FALL 2011

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

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Exploring High-Dividend Equity Strategies

In the quest for yield, some investors have replaced or have considered replacing high-quality fixed income with high-dividend equities. Historical evidence points to sizable differences in risk between high-quality fixed income and high-dividend equities.

From 1928 to 2010 (the longest available period of data), the three lowest annual returns for five-year Treasury bonds were –5.1 percent, –2.4 percent and –2.3 percent. The comparable returns for high-dividend equities were –55.1 percent, –42.6 percent and –41.8 percent. In years where the annual return of the S&P 500 was negative, the returns of five-year Treasuries averaged +5.7 percent while returns of high-dividend strategies averaged –10.9 percent. This illustrates high-quality fixed income has tended to do well when investors needed it most while high-dividend equity strategies have not.

A high-dividend equity strategy is a poorly designed and poorly diversified version of a value-stock strategy. Value-stock strategies — which can be an important component of a diversified portfolio — tend to own many high-dividend-paying stocks. However, a value-stock strategy typically owns some stocks that pay relatively low dividends, which improves diversification across industries. Historically, a strategy of buying just high-dividend stocks has underperformed value-stock strategies that form portfolios using price/earnings ratio, price/book value ratio or price/cash flow ratio by sizable amounts.

Nothing in the historical data suggests high-dividend strategies are an appropriate substitute for high-quality fixed income or are the best way to gain exposure to value stocks. A high-dividend approach has substantially more risk than a high-quality fixed income approach and substantially lower returns compared with other value strategies.

Making Sense of Low Rates and the Risks of Stretching for Yield

The credit crisis in Europe clearly intensified in the third quarter of this year with yields on Greece's two-year bonds going from 26.7 percent at the beginning of the quarter to 62.2 percent at the end of the quarter. While the developments in Europe affected all financial markets, they had a particularly strong impact on high-quality fixed income yields. For example, the five-year Treasury yield was 1.76 percent as of June 30 but fell to 0.97 percent as of September 30.

As a result of these low rates, investors have consistently asked two questions: 1) Why are rates so low? and 2) Should I move out of high-quality fixed income into other investments to improve the yield on my portfolio?

Understanding the Low Interest Rates
Four factors have influenced interest rates: 1) Federal Reserve interest rate policy, 2) flight to quality, 3) relatively low levels of realized and expected inflation and 4) slow growth in the economy.

Federal Reserve interest rate policy — The Federal Reserve has kept the federal funds rate at low levels since late 2008. A low federal funds rate flows through to other interest rates, meaning that a low federal funds rate will lead to other interest rates being low as well. The Federal Reserve has also purchased large quantities of Treasury bonds, which has moved interest rates even lower.

Flight to quality — When equity markets drop sharply or volatility increases, a large fraction of investors flee the equity market in search of safety. One of the places they historically flee to is the U.S. Treasury market, which depresses interest rates on these bonds and increases prices.

Inflation — From 2008 through 2010, inflation has averaged just 1.4 percent per year. While realized inflation in 2011 has been higher, the market's expectation for average annual inflation over the next 10 years is currently just 2.0 percent. A low expected inflation rate puts downward pressure on interest rates.

Slow economic growth — From 2008 through 2010, the net-of-inflation growth of the U.S. economy averaged –0.3 percent per year. While growth is expected to improve in the United States, it is not expected to be high. This also contributes to lower interest rates.

Risks of Stretching for Yield
Fixed income investors who follow a prudent investment plan typically stick with high-credit-quality, short-to-intermediate-term fixed income. Another way to understand this fixed income philosophy is that the focus is on return *of* principal first and return *on* principal second. This approach helps ensure that when the equity markets are doing poorly, an investor's fixed income portfolio will typically be holding ground or appreciating. In this low-rate

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Sovereign Debt Ratings and Stock Returns

In August, Standard & Poor's downgraded U.S. government debt from a top-rated AAA to AA+, after the United States had held S&P's top rating since 1941. The downgrade was mostly expected, as S&P had issued a negative long-term outlook for the United States in April and July. Credit agencies Moody's Investors Service and Fitch Ratings maintained top ratings for the United States.

Some market observers expected a downgrade to result in higher interest rates and lower stock returns. After the downgrade, yields on U.S. government securities fell across the term spectrum as investors fled to the safe haven of U.S. bonds. U.S. stocks experienced negative returns in the following weeks but logged positive performance from the day of the downgrade to month-end.

