

# Rochdale Investment Insight

With compliments  
*Symphonie*  
FINANCIAL ADVISORS

February 17, 2010

## High Dividend and Income Equities: Uncovering Opportunities and Enhancing Returns



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

### *Highlights:*

- Overall, for the full year of 2009, the High Dividend and Income strategy held up well after rebounding from a very difficult first quarter.
- Going forward, we feel that as the economy continues to slowly but steadily recover, high dividend equities are in a good position to have solid operating results. We feel these solid results can result in strong dividend flows and can have positive effects on the stock prices.
- Economic indicators do seem to support a steady economic recovery with a lagging improvement in unemployment rates. In our view, this type of environment would be favorable for our companies.
- Our Three Box Research Process focuses on the level of the dividend, the maintenance of the dividend, and the growth of the dividend. This process has helped us perform well relative to peer strategies and has helped to maintain the dividends of the bulk of the companies that we hold.

*The following discussion, conducted on February 17, 2010, is moderated by Charles Alberton, CFA, Portfolio Manager – Rochdale Investment Management.*

**Q:** David, lets talk about 2009. Despite a poor first quarter, the market in general seemed to rebound. However, according to Standard & Poor's, 2009 was the worst year for dividends since 1955. During the first six months of the year, the number of companies that suspended or reduced dividends was more than three times the number that did so in the first half of 2008. With the record amount of cuts in 2009, how did Rochdale's dividend and income strategy hold up?

**A:** Overall, the strategy held up well for the year. After a very tough first quarter, the market, including

HDI stocks, rebounded very well. As far as the dividend is concerned in the context of all those big cuts that took place in the S&P 500, the majority of our holdings and, in effect, the real core holdings of HDI stocks maintained their dividends and even increased their dividends in many cases. That had a lot to do with the focus of research on companies that can maintain and increase their dividends.

The majority of cuts in the S&P 500 occurred in the banking sector, which we avoided for the last couple of years. There were other cuts by select companies that I would not characterize as steady dividend payers. Last year, I did a call on February 4<sup>th</sup> and I mentioned Macy's, Motorola, and Bassett Furniture in that call as examples of companies that had recently made cuts. Those are not companies that I would characterize as having steady, stable cash flows and dividend payments and those are not companies we would have bought. Having said that, there were some companies that we had trouble with, but by and large the majority of our companies withstood the test of dividends pretty well during that period and recovered nicely off the lows of the first quarter and 2009 ended on a nice note.

With that, in terms of the broader market, it does appear that the worst of the dividend cutting is behind us. You are starting to see more and more companies actually increase their dividend and this is taking place in the broader markets. We are seeing more and more of our steady dividend paying companies increase their payments as their earnings increase.

Therefore, from a dividend payment point of view, we have more optimism at this point.

**Q: I can attest to being on the front line with nervous clients and your meticulous navigation through the dividend cuts is greatly appreciated. With the challenging 2009 behind us, what can we expect for 2010? Did the 2009 holiday shopping season give us any indication as to what lies ahead? I know some retail numbers came out this morning as well.**

A: Yes, that is all evidence that our view is that the economy is steadily improving but there will still be lagging numbers such as unemployment. There are still going to be negative elements. By and large, there has been a steady and continuous improvement in the economy. One of the economic tea leaves was the holiday sales figures for 2009 which were better than expected. They were up in comparative terms to the prior holiday season by 4%. They were actually up above 4% again in January 2010 and that was the fourth positive month in a row.

So while retail sales overall are still weaker from their peak, they're stable and slowly improving. You are seeing that in other economic indicators such as GDP and the ISM, the supply management index number which indicates whether manufacturing is expanding, and there are a host of other economic indicators that are slowly improving as well. Our view is that as the economy continues to slowly improve, that should give rise to an improved market. We've recovered a lot off of the lull in the first quarter of 2009 but a stable and growing economic environment will certainly be good for the companies we select and good for the markets in general.

**Q: Many experts believe renewed near-term risk aversion combined with lower long-term return prospects likely points to a renewed importance for dividends. Are you of this belief?**

A: Well I'm actually a believer of steady dividends in any market, including during a strong bull market. However, in a flatter market, dividends become a more important part of the yield. You saw that in indexes that may have been flat for a certain amount of time but that didn't include the dividend yields. So on a total return basis there was some positive yield and certainly, I think dividends will be an important part of total returns.

