investor and really where does it sit in a client's overall portfolio?

A: Basically, it's designed to have equity exposure with potential for capital appreciation, like other stocks, but with an emphasis on a recurring dividend stream that will grow over time. It should have, over time, less volatility than regular stocks, but having also a higher total return than fixed income, so it kind of falls between the two in terms of total return and volatility.

Q: How does this strategy differ from other equity income strategies that are out there?

A: A lot of equity income strategies out there really are more of a large cap value approach, which might be a fine asset class, but it's a lot of stocks yielding maybe 2% to 2.5%, which is generally considered high dividend when you read the literature. Or you may have sector funds that are just REITs or utilities, but they are very concentrated obviously to that sector. So the uniqueness of our HDI approach is that we're in various sectors based on what's relatively the best or most attractive valuation. We can use REITs, MLPs (master limited partnerships), utilities, banks, and miscellaneous stocks. We can vary the weightings depending on what we believe is the best valuation.

Q: David, now that we're into the beginning of tax season, as I travel around the country, one of the questions I am asked most often by advisors and prospects and/or clients is with the changes of control of the House and of the Senate, do you see any changes coming that may affect tax treatment of dividend income?

A: That's a good question, John. I'm asked that a lot as well. Essentially, it's the 15% tax rate on dividends that came into being in 2003, that's qualified dividends, and that tax law was extended recently into 2010; however, it was not made permanent. So the worry is that, come 2011, which is going to be here sooner than we'd like to think, the tax rate on dividends could go back up to the ordinary income level, which in addition could go up. Currently the top rate on ordinary income is 35%, but that could go back up to 39.6%, I believe, so there's that fear.

First of all, it's an unknown. A lot will depend on what happens with the elections in 2008, so this issue will really be a 2009 kind of political impact. But one thing to keep in mind is that part of the rationale on bringing those rates, capital gains and dividends to 15% was also to put the two in alignment. So even if this tax bill expires, tax on capital gains would only go back up to 20%. That's what they were before the 2003 bill. Part of the rationale was to get those two in line so that companies wouldn't necessarily have an incentive to not pay dividends, and instead buy back stock to try to produce capital gains, which would be at a preferential rate. This would argue for the two rates to remain in synch.

But it's an unknown and something we actually are very actively watching. If it does end up in the worst-case scenario, we would proactively rearrange the portfolio to take advantage of that, or to minimize any impact from it.

So certain asset classes, like REITs, which didn't actually benefit from that bill, shouldn't be negatively impacted if dividend tax rates go back up to ordinary rates. Also, MLPs would continue to be at a tax advantage. We would put maybe some of the higher-tax stocks in non-taxable accounts. So there are definitely approaches that we would do come 2011, if that were to be the worst-case scenario. But in any event, the idea of investing for dividends and recurring dividend streams is something that goes way back. I think it's just something that will continue to be interesting to investors.

Q: You make a great point. If you go back to the '50s, '60s and early '70s, essentially investing for dividends was the primary investment methodology for most investors. Obviously there was not even an attractive tax situation at that time. With that being said and with the long line of presidential candidates now throwing their hats in the ring for 2008, are you aware of any of the candidates that are really hawking this as we need to get rid of the dividend exclusion for exemptions?

A: I don't hear that so much out of the presidential candidates. I don't think they're getting into the nitty-gritty of the



different parts of the tax bill. I definitely think that there is an idea that they would want to increase taxes and that the "rich" are not paying their fair share. That's kind of always something that's said, but that would more likely increase ordinary tax rates. So instead of the top rate being 35%, the top rate would probably go back to 39.6% or higher. That is probably much more likely than dividends and capital gains taxes increasing. Capital gains were at 20% before the 2003 tax change and the idea that companies could just stop paying the dividends and start buying back stock in an effort to drive capital gains, so you would have a change in behavior from companies. Because of this, I don't think it would actually get much revenue, but it's not an issue that specifically is being talked about just yet.

Q: Can you explain to us how you would use the high-dividend strategy differently in a taxable versus a non-taxable account?

A: In a taxable account, we would try to put currently as much as the tax advantage holdings as possible into it. MLPs are something that actually can only be owned by taxable accounts. We can talk about MLPs more later, but they have a tax advantage in the sense that most of the dividend is considered a return on capital for tax purposes and, therefore, deferred, so that helps with the overall tax liability in a taxable account. Also, the qualified dividends, at least through 2010, are taxed at a 15% rate, so we would put more of those in a taxable account.

