INVESTMENT UPDATE

Skating to Where the Puck Will Be: Why Chasing Yield Might Not Always Mean Safety

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SUMMARY MESSAGES

- Fear about the future is causing investors to chase investments offering yield and perceived stability, in our view. Longer term, we believe the price for safety remains high. Defensive investments of course play a vital role in portfolios, but they cannot be substituted for out-of-favor offensive investments longer term.
- Dividend-paying stocks play an important role in our larger cap portfolios, particularly for conservative risk profiles, but our view is that dividends alone should not be the lead criteria for owning a stock. We provide a detailed discussion below.
- From a broad perspective, we are avoiding Treasurys and keep corporate bond maturities relatively short, given negative real returns. We have sold investments which we consider to have attractive but expensive yields (domestic REITs and certain stocks). US equities offer selective opportunity, particularly in out-of-favor value stocks. Commodities, European stocks, and emerging market equities may present opportunity for the long term.

MAIN COMMENTARY

Wayne Gretzky, widely regarded as one of the best hockey players in history, says he was successful because he “skate(s) to where the puck is going to be, not where it has been.” We think this observation applies to the investment landscape too. As Europe wrestles with its debt crisis, the global economy slows, and the US faces a challenging fiscal cliff, the current play in the investment game is focused on preservation. Safety is where the play is now.

The current play is manifest in many ways. Investors continue to buy investment grade bonds, despite their historically low yields, and stocks offering attractive dividends from stable business models. Investors are generally selling US equities and avoiding European stocks. Commodities were some of the worst performing assets over the past 18 months. Investment grade bonds imply investors expect recession, if not deflation, in the coming years.

Of course, these expectations may be right, and it will take time for global conditions to improve. But we must also recognize an often overlooked point—a significant degree of bad news is already reflected in many investment prices today.
Most investors are afraid to take risk right now, potentially at the expense of longer term wealth generation. Certainly, for the defensive parts of a portfolio, risk needs to be managed so that assets can be preserved. But for the portfolio to grow over the long term (“the reward”), volatility (“the risk”) needs to be accepted and permitted, for the more offensive investments of the portfolio.

Looking ahead, we cannot predict when and how the puck will move for a different play. But we can make an educated assessment of what the play will be, based on probable outcomes for given asset prices. We believe the price for safety remains very high. Defensive investments of course play a vital and permanent role in portfolios, but they must be managed for inflation and cannot be substituted for out-of-favor offensive investments.

Aren’t High Quality Dividend-Paying Stocks Best for These Tumultuous Times?

We recognize that dividend-paying stocks are attractive and play an important role in portfolios. They provide income and arguably some relative stability to portfolios. At the same time, they cannot be used to replace lower-yielding bonds, and valuation must be considered when owning them.

Our stance on dividend-paying stocks:

- **They play an important role** in our larger cap stock investments. Currently, a third of our holdings have a dividend yield of 3%-5%. These include stocks like Microsoft, Intel, AT&T, Conoco Phillips, Eaton, and Abbott Labs. Our total large cap holdings yield 2.6% in dividends, which meaningfully exceeds the yield on 10-year Treasurys.

- **Dividends should not be the main criteria** for buying a stock. Valuation matters, in our view. A stock with a good dividend might be expensive, which poses risk longer term. Our dividend-payers trade at an average earnings multiple of 10 times with a dividend yield of about 3.9%, compared to some higher profile stocks like McDonald’s, Coca Cola, Kimberly Clark, and Verizon, which pay a similar dividend but trade at 16 to 19 times earnings. For reference, the S&P 500 trades at 13 times earnings.

- **Portfolios need a blend** of dividend paying stocks and stocks focused on appreciation. Our research shows that over the long term, dividend paying stocks (excluding utilities) produce some of the lower returns. That is because they tend to be in mature industries and believe reinvestment in the business is not the best use of cash. In contrast, some stocks use extra cash to invest in growth opportunities, which could drive better returns over time.

- **Dividend-paying stocks are not a substitute** for bonds or other defensive investments.

Tough Times for Stock Picking

We have a disciplined system for selecting individual stocks, which should produce favorable results for clients over time. Nevertheless, for the past 12-18 months, it has not generated good investment returns in larger cap stocks. We have underperformed benchmarks like the S&P 500 and the Russell 1000 Value. Why?
One reason is that the market is seeking safety in “mega cap” stocks with healthy balance sheets. Valuation does not necessarily matter. We have not owned many “mega cap” stocks, and our value-driven approach (i.e., our philosophy of buying stocks “on sale”) has not been in favor.

