

Rochdale Investment Insight

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February 4, 2009

Generating Income in a Low Yield Environment: Dividend Safety During a Recessionary Period



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

Highlights:

- The equity and fixed income markets went through a watershed year in 2008; so far this year is mostly a continuation of that heightened volatility and negative return. As we progress through the year, we hope to put some cash into deep value stocks with strong cash flows that can weather the recession to a relative degree.
- The bread and butter of our strategy is a reliable and growing dividend stream. In the current climate, companies are recording dividend cuts at a record pace, especially within the financial services sector. We believe that our fundamental approach allows for a more stable and predictable total cash flow of dividends, especially relative to the broader markets and other strategies. It is our goal to have dividends increase over time; however, in the current market our approach is in maintaining the aggregate dividend level.
- We feel that it is prudent to get through the first quarter of 2009 and determine how companies reported their earnings and what forward guidance they indicated. In addition to the earnings comparisons, we need to see what the Treasury has in store for the banking system and how the market will react. After all of this, we could start to buy into selected stocks that have a deep value and present an attractive long-term opportunity. Even if the economy is still not where we want it to be, the latter half of 2009 could present us with improved markets and so certainly buying on dips could be warranted.
- Our holdings and selected investments will be much more defensive than in past years reflecting the weak economy, the weak equity markets, and the troubled credit markets. Our focus will be on companies with the most stable business models, commitment to the dividend, and strong balance sheets.

The following discussion is moderated by Ted Cox, CFA, Senior Vice President – Investment Consulting of Rochdale Investment Management.

Q: Let's talk about 2008. Despite great performance throughout your tenure, the Rochdale Dividend & Income Portfolio, and really the whole sector, has not been immune to the extreme market volatility. With that said, what is your outlook for 2009?

A: 2008 was a watershed year. Whether it was in a domestic sense or international; whether it was small cap, mid cap, or value related; whether it was traditional bond investments or higher yielding bond investments – it was hard to make money almost anywhere in 2008. We saw four negative quarters across the board. It was described as a nowhere to run, nowhere to hide type of year.

Dividend and income stocks were less volatile than the overall market and the portfolio as a whole was less volatile than other pure market, if you will, S&P 500-type portfolios. Despite being somewhat less volatile than the overall market, 2008 was still a record year of instability and a year that we would hope not to see again for a long time.

Having said that, January was a bad month and, so far, 2009 seems to be mostly a continuation of 2008. We are definitely in a recession that seems to be getting worse. Officially, it began in December 2007 but it does seem like it is currently accelerating.

The hope is that markets begin to stabilize in advance of the bottoming of the economy and we do not know when that will take place. We are hoping that there is some sort of stabilization sometime this year and, going forward, valuations will begin to look attractive, providing opportunities for good buys.

I hate to say this as it's such a cliché in our business, but I think it's really a stock pickers market in the sense that there will be certain companies that have very defensive characteristics that you will want to be in and other stocks that you just want to avoid. So you really have to be very careful when building out a portfolio.

Q: In speaking further about the volatility, this seems to be the number one concern in the mind of investors. Do you anticipate that the volatility will continue and how does the volatility affect HDI stocks as compared to the broader market?

A: The volatility was the highest it had been since the strategy was implemented. We estimated the volatility would be roughly two-thirds as damaging as the total market volatility. However, if said volatility is intense, two-thirds of a very high figure can be quite destructive. With all of that in mind, I do think the volatility will start to come down.

There is an old market wisdom that says bear markets end with a whimper. As the volatility starts to die down, the markets don't necessarily recover right away. Initially, you start to see a bit of a flat line in the trading range and after all we have been through over the last year, we would be pleased to see the leveling out amidst the instability.

I do think volatility will still be greater than it was in 2004 and 2005. All things considered, some of the volatility we saw in the fourth quarter, when it looked as though the whole banking system was going to collapse, is hopefully in the past and we will likely experience less instability this year.

Q: Let's shift our focus to dividends and the respective cuts. The last quarter of 2008 was the worst for dividend cuts since Standard & Poor's began keeping track in 1956. Do you believe the worst of the cuts are behind us? Do you see more cuts ahead in 2009?

A: The bread and butter of the strategy are the dividends and we like to think that we have a stable and predictable total cash flow of dividends. We want that to grow over time and if a couple of companies here and there cut their dividends while other companies increase their dividends in aggregate, you're stable to even increasing and that is our goal.

The strategy is always to maintain the dividend and then increase the dividend. Nevertheless, we are in a year where companies are cutting their dividend left and right, and you are reading articles discussing just how big those dividend cuts are.



I was recently interviewed regarding the dividend and income fund and the first question was "Is the worst behind us?" In that interview, I actually said that this year could be just as bad as 2008 and, in some cases, worse if the recession becomes worse.

I think that you have to keep in mind that these are primarily financial service companies which are, across the board, cutting their dividends. We are underweighting to really no weight within the strategy in financial services, including bank stocks.