Within the non-taxable, they might have a higher proportion of REITs, because REIT income is actually passed through. They don't pay tax at a corporate level, these real estate investment trusts, so they would be taxed at an ordinary rate at the investor level. However, non-taxable investors are allowed to buy them. So if a non-taxable investor buys REITs, there is no tax paid on any level. It's really one of the most tax-advantaged investments possible, to buy a REIT in a non-taxable account.

Q: Now 2006 was a wonderful year for the strategy, as most of our clients and our advisors that have been working with us, particularly taking advantage of the fund, as well as separate account management with Rochdale, but it's been more than just a one-year wonder. Tell us about the performance of the mutual fund that you manage, our high dividend and income fund, over the last several years.

A: Over the last several years, and I don't actually have those numbers in front of me, but I recall they were in the 12% to 13% range, which is higher than the S&P 500 and much higher than fixed income. Remember, we're trying to capture some of the market gains in the sense we have some capital appreciation. But in return for more volatility than fixed income, we definitely want to have higher total return than fixed income over longer periods of time. That was very, very evident in the past three years.

The last year, for calendar 2006, 22.1% was the total return. That was much higher than the S&P 500 and most equity income funds for that matter as well. It's much, much better than fixed income. Generally speaking, the private accounts did a little higher than that, in part because they have a little bit more MLPs and REITs in them, which were two asset classes that did especially well within the HDI universe. People ask me, "Why was 2006 so strong?" Generally speaking, I think you had some great valuations coming at the end of 2005. You had some movement in the stocks that has made the valuations, in a lot of cases, more fairly valued. Certainly there are opportunities out there, but you really, at the end of 2005, had some great valuations.

Q: With it being up a little over 22% for 2006 in the fund and more in the separate accounts, looking at 2007, are you at all concerned about the fact that it's going to be difficult to continue finding opportunities?

A: It's more of really just hitting the numbers and the reports and the spreadsheets a little harder. I started putting various portfolios together back in 2001, and we had the first investors in the beginning of '02, composite data going back to June of '02, so I've been looking at various stocks and models, different baskets of portfolios for a good while. There have definitely been periods when it was kind of like shooting fish in a barrel to find really good dividend stocks that had a good expected return. I would say the environment we're in now, it's a little bit more like fishing patiently. There's still some good fish out there to be had, but it's not quite shooting in the barrel. It just makes my job more challenging. But in terms of getting a basket of stocks together for a client, there are good stocks out there that I think will continue to have a good return going forward. That also means that some of the stocks that may have run up last year we would be trimming back

on and getting into some more attractively valued stocks to replace them.

Q: Do you see any marked increase in the volatility or risk in high dividend equities?

A: It's really difficult to say what the volatility will end up being, but I would say that expected volatility would be similar this year as it was last year. In other words, some of the stocks might be more volatile going forward or have run-up and then we may be taking gains on those and getting into some that are much less volatile. I'm trying to maneuver the portfolio so that the volatility is similar to what it was last year.

Q: Many economists are forecasting a stable interest rate environment. In fact, if there are any decreases by the fed, it's probably not until the latter half of the year. How does that impact your strategy?

A: Right now the interest rate environment is a great environment for this strategy. Part of the reason why some of the valuations were so good at the end of 2005 is that it was a relatively flat year for the strategy. It was a flat year for fixed income and the S&P 500. It was just overall sort of a lackluster year. What we had was the fed basically increasing rates hard and 2005 was especially tough in terms of feeling the effects of 17 rate increases. That was just a very big headwind. In retrospect, it was a tougher headwind than I thought. I knew that it would be a headwind, but it turned out to make things kind of challenging. Being past that is kind of an excellent place to be. You can maybe argue that a falling rate environment is even better, but this is a great environment to be, kind of the so-called Goldilocks economy, where growth is there; it's enough to drive profitability; it's not too strong that it sort of re-ignites inflation worries; interest rates are steady. It's a really good environment to be in.

Q: The sectors you invest in for the strategy include REITs, MLPs or utilities, financials and then other consumer and basic materials. If you would, walk us through each of those and give us a thumbnail sketch of your opinion, your viewpoint, your forecast of each of those.

A: I'll start with REITs. In terms of dividend-paying machines, there's nothing really out there like REITs. They don't pay tax at the corporate level; it's all a pass-through. A lot of the REITs we own have paid dividends and/or increased dividends consecutively for 30 years, even before they were public companies, just a great history. There have been points in REIT industry where the phrase "shooting fish in the barrel" really seemed to apply to that sector. Right now you really have to look harder to find what is an attractive valuation.