This is the case in many portfolios, but in dividend-focused portfolios it is especially true that the dividend is an important part of the total return.

In addition, as you pointed out there are nervous, risk averse investors out there. As they tip toe back into the market, those investors look at that steady yield and are attracted to dividend paying stocks which are often a better valuation than stocks that do not pay a dividend. So that increased demand can be a positive for the dividend stocks. I would agree that those would be factors as to why this sector is attractive. Even in a good bull market, I am a believer in steady dividends.



**Q: I know all of our listeners want to hear about the specific HDI sectors and we'll get into that in a moment. First, can you share with us how and what you look for when you're evaluating companies for potential investments?**

A: Essentially, it starts out with screening for companies with an attractive yield. The universe within which we search includes the S&P 1500 Index, the Russell 3000 Index, publicly traded REITs, preferred securities, and other higher yielding stocks. International stocks are included in the search, but our focus tends to remain on domestic holdings.

That is only the first step and the second and third steps of the process are more important. In a nutshell, these steps are looking for companies that are maintaining the dividend and then increasing the dividend, respectively. To determine which companies maintain their dividend, we are looking at factors such as the balance sheet, the debt levels and if they are reasonable, the payout ratio, the track record of dividend payment, reasonable dividend payout levels to cash flow and earnings, and the management's commitment to the payment as well. Beyond that, though, in this strategy, it is important to have increasing dividends. It helps total return and it helps hedge against rising interest rates and rising inflation.

In searching for companies increasing their dividend, we look at the overall business franchise, the opportunities to grow earnings, and if they reside in a profitable sector of the economy. Essentially, we are looking at specific companies from the bottom up while simultaneously paying attention to what stage of the economic cycle we are in. Is this a company that will perform better in a period of economic improvement? Does this company have recession-resistant characteristics? Questions of this nature must be answered during our process.

We are really getting a sense of what is going on at the company level and within the sector. Primarily, the goal is to find an attractive yield, maintain that yield, and then ultimately increase that dividend. We have generally found that if you find a company that meets our three criteria and trades at an attractive valuation, this should prove to be a very solid investment over time.

**Q: It sounds like it is really a bottom up strategy and not just picking a sector, such as exchanged-traded funds (ETFs), if you will.**

A: That's right. I think sector ETFs can be dangerous because by not looking at the fundamental factors of maintaining the dividend and increasing the dividend, you can run into some real trouble. Most of the cuts in dividends, as I mentioned, were in banks and many high yielding strategies were very focused on banks in 2008. Some of those funds lost half of their value. So it is very, very important to look at the maintaining and increasing of the dividend and that really is a lot of the "roll up your sleeves" type of work.

**Q: Let's move on to the HDI asset class sectors. 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? Let's begin with financials which have historically played an important roll in the HDI universe.**

A: That's right. As I mentioned earlier, financials have been a significant part of many equity income and high yielding strategies. However, financials have also gotten those strategies in a lot of trouble. We had not been a buyer of banks for the last couple of years. Even though these were an important part of the underlying indexes that we would look at and compare ourselves to, we fortunately had really minimized the weight in financials. There were a few that we held historically but we were not buying new names as we were very underweighted to that sector which proved to be quite helpful.

Going forward, I think there has been a lot of movement off the low end in financials and specifically banks and I think we still need to tread cautiously in that sector, at least for the high dividend strategy.

**Q: When we're talking about banks I'm assuming that you're talking about the regional banks here. Are there any opportunities with any of the big banks?**

A: Yes, and that is a good question but, no, there are not opportunities among the larger banks. Most of the big banks had to cut their dividends to raise capital and they were receiving TARP money as well. As it stands, JP Morgan has a

dividend yield of 0.5%. Bank of America sits at 0.59%, Citi Bank is at 0.0%, Wells Fargo, which took over Wachovia, is at 0.734%, and U.S. Bank is currently 0.845%. We are talking about five of the largest banks in the U.S. all paying less than a percent in dividends. For the strategy of achieving a high dividend, maintaining it, and then increasing it, these large banks just do not make the cut as they don't even pay a moderate dividend.

Now, there are regional banks that do pay a pretty good dividend, but you need great care in this area. You really have to be careful because any commercial loans that may come due in 2011 or 2012 could come back to haunt them. We really want to make sure that they will be able to maintain those yields. However, there still may be some opportunity there as we progress into the year.