However, these cuts extend beyond the financial services sector. This week, a company called Basset Furniture eliminated their dividends. We recently saw Macy's cut their dividends 62% and Motorola suspended their dividends. Generally speaking, Basset Furniture, Motorola, and Macy's are not stocks that we would say have predictable cash flow yields. They would not be companies that we would have put in the portfolio to begin with. These are just a few examples of what I would call non-dividend paying stocks or stocks in which the dividend is secondary to their strategy and are now cutting to conserve cash.

We are seeing these types of cuts quite often and our primary focus is to investigate the sequence of events that could make a company cut its dividends. That is the number one factor that we are taking into consideration.

Q: Could you describe how and what you look for when you are evaluating companies and their cash flow?

A: When you look at the financial statements of a particular company, you obviously want to see stable cash flows over the years. However, going forward, we look for insight as to how the business can be affected in a downturn. What will happen to those cash flows going forward? It's a qualitative and quantitative analysis based on what the cash flows are, what the cash flows are likely to be, and how much sales can fall off. Is this a company that has a lot of contract renewals in 2009 that are going to be assigned for less? That is the type of thought process we use to basically verify if cash flows can be maintained in a declining environment.

If we were in an economic environment that was flat to, say, 2% growth, it would be less of a concern. But when you're in a recession where companies and consumers are cutting back, you have to take into account how the company is going to be impacted by all those factors.

Q: Let's start to break down the HDI asset class by sector. Starting with REITs, can you give us an overview of each sector and the description of how you have adjusted the weights in each sector given recent market events?

A: Our weighting in REITs has been the lowest it's been in the last five years and, again, I think things could get a little worse before they get better. The problem is that REITs have been affected by the credit crisis and are in need of a pipeline of good credit. The credit crisis is not as dire as it was in the fourth quarter of 2008, but it is still a major strain on the REIT sector. Certain REITs, including those which can be classified as retail-oriented or office REITs, have been hit harder than others.

So until the economy starts to look like it's bottoming out and the credit crisis looks like it has begun to stabilize, I think that you have to be very careful with REITs. It may be not the same pipeline of credit it was a couple years ago and full recovery may not happen for a while, but at least the emergency part of the situation is now behind us.

Some REITs that we would be interested in would include diversified REITs, as well healthcare REITs, and even certain storage REITs. You have to find a niche in the economy that can do better in this type of environment, but we have to be cautious and use careful reasoning. REITs are the lowest weight they have been since the strategy has been around and I wouldn't change that weighting right now.

However, I will say that many REITs are the most attractively valued since we experienced a large decline in 1998. That was a period when we traded at a 35% price to net asset value discount. We are now seeing similar REIT prices and the valuations are very attractive. With that said, there could be some opportunities in this sector once we trudge through all of this, but we're not through it just yet.



Q: Let's switch gears and touch on the financials segment of the strategy.

A: Generally speaking, financials comprise a large portion of a lot of equity income strategies. This isn't the case here at Rochdale, but more so in the financial world at large. Presently, we are underweight and we would not be buying any banks for individual accounts right now. To be specific, the financials portion of our portfolio is weighted at less than 5% as compared to other equity income strategies which traditionally hover around a 40% weight for this sector.

Before we begin adjusting this financial service weight, we need to get through the credit crisis and the accompanying write offs. As the crisis moves from mortgages, to credit cards, and to other consumer and commercial loans, we will monitor the fallout as well as the Treasury's plan to fix this mess.

As I've said, right now does not seem like the time to invest in financials. Still, there could be opportunity on a name-by-name basis as we trudge through this crisis, especially after the Treasury comes out with a legitimate plan which has a chance to succeed.

Q: Could you share your thoughts on utilities?

A: At the moment, I think utilities are a good sector. We are using tier one and tier two definitions to classify attractive utility stocks. When I say a tier one utility, I'm referring to a utility that does not have a lot of capital expenditures coming over the next couple of years and has a relatively stable business in its particular part of the country.

On the other hand, we are seeing other utilities with capital expenditures on the horizon that are located in a region that has been negatively impacted. Or, perhaps they have a rate case that is not going their way. These stocks have been beaten up within the overall market and would be classified as tier two utilities.

Obviously, we will be focused upon tier one utilities as this particular sector will remain defensive for the foreseeable future.

Q: Let's conclude our sector discussion by discussing consumer staples and any others that you want to comment on as well.

A: There is opportunity in consumer staples but, ironically today is not a great day for consumer staples in the sense that a relatively safe stock, Kraft, guided down. A great deal of that had to do with the dollar being very strong and the fact that about half of Kraft's business is international. When you translate those figures into U.S. dollars, you realize you did not actually earn what you had been in years past. Generally speaking, the recession is impacting a company like Kraft to a larger degree than people thought, as recently as a week ago. Today the stock is down 8.5%.

So even though with what I think is a defensive consumer staple stock, you have to be careful in this type of market. Even some guidance that is not what the market expected is causing what I would say is generally, an overreaction.

I think Kraft is a good buy at these levels. The dividend is safer than most stocks, HDI and otherwise, but you can see that even in this type of market you're not fully immune with the consumer staple stock.

Another example of this is Phillip Morris, the international spin-off of Altria, which sells Marlboro and other cigarettes overseas, who experienced a similar outcome as Kraft. That stock has been a little beaten up today as well, and could prove to be a good buy based on the current weakness.