Recently we just started selling a REIT that was one of the REITs back in 2001 in the original model, Health Care Property Investors (HCP \$41.50). It's the largest publicly traded healthcare REIT and it's a great company, but it had moved up over 55% in the last year and the yield had fallen down to 4.3% from the 7% to 8% range at one point when we were buying it. So basically this is an example of getting out of one and into a new name, Healthcare Realty Trust (HR \$43.51), which is a healthcare REIT that is definitely a much more attractive valuation. In other cases, we might sell a REIT and reduce the exposure and get into a miscellaneous name.

Overall, the operational business of REITs is very promising. In some cases, especially within the retail part of REITs, the valuations are looking a little less attractive than they once were. Some of the interesting areas now are what are called triple-net leases, which is where a big tenant that has a long-term lease, with some escalators each year that go up with the rate of inflation. Those are examples of the less volatile types of REITs that we're looking into, and also diversified REITs, with properties in many different sectors. There are still some interesting REITs out there; but, in some cases areas of valuation are a little stretched.

MLPs have been an excellent sector with very high dividends and with growing dividends. We focus on a combination of propane companies, which have kind of utility-like characteristics, and then the natural gas pipelines. Natural gas continues to be a growing market share of total energy in the United States, and will continue to be for a number of reasons. One, there's a lot of natural gas in North America. Two, it's environmentally one of the better energy sources. The thing about natural gas is, whenever you find natural gas in the middle of Canada or something, it needs to be piped out, and that's where these MLP natural gas pipelines come into play. That really continues to be a great sector for taxable accounts.

Utilities have moved up a bit. The utilities are a little better valued, in the 5% yield range, and attractive. We still have some banks in our financial exposure; a lot of them are regional banks that probably no one's ever heard of unless you live in that area, paying maybe anywhere from a 5% to even 6% yield. They have taken it a little bit hard in terms of the flat yield curve, but kind of the worst is behind them, and going forward, maybe even in a year or two out, could have a much brighter operating environment. So the future looks brighter, and we may actually increase the exposure in that area.

Then there's a basket of miscellaneous stocks, which includes a lot of food companies, for example, B&G Foods (BGF \$21.60), has been a great name. We've had Centerplate (CVP \$18.85), which runs the concessions of a lot of baseball and football and convention centers; and a fair amount of regional telecom as well.

Q: You mentioned one area that gets a lot of discussion, particularly as I travel around the State of Texas, Oklahoma, Arkansas, etc., is energy prices. What effect do energy prices have on the natural gas companies and the pipelines that you're investing in?

A: That's a good question. Generally speaking, I would say, within HDI, I have tried to avoid having stocks that pay a dividend that is based on commodity prices going up or down. There have been a couple of exceptions, but generally speaking, 95-plus percent of the portfolio tries to avoid that, because it adds risks and volatility that we're not interested in.

So how do energy prices, which are extremely volatile, affect the MLPs? Generally speaking, the MLPs are moving volumes of natural gas and charging basically on the volume. It doesn't matter if the price goes up or down. Really all that matters is the volume. The volume of natural gas never goes down year over year. We're going to be using more natural gas next year than we used this year, and in 2009 it will be more than 2008, etc., so you definitely have a growing volume.

But having said all that, there is a little element that natural gas prices not being too weak is a bit more beneficial in the sense that, when natural gas prices are higher, there is a bit more drilling and the need for more pipelines. You do have a situation where a little bit stronger natural gas can actually cause the companies to grow their earnings a little faster or grow their dividends a bit faster. But in terms of the stability of the dividend where it stands today, that would be based on volume. Your expected return will be higher given a better growth rate, and you'll get a better growth rate with a bit better natural gas prices.

Q: You mentioned telecom, and I'd like to follow up on your mention of that. That's obviously an area over the last two, three, four, five years that has not done very well at all, but you tell us if you've either just added or you had quite a bit of exposure in telecom. What's your outlook for that industry sector?