**Q: Let's stay on the sector theme and move on to Real Estate Investment Trusts (REITs). Traditionally, REITs have been a steady component of the HDI asset class and have paid some pretty nice dividends. Can you give us an overview of the sectors and weights and maybe talk about one or two of the sub sectors within REITs?**

A: REITs were a cornerstone for many years and they once comprised as much as 1/3 of the portfolio. We were not new buyers, or buyers of new names, from roughly mid-2007 to mid-2009. However, we did hold existing names that we had previously bought to that time. As a result of not buying new names and cutting a couple of the names that had run into some trouble, our REIT weight was in the single digit weight. Only recently did we start buying new names. Again, in this sector, you need to take great care as many REITs cut their dividends even though they are required by law to pay 90% of their net income in a dividend. Some of them ran into loss situations and they actually didn't have to pay a dividend. In other cases, the IRS allowed REITs to pay a stock dividend so some notable REIT names that we do not own are currently paying a stock dividend. The REITs that we did continue to hold and are buying again did not cut their dividends. This includes healthcare REITs and a diversified REIT such as Washington Real Estate Trust, which has been a core holding of ours.

Going forward, I think there are still opportunities in REITs with solid balance sheets and solid business structure. You do have to be careful, though, on a sub-sector basis of the business as it could be tricky depending on the market. You are going to see a lot of private deals, and even some public REIT deals, but primarily private deals that were done in 2005 with five year money that are going to need to be refinanced next year. Those properties are underwater so there is going to be a situation where you might have properties enter the market, as foreclosed properties. That could be an opportunity for some of our better capitalized publicly traded REITs to buy cheap properties. Again, it's a real stock picker's market in this market, but in the names that we are buying now are solid companies that have weathered the 2008 and first quarter of 2009 storm very well.

**Q: So if I understand you correctly, we continue to favor the healthcare and diversified REITs but we're still going to stay on the sidelines for the offices and apartments right now.**

A: Yes, that is right and we would also stay on the sidelines for industrial REITs. We are actually buying several REITs within the retail area. Although retail sales though do look to be stabilizing and the retail REITs are starting to improve, we still have to be careful here. There was actually a notable deal yesterday, where the largest mall REIT, Simon Property Group offered to buy General Growth Properties, a company that ran into trouble and declared bankruptcy in the first quarter of 2009. The offer price was \$10 billion and that is a real sign that there is some mending in the retail part of the REIT business as well.

**Q: Let's move on and talk about utilities and master limited partnerships, also known as MLPs. The utilities sector lagged the market in 2009 while the MLPs seemed to do very well. Are you expecting those similar trends this year?**

A: Well MLP's were the best performer of the HDI asset classes in 2009 and, in some ways, utilities were the worst. Banks would have been the worst but, fortunately, we were not exposed to that sector in 2009. The question remains; do I think this will continue?

We have very strict limit prices on these MLPs. Our portfolio management associates who perform some of the "in the



trench" buying really try to take advantage of a couple down days in the market to get into the MLPs we like. If you buy them at the right price, the yields are very attractive the businesses are solid. They were solid through the recession and, in all likelihood, they are going to be solid during the recovery. So I still like that sector but do I think they will have the outsized gains in 2009? I wish I could say that but I do not believe so. However, the yields are around 8% in a lot of the MLPs and we are also seeing growth in the yields so I think the total return there is still quite attractive.

Utilities, on the other hand, have been beaten up relative to other sectors. The spread, or the dividend yield versus the ten-year treasury rate (the amount that it trades in excess of the treasury), is very attractive. In fact, it is the most attractive it has been in years.

Utilities were beaten up a bit because their business was down in 2008 and 2009. It was the first time you had two negative back-to-back years in over 50 years. Obviously, they were deeply affected by the recession. Electricity use went way down. It is interesting because economics professors always talk about the utility industry as a cash cow that can never falter. Ironically, utilities did falter and actually had negative net income growth. I think that affected the stock price but going forward as the economy recovers, energy usage, whether its natural gas or electricity, should increase. The spreads are attractive and I think utilities should be a brighter sector going forward.

**Q: You mentioned the banks were traditionally fairly big weights of the portfolio. Consumer staples and miscellaneous holdings appear to have taken the place of the banks and I'm wondering if you are tracking any opportunities within those sectors at present.**

A: Yes, we moved into a larger weight for consumer staples, as well as other high yielding HDI stocks, than in years past. A lot of it made up for the bank weight but some of it made up for being underweighted in REITs relative to where we had been.