Consumer staples in general, whether it would be a food company, a packaged goods company, or maybe a consumer drug company would be defensive in this kind of market, in my view.

Some of the MLPs we hold, whether it's a natural gas pipeline or a propane company, fit into that utility mindset of where we think they would trade. Our tier one versus the tier two concept applies to MLPs as well.

Q: Back to the volatility theme, would you say that it presents a buying opportunity in some sectors? Are we looking to jump in at certain price points as the stocks fall?

A: We sold stocks in 2008 to the point where the cash allocation in the portfolio, on average, is the highest it has been since the strategy was developed. As a whole, we have high cash balances across the firm.

How long do you keep that cash? When do you start to buy? We would like to get through this first quarter and compare earnings to those of 2008 to determine whether specific companies guided down as Kraft did. In addition to the earnings comparisons, we need see what the Treasury has in store for the banking system and how the market will react.

After all of this, we could start to buy in. Even if the economy is still not where we want it to be, the latter half of 2009 could present us with improved markets and so certainly buying on dips could be warranted. Again, we still need to get through this first quarter and review earnings reports, review the guidance, and review the Treasury plan.

I wouldn't necessarily be rushing out and buying tomorrow because you're going to have a lot of earnings calls in the next two weeks. However, once the dust settles, I think there could be selected buying opportunities.

Q: On the flip side of the volatility, as stock prices have fallen, the yields in the portfolio are going up and even skyrocketing in some cases. Some advisors and clients want to jump in and capture these yields. What are your thoughts on this strategy?

A: In some cases, if you have done the proper research and are confident in the yield, it will certainly appear to be an attractive option. But I would say that you want to make sure, like in the last point, that we are past the point of all these companies and the dirty laundry that they air in terms of guidance.

For example, if you have a stock that has a 12% yield that looks very interesting, but the market pulls back. There's a lot of noise in the market. Say the stock is down 8% with the market, you've basically lost 2/3 of your yearly dividend just in terms of the stock being very volatile.

I think that we need to be prudent and cautious as we get into these things. However, we will keep a close eye on the relevant data and be ready to buy back into stocks with attractive yields from stable businesses.

Q: Let's touch on the political environment. Now that we have a new president with new ideas involving economic stimulus, how will this affect the HDI sector? Will we see a change in the tax treatment, for example, of the dividends coming from these stocks?

A: Yes, let me address the last part of that question first. There was some worry about the 15% rate on qualified dividends expiring. This is not permanent as it goes to the end of 2010 and, at the worst case scenario, it would not be renewed and dividends could be taxed at ordinary rates.

In the plan that President Obama laid out during his campaign, the dividends and capital gains would increase to a 20% rate and that would become permanent. This proposition was widely discussed on CNBC, among other media, bringing it heightened attention and we view that as favorable.

I remember sending a memo to all employees informing them of the President's proposal and that this is what they can expect. However, in the new stimulus plan that was passed by the House, this was not addressed.

I think they kind of kicked the can down the road on that but the expectation is that there would still be favorable treatment regarding the dividend tax rate. Again, the rate would now be 20% as opposed to the expiring 15% and that's what we're looking at down the road.

I don't want to throw cold water on the new President and the plan to fix the economy but, to coin a show on HBO, it might be best to "curb our enthusiasm." Basically, the stimulus might be good and it might not be. We need to continue to look



at how these companies can operate in a slower environment. What is their cash flow? What is their commitment to the dividend?

We can not view the stimulus as something that is suddenly going to bring the happy days here again. The stimulus may not exactly work right away and it may not even work at all. It still may be a tough economy for awhile.

We have to approach this on more of a stock-by-stock basis. In addition, I think that the popularity of the President as well as the idea of a stimulus can improve consumer sentiment, and therefore, improve consumer spending. A lot of that is self-fulfilling in a sense that it could help the economy and I'm optimistic and hopeful that it will.

Regardless, no matter how optimistic we can be, we must keep in mind that this plan simply may not work and our economy will continue to struggle as we work out some of the excesses which built up over the past few years.

Q: What is your opinion on mortgage REITs?

A: Our HDI strategy has never included mortgage REITs. Even in 2003 and 2004 when there was potential opportunity in this sector, I was skeptical and hesitant. Given the environment we are in now, some of the mortgage REITs that have survived can attribute that survival to a different business model as opposed to those who did not survive such as Thornburg Mortgage. My stance on mortgage REITs remains constant as they are surrounded by potential volatility and many have problematic business models which may have trouble obtaining stability during this recessionary period.

Please see next page for important disclosures

The Rochdale Dividend & Income Portfolio holds the following positions as of 1/31/09: MO, 0.14%; KFT, 1.17%. Securities mentioned in the document had the following closing prices as of 2/5/09: Bassett Furniture Industries Inc. (BSET, \$1.99), Macy's Inc. (M, \$8.75), Motorola Inc. (MOT, \$3.68), Kraft Foods Inc. (KFT, \$26.00), Altria Group Inc. (MO, \$16.47).

Source: Bloomberg.com

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