

## Thought for the Week: Monday, August 29<sup>th</sup>, 2011

### Growth vs Income?

Equity markets are at similar or lower levels to those seen in 2000; investors may still be experiencing the “Lost Decade” for consistent capital appreciation from stock markets. When the effect of inflation is taken into account, the loss in real net worth is even greater.

Looking at the chart below of the S&P 500 since 2000, “Buy-and-Hold” it will all come back clearly isn’t working.



So why would anyone invest capital in an asset class that has failed to provide capital appreciation over the last ten years or more? Moreover, how can a conservative or moderate investor tolerate the volatile swings in stocks?

For many, the answer is INCOME.

#### The Lost Decade

The chart at the top of the next page is taken from a 2006 Global Financial Private Capital Fact Sheet. We suggested the coming 3 – 7 years would compare to the period between 1967 and 1982 – a period where consistent long term capital gains were hard to come by.

What we actually said in 2006 was:

*“Given the significant appreciation experienced by equity markets since 1982, the view of Global Financial Private Capital is that for the next 3 to 7 years Equity Markets will “revert to the mean” and behave in a manner similar to 1965 to 1982. During this period, positive returns were a function of reinvested dividend income. Income and conservation of principal are therefore the primary focuses...”*

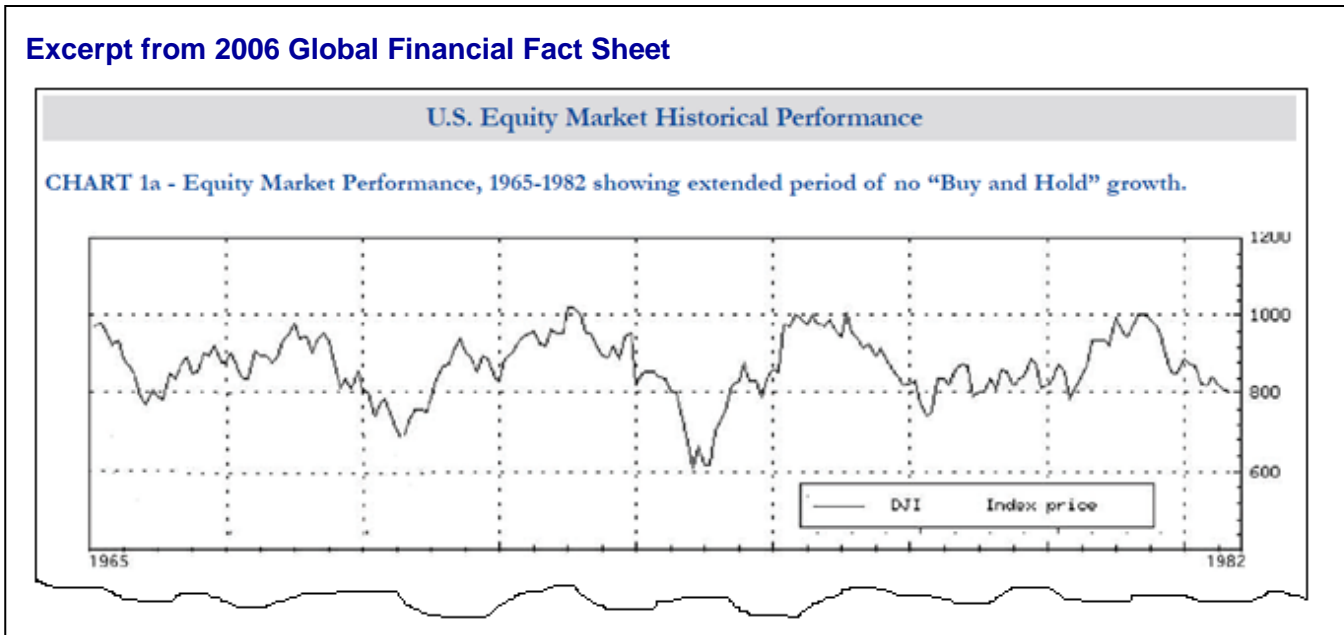
INCOME looks like a great reason to invest in equities, not Growth.