Consumer staples, just like the name staple implies, is a sector that hangs in there, relative to other industries. When the going gets tough, the issue becomes, when will the going get better. Some of the investors who were in those stocks may be more interested in stocks with higher growth potential and consumer staples could underperform. However, as far as the core business is concerned, the growth and the yields they generate are very solid, even in a better economy. There is always room for certain consumer staple names in this type of strategy so we are still favoring this sector. As the economy improves, it may make sense to get into certain businesses that have a more cyclical element, a stable business plan, and a steady dividend that might have been beaten up in 2008 and in the first half of 2009. Even though they may have moved a bit off their low, it could still prove to be a sensible investment for us and we may be looking to do more of that moving forward.

But we'll still have exposure to consumer staples. And there are other areas, such as telecom, that we were in a little bit bigger. Telecom I'd say underperformed in 2009, but going forward the yields are very attractive in that sector. And that is also a sector that should do better as the economy improves. So there'll always be room for that miscellaneous category as we sometimes call it. But one thing that they'll all have in common is a nice yield and a good business plan that we think can do well in the upcoming economic environment.

**Q: What is the overall yield right now of the portfolio, David?**

A: The yield of the portfolio, and it would depend if it is taxable or nontaxable, is around 6.5% and we are pleased with that in today's environment.

**Q: Now that we've covered each sector, would you mind commenting on the potential of rising interest rates and how that may affect these sectors?**

A: I remember being on vacation during the first quarter of 2004 and the jobs report was very strong. I was phoning in from overseas because the employment report had just shown 330,000 new jobs and this caused a worry that we might be in an inflationary environment with rising interest rates. Consequently, there was negative effect over the next couple weeks based on that report. It is a legitimate, perennial worry that must always be on our radar. Today's 10-year treasury

rate is 3.7%. That does seem low and it does not seem likely that we will be able to maintain that rate going forward.

However, if you go back to 2002, you had a 4% to 4.5% 10-year treasury rate and that was a fine level to be at as HDI stocks traded very well at the time. It is usually a reflection of the fact that the economy is stronger. You can even find some rates in between 5% and 5.5% percent as we saw in mid-2006, mid-2007, and even in early 2002. I think if we stay within the historical ranges where we have been, it will be great for HDI and especially if interest rates go up as a result of a stronger economy.

If we start to go north of 5.5% to 6%, we would have to reevaluate the situation and the market, in general. This would probably mean that we are in a more inflationary environment than we expected. Given where the levels are at now and where we are predicting them to go, which is certainly higher than now, the environment should be fine for the HDI sector.

**Q: So it sounds like we have some room and if we continue to see a growth in company earnings and a growth in dividends, then the name should continue to perform here.**

A: That is correct and it depends what drives the interest rate. Certainly, rates were a lot higher during the recovery from the 2002 recession up until even mid-2007 and the HDI stocks did well because, operationally, they were performing well.

**Q: The 2011 White House Budget Proposal imposes a 20% tax rate on capital gains and dividends for married taxpayers with income over \$250,000 and single tax payers with income over \$200,000. Could you share your thoughts on the government's recent tax increase proposal and how that may affect the high dividend names?**

A: As you mentioned, the recent White House Budget Proposal proposed increasing dividend and capital gains rates to 20%. In addition, the top ordinary rate goes back to 39.6%. That is the same as last year's budget, which did not actually happen, but it is more likely to happen this year because the rates expire at the end of this year and some sort of tax action is going to need to take place.

At this point, we are envisioning the likeliest scenario to be the recently proposed 20% rate. The reason for this is that it represents the ceiling of what the White House proposed and no one really wants it to go higher than that. It is currently at 15% and there are probably some people that would love to see it at 10%.

I think all of that is what is priced in and it is what dividend investors are expecting. No one is happy about any sort of tax increase and an increase to a 20% rate in capital gains and dividends and a top rate of 39.6% will not be positive for the economy. It will definitely be a constraining factor but on the other hand, it is priced in and expected. So I think that will be OK if it in fact happens.

We will need to monitor to make sure that if it does in fact happen that Washington doesn't let the tax bill just sunset. Unfortunately, there is a lot of fighting taking place in Washington right now so we have to really pay attention to all of the details. However, it does not appear that anyone wants taxes on dividends to spike back up to ordinary rates.