As noted above, we own many dividend-payers, but they tend to be “value” stocks; we have sold or avoided the more expensive ones, as we always do. These sales (e.g., Kimberly Clark and Reynolds Tobacco) have hurt us on average. Importantly, most of our stocks have relatively healthy balance sheets (only 3 out of 47 have above average risk by our criteria), which we believe should be rewarded at some point if we stay with our proven approach.

In addition, we have not owned Apple (AAPL). This one stock has contributed outsized gains for the S&P 500 and not owning it has hurt us meaningfully. In our view, Apple is a great company, but it does not meet our valuation criteria as profit margins are meaningfully higher than usual, which poses risk if the business stops performing optimally.

Likewise, utilities have been a top performing sector in the S&P 500 over the last year, and we have avoided them due to their high relative valuations. This group has benefited from an ultra low rate environment and from investors stretching for a stable income flow.

We have also made some poor stock selections, particularly in tech and energy. Alpha Natural Resources has been hurt by slowing steel usage in emerging economies as well as a glut in natural gas after a record warm winter in the US. In addition, three of our investments (Apollo, Computer Sciences, and Hewlett Packard) have ended up being more difficult turnaround stories than expected. These three remain “buys” in our research, although visibility is clearly limited.

To summarize, we understand why we are lagging during this period. We won’t “switch to what has already worked” since that would most likely be buying in at higher-than-favorable valuations. We will stay with our discipline, which we believe should benefit our clients over time.

**Our View of Broader Investment Opportunities by Asset Class**

From a broad perspective:

- We prefer cash over Treasurys and keep corporate bond maturities to five years or less in most cases.
- We have sold asset classes with attractive but expensive yields, such as domestic REITs and stocks with a growth premium or expensive dividend yield.
- High yield and domestic US stocks aren’t cheap as a group, but they offer selective opportunities in our view. We particularly think out-of-favor value stocks are attractive.
- We are taking closer looks at commodities, European stocks, and emerging market equities, which have been some of the worst performing sectors over the past two years. We already have allocations to these groups for appropriate clients, but are likely to add to positions. For appropriate accounts, we are also finding residential mortgage-backed securities of interest.

Below are our more specific comments for the major asset classes:
**Equities:** At about 13X earnings, US stocks are not “cheap” on an absolute basis. Our research indicates profit margins remain at historic highs, which could put a cap on earnings growth unless top-line growth improves meaningfully. This may create volatility, but the risk-reward relative to bonds remains attractive longer term, in our view, given earnings yields. Moreover, corporate balance sheets remain healthy—debt is at average levels, but cash levels are very high—which brings flexibility for companies to pursue opportunities. On the international front, both emerging market equities and European stocks are at historically cheap levels (about 9X earnings) and may present selective opportunity for longer term horizons. We are buying additional shares in these areas on weakness, for clients with the right risk profile.

**US Treasurys:** After another surge in prices during 2Q12, yields are now lower than they’ve been in over 60 years, implying Treasurys are still priced for recession, if not worse. We consider them expensive and are avoiding them under most circumstances.

**Inflation:** We consider inflation a high probability over the next five to ten years. Accordingly, we prefer to keep fixed income maturities shorter, and favor real assets or broad commodities longer term. Despite our assessment of inflation, we have generally sold TIPS investments with maturities less than ten or 15 years, given unattractive valuations and real yields.

**High Yield:** Risk-spreads have widened incrementally over the past few months. The spread is now 580 bp over the 10 Year T-Bill, which is close to the 600 bp average of the past ten years but still within reasonable ranges.

**Corporate and Agency Bonds:** We are still reinvesting in corporate and agency bonds, but cash has also been attractive for short-term horizons given the low opportunity cost.

**Municipal Bonds:** State and municipal budget deficits should be manageable for most and have improved since 2009. Unfunded pensions are the bigger problem, requiring creative solutions over time. Our approach to muni bonds is to buy good quality across diversified issuers, to manage risk.

As always, bonds, stocks, and other investments all play a role to support each investor’s near-term and long-term goals. We believe portfolio diversification is the right investment approach as global issues unfold. Volatility should be expected as the world works through its challenges, but the appropriate investment strategy should be able to balance risk/reward with fundamentals and probable outcomes to help investors meet their long term financial objectives in an uncertain time.

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