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If you have the ability to invest for ten years or more and not worry about price movements in the meantime, stocks may still provide growth. If you need to meet expenses or hit a regular appreciation assumption, it may be a good time to consider stocks as an income producer.

**Excerpt from 2006 Global Financial Fact Sheet**



Since the early 1980's, years of rising stock markets have created an investing public accustomed to receiving positive returns and liquidating enough money to meet bills and lifestyle goals.

Financial advisors promoted the message: "Sure, markets can go up and down, but long term the market always made something like 7%. All you have to do is stick around." But is this still the case?

Can stocks be relied upon to cover consistent, inexorable household expenses?

**Stocks – the new Fixed Income?**

No, we are not suggesting stocks are the new bonds...although it's a catchy line.

But why not think of dividend-paying stocks like a bond. This would result in a simple process for assessing a potential investment, in order of importance:

1. How much Income does it pay?
2. What is the chance of Default (aka will the company be around in 5 years and still generating the cash flow to pay the income?)
3. Will the investment be down at the end of my investment period, hopefully 3 years minimum?
4. Can I cope with any price Volatility?

This process may allow investors to cope with periodic price volatility compared to the alternative of sitting around waiting for price appreciation.

### That Said...

...Interest Rates are at such low levels that the yield paid by common stock can be higher than the same company's bond yield.

Verizon, AT&T, Kimberly Clark, Procter & Gamble, Kinder Morgan Partners, Philip Morris International, and Altria have yields that are particularly favorable when compared to their own bonds.

Bond holders, in all seven companies, now must go out at least 10 years to match the yield paid by the stock. In the case of Altria and Philip Morris International, bond holders need to go out to 2038 to achieve rates greater than the common stock. No Kinder Morgan Partners ([KMP](#)) bond equals the stock's 6.94% distribution.

One way to look at this: Bond investors are lending money to these companies at low interest rates. The companies are using that cash to generate higher returns. In return for owning the stock not bond, you therefore receive dividends at much higher rates than the bond lenders. You become a bank enjoying increasing interest spreads. The extra risk for this additional income is the increased risk associated with owning common stock not bonds in a default situation. Also, companies can easily cut their dividends if their cash flow turns bad. But remember, we try to find companies where these risks are very low.

These are all strong companies with a proven record of raising their dividends, in some cases for over 25 years. Whether we have a recession or not, people will still smoke, make iPhone calls, and consume energy and commodities.

Moreover, their dividends are currently taxed at a lower rate than the interest obtained from their bonds.

This is important as stocks and bonds vie for the investment dollar based on their relative value. Clearly, when an "Income focused" investment such as bonds pays lower than the respective stock, there's an imbalance somewhere.

### Income from "Stock-like" Investments

In addition to dividend-paying common stock, we have had success generating income and periodic capital gain from asset classes that behave somewhere in the middle of bonds and stocks. Preferred Stock and Master Limited Partnerships (MLPs) being two excellent examples.

Preferred Stock is higher up the corporate scale than common stock so the probability of a negative answer to the Default question number 2 above is much lower.

### Caveat Venditor – Seller Beware:

We have received a number of questions along the lines of:

*"I own individual bonds, why were they less volatile than the general bond market and bond ETFs?"*

In most cases, the reason is Liquidity. The bonds probably don't trade or price as frequently as many of the bond instruments we use.

We would therefore suggest an investor tries selling the bonds in question during a volatile economic period. If they are lucky enough to receive an offer, it will probably be well below the quoted price or the value on last statement.

This situation will get worse the smaller the bond lot being sold. The securities held in DIAS portfolios are virtually all immediately liquid – the prices you see may look volatile at times, but that's the real price they can be sold for.