**Q: Some investors see the HDI strategy as a potential inflationary hedge, can you comment on this?**

A: There are some companies that produce very steady dividends. They don't really increase their dividend but they do tend to be consistently high. For example, utility-type businesses may not be able to achieve too much earnings growth or dividend growth, in turn.

Then there are other companies that could perform better in a more heated economy, or at least have the pricing power to pass on the higher prices in an inflationary period to their consumer, including industrial consumers. Therefore, they see increased earnings and in turn, a higher dividend.

We do have many companies that meet the latter criteria. We would position the portfolio to invest in more of those companies that will have pricing power and if we're in an 8% inflationary environment, ones that they could potentially raise their prices 8% or more. Ideally, they would be in a sector of the economy where they could raise prices 10%.

As a result, they would be able to raise their dividends, all else equal, 10% and a growing dividend should help hedge against inflation and help drive earnings higher. That should at least help keep the price to earnings ratio stable which should also help the stock price.

**Q: David, we have covered a lot today. Is there anything you would like to add in terms of closing remarks?**

A: We did go through some rough times in 2008, the first quarter of 2009, and even during parts of 2007. Obviously, we can look back and see a real economic downturn and accompanying credit crisis. Now, we can put our finger on it we can see bona fide recovery taking place. Many of the stocks we were invested in during the past are now being revisited as we know that these have the potential to be solid businesses. We know we can feel more comfortable with them as the economy improves. That is really an opportune time to be in stocks as the economy improves even though prices have moved quite a bit off their lows. We think there is still opportunity and certainly the future looks brighter now than it did a year ago.

On the February 4, 2009 call, just given the great uncertainties that existed, I thought there was great opportunity given the valuations. However, the market did not bottom until March 9. You had another five weeks of real pain if you got in that day. Now, I would say, "Hey, you know we are in a recovery and these are solid companies. They have been properly evaluated, they produce good dividends, and the dividends withstood through the fourth quarter of 2008 and first quarter of 2009." I'm more optimistic on them going forward and I believe now would be a good time to invest in this strategy.

---

**Please see next page for important disclosures**

Rochdale Investment Management makes the Rochdale Insight series available to clients and their advisors to provide perspective on Rochdale's portfolio management process, our outlook for the economy and industries, and changes to clients' portfolios. The research recommendations herein are determined by Rochdale and intended as a guide. Final determination regarding inclusion in client portfolios is made in accordance with the client's investment objectives at the Portfolio Manager's discretion. To subscribe to the Rochdale Insight series, please send an email to [info@rochdale.com](mailto:info@rochdale.com).



The Rochdale High Dividend & Income Portfolio holds the following positions as of 12/31/09: WRE, 3.00%. Securities mentioned in the document had the following closing prices as of 2/18/10: Macy's Inc. (M, \$8.75), Motorola Inc. (MOT, \$3.68), Bassett Furniture Industries Inc. (BSET, \$1.99), JP Morgan Chase & Co. (JPM, \$40.41), Bank of America Corp. (BAC, \$15.88), Citigroup Inc. (C, \$3.43), Wells Fargo & Co. (WFC, \$27.34), U.S. Bancorp (USB, \$23.91), Simon Property Group Inc. (SPG, \$77.22), General Growth Properties Inc. (GGWPQ, \$12.69), Washington Real Estate Investment Trust (WRE, \$26.70),  
Source: Bloomberg.com

Securities listed herein are not stock recommendations and should not be used as such.

The ISM Index is a monthly composite index, released by the Institute for Supply Management, that is based on surveys of 300 purchasing managers throughout the United States in 20 industries in the manufacturing area.

The S&P 500 Index represents 500 large U.S. companies.

The S&P 1500 Index combines the S&P 500 large-cap, S&P 400 mid-cap and the S&P 600 small-cap indices and represents approximately 90% of the market cap of investable U.S. equities.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

Investing in small and medium-size companies and REITs may carry additional risks such as limited liquidity and increased volatility. Investing in international companies carries risks such as currency fluctuation, interest rate fluctuation, and economic and political instability.

This publication is for informational purposes only and is not intended to be a solicitation, offering, or recommendation by Rochdale or its affiliates of any product, transaction, or service, including securities transactions and investment management or advisory services. The opinions expressed in this publication should not be considered investment, tax, legal, or other advice and should not be relied on in making any investment or other decision.