A: I think when people think about Telecom, they're thinking Nortel (NT \$29.20) and all those stocks that got crushed from the Internet bubble. But the telecom that we own are all regional telephone companies that have land lines in which case there isn't a lot of alternative. It's really more of a utility business. In other words, somebody that lives in more of a rural area, they can't decide, "You know what; I don't want my land line anymore. I'm just going to use my cell phone." Well, half the time their cell phone doesn't work, so they basically have to keep their land line. Those are very low-growth, high-margin businesses. The low-growth element makes them less attractive to the bigger telecom companies that are still trying to grow. A good example of that is Verizon (VZ \$37.95). Verizon just sold some of its rural land lines to FairPoint Communications (FRP \$19.51). They actually sold it to FairPoint for such a good price that FairPoint's stock jumped 15% on the day they announced that deal. That was a couple weeks ago.

Verizon's stock, by the way, didn't move one way or the other really, because it wasn't a significant portion of their business. In one sense, it's the boring part of telecom that's non-growth; that companies like Verizon really aren't even interested in anymore, but have a definite cash cow utility-like business. In a lot of cases, they're paying around 8% yield, because they're not really growing their business. What they're doing is they're saying, "You know what; we're going to take this cash flow and we're going to give it to our investors." Actually the regional telecoms that we've been invested with have done very well. A number of them have moved above their limits. In other words, they've moved to a valuation that we wouldn't be buying them at currently. FairPoint is something we would be interested in, especially at a slightly lower price.

Q: How do I position a high dividend strategy versus fixed income when talking to clients or prospects?

A: That's a good question and it goes back to where was the position of this investment in the grand scheme of things. What we're trying to do by design is get a yield that is actually higher than the yield you would get on fixed income. Then additionally, for taxable accounts, we're trying to make it so that the bulk has some sort of tax advantage as it currently stands, whether it's the 15% qualified rate or MLPs so that the actual after-tax yield is even more attractive versus fixed income, which is generally all at the ordinary rate. Then as far as muni fixed income, that's at such a lower yield that the yield differential is much greater.

In addition, we're trying to get growth in the dividends. That's a major thing I didn't hit on, but growth in the dividend will hedge one against rising inflation and rising interest rates. It's almost like a treasury security that is adjusted for inflation (known as a tip), whereas fixed income will be maybe static at 4.8% or whatever it is. Here if you have a dividend yield of 5.3%, you would hope that each year, on average, the dividends are rising. Hopefully that will translate to capital gains; but, at a minimum, hopefully it will give a hedge against the portfolio going down if interest rates were to continue to go up. But for all that, you get a little more volatility in the short run. It's sort of positioned to have a higher yield than bonds, less volatility than equity, more than fixed income, but certainly the expected total return should be higher than fixed income.

Q: I was doing an economic forum yesterday evening in Dallas, Texas, for an advisor that we work with. We had a number of attendees. One of the questions that popped up was referring to Canadian income trusts, which you briefly touched on. There seemed to be a shakeup in the market at the end of last year with regards to Canadian income trusts. What's your take on what's going on and what do you see for this market in 2007?

A: Canadian income trusts are an interesting pass-through security that was growing very rapidly as a percent of the Canadian stock market. It initially was a very small part of the Canadian market, but then it exploded over the years to be so big that the government decided to pull the plug on it. That happened actually Halloween of last year.

Essentially they are pass-through securities where tax is not paid at the corporate level, and it is paid at the investor level, similar to U.S. REITs. It took the Canadian markets and U.S. markets by storm in the sense that the party in power pledged as part of their campaign that they wouldn't tax them. They were actually the party that reversed things and decided that basically they would be taxed like regular corporations starting after a five-year window. That basically took the market by complete surprise, as I mentioned, and there was a lot of volatility. Some names, especially the energy-related trusts, were hit especially hard.

At the time, we had a couple names within the utility sector, hydroelectric utilities, a healthcare name, and then we had one energy name. Now the energy name we've since sold out of, but we resumed buying the two utility names. They have sort of stabilized. They are hydroelectric energy producers, electric, very stable cash cow-type businesses. I think what's happened is it's a new dynamic where they are going to continue to be passed through, no taxes for five years. Then you will have taxes; but, when you do all the math and all the calculations, the prices that exist now make them attractive. The legislation that's out there is as bad as it's going to be. In other words, what ultimately gets passed may increase the window a few more years or exempt certain industries, but it shouldn't be worse than it is now. It's all kind of priced in, but I would continue to avoid the energy-related ones at this point and really focus on the most boring cash cow ones, such as the hydroelectric power companies that we're currently in.

Q: Dave, you've really covered a lot of material, and I really appreciate and thank you for that. Is there anything that you would like to discuss that you may not have or that you want to spend a little bit more time elaborating on before we let everybody go?

A: I'd like to just kind of re-hit the point, because people do ask it and it's a reasonable point to make, given such strong gains last year, 22-some percent in the fund and 26-ish level in private accounts, can that continue? Again, it really is that shooting fish in a barrel analogy versus just kind of fishing on the one line. The end result is will you be able to populate a portfolio with enough good names, and I think you will. I would not expect a continuation, a 22-plus percent year, in 2007, but I think the gains will move to a more normalized level, which is the dividend yield plus 1% to 3.5% in terms of capital appreciation. With the more realistic expectation of that, it remains an excellent strategy. Some people are now spoiled



from 2006 and want 2007 to be a repeat. While certainly I would try to do that, it is not our expectation. However, I think high dividend equities are an excellent sector of the stock market universe to be invested in.

With the current yields, on average, you can build a basket of high-dividend stocks in the private accounts with a yield of roughly 6.5% to 7%. If you get the capital appreciation of 1% to 3% on top of that, you're talking about 7.5% to 10% returns. That's pretty good on an annual basis.

That's what I want people to get more in tune with and that's really more the expectation at this point. I don't think we're due for any big correction. I mean certainly some individual stocks that hopefully we're taking gains on or we don't own may have some correction, especially if they are ahead of themselves and the stock price is sort of reflecting gains that may or may not have happened in terms of earnings. Then if those stocks miss their earnings, they'll come down a bit, but we're trying to get into things with a much more attractive valuation where the earnings expectations are definitely in line with what realistically they'll do as a business.

Q: I have a question and it goes to what you were just speaking about. We're four and a half years into the business cycle right now. You're evaluating this on a security-by-security basis, which is encouraging, but what if we have the long-overdue generalized market correction of 10% to 15% that we haven't had since 2000 to 2002? What is your anticipation for your dividend and income securities with regard to how they will respond and what can our expectations be there?

The Dow has gone 53 months without a 10% correction. And we're at historical lows for volatility. We've had 137 sessions without more than a 2% correction, which is the second largest on record. Dave, how would you respond to that?

A: It's really sort of impossible to say when a correction will happen or if it will happen, but what I'll say is there are certain things in the economy that could trigger it, things to watch out for that we would be watching out for. One of them would be a pickup in the decline of housing prices or an increase in the amount of unsold homes or anything that in any way makes the housing market look worse than it currently is. It seems to have stabilized to a degree, but that is the one trigger that you could see out there that could start to pull the economy's growth rate slower than you might have thought and actually start to bring down the consumer sector, which could trigger a correction.

If it's just a correction based on suddenly the market thinks it's overvalued and it corrects, those are usually good buying opportunities and/or, if you look at it a year later, you've kind of gotten that back. But on the other hand, if it is a correction due to a slowdown as a result of housing worsening, that could be a longer-term impact or it wouldn't necessarily correct back right away. We're watching out for that sort of thing. I would say some of the HDI names that are ones that we used to own and are a bit more richly valued could be ones that could correct along with the market. I wouldn't think that they would necessarily do worse than the market on average, but those names I think could, if the market were to be down 10% to 15%, they could be down in line with that. But some of the names we've been buying into, say some of the triple net lease REITs, those are very low volatility stocks. Some of the newer utilities we're getting into have been very, very low volatility. We're hoping that there is at least some movement of money out of the volatile sectors and into sort of the safer sectors.

Q: Is it fair to say you're defensively positioning the portfolio just a little bit anyway?

A: That's right. This is defensively positioning the portfolio. Generally speaking, I would say, without having a crystal ball, if there were a 10% to 15% correction, one sector I would guess that would get hit as hard or harder than any other sector in such a correction would be technology. A lot of the technology names have moved up quite a bit. I'm not a tech investor by any means, but that certainly is a sector that seems like it would get a bit harder, whereas the defensive names, while it's hard to say that they would escape it entirely, certainly should in all expectations do much better.

Stock prices shown are the closing prices of 2/8/07 (Source: Bloomberg). The Rochdale Dividend & Income Portfolio holds the following positions as of 1/31/07: BGF, 2.31%; CVP, 2.17%; HCP, 0.85%; VZ, 0.73%. All opinions constitute Rochdale's opinion and are subject to change without notice. Rochdale Investment Management LLC, its affiliated companies, or their respective shareholders, directors, officers, and/or employees may have long or short positions in the securities discussed herein.

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