These events raise questions about whether changes in sovereign debt ratings influence financial markets. The short answer is results are mixed, and other factors affect a country's cost of capital and stock market returns.

Some research suggests countries with high credit ratings may withstand a downgrade better than countries with lower ratings. A 2011 AllianceBernstein study by Ivan Rudolph-Shabinsky and Dennis Shen looked at sovereign credit rating downgrades since 1990 and found bond yields changed little among countries downgraded from the highest triple-A rating. However, countries with lower credit ratings (single A or below) experienced significant interest rate increases following their downgrade.

Another question is whether the U.S. downgrade played a role in the U.S. market downturn. A study of ratings changes by Moody's from 1983 to 2009 logged the market performance of developed and emerging markets tracked by MSCI in the 12 months before and 12 months after a ratings change. During the 27-year period, Moody's made 71 upgrades and 25 downgrades.

Aggregate results summarizing stock market performance show stock markets of upgraded countries outperformed their respective market index in the 12 months before the rating change while stocks in downgraded countries aggregately underperformed the market index before the event (13.83 percent versus –6.56 percent). However, cumulative returns in the 12 months following a ratings change were almost the same for the upgraded and downgraded countries (3.87 percent versus 3.73 percent).

These results suggest market prices reflect all available information and expectations about a country's economic prospects — including the possibility of a ratings change. By the time a country's debt rating is upgraded or downgraded, the market has already integrated the news into prices.

This underscores the importance of looking to market prices for signals about the fiscal health of a country. Based on the above research, markets appear to work faster and more accurately than ratings firms to assess a country's financial condition and evaluate the potential impact on its cost of capital and equity market.

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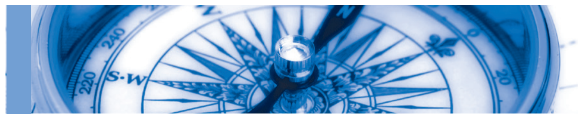
environment, however, investors have become interested in ways to increase yield, including high-dividend equities and corporate bonds. Neither approach is a suitable substitute for high-credit-quality fixed income.

High-dividend equities — Historically, high-dividend equities have been much riskier than high-quality fixed income and have tended to fall when equity markets fell (see sidebar on Page 1 for more on high-dividend equity strategies).

Corporate bonds — Historically, corporate bonds have offered meager returns compared with Treasury bonds. From August 1988 through September 2011 (the longest available period of data), the Barclays Capital Corporate Bond Index outperformed a comparable portfolio of Treasury bonds by just 0.1 percent per year before fees and transactions costs.

When interest rates are low, it can be tempting to stretch for additional yield. Before venturing into high-dividend stocks or corporate bonds, investors should remember why they invested in fixed income. The fixed income part of an investor's portfolio should be the safe part of the portfolio, one that is built to maintain its value even as equity markets decline.



Making Plans

The Importance of Accurate Beneficiary Designations

Having the correct beneficiary designations in place is a key step in ensuring your personal wishes and instructions will be followed. Many people believe a will is all that is needed to properly express their personal instructions, but a will cannot supersede beneficiaries named on individual accounts. It is critical to review and update beneficiary designations frequently or with life changes.

Naming Multiple Beneficiaries

Unless a trust is named, it is essential to identify multiple beneficiaries because whoever is listed as a primary or contingent beneficiary will receive the assets. For example, the oldest of three children is listed as the sole beneficiary on a policy but the two younger siblings are never added. This would mean the oldest child would receive the entire amount with nothing allotted to the other two children.

If just one person is listed, and that person is deceased, the assets will go to the estate. Anything in that estate could go through probate, a public record that can be costly and allows for no control over how assets are distributed, or it could go to a beneficiary named inside the estate, such as a person or charity, never intended to receive such assets.

Checking for Outdated Beneficiaries

The most efficient way to check for outdated beneficiaries is to review all beneficiary designations at once. Among other assets, beneficiary designations are commonly used with life insurance policies, IRAs, 401(k) accounts, Roth IRAs and annuities. Older accounts/policies are more likely to have incorrect or incomplete designations.

This is also a good time to verify the relationship data associated with named beneficiaries. Including as much supporting information as is available (relationship, address, date of birth or Social Security number) can help ensure assets go to the appropriate person or trust without delay. For example, an incorrect address could cause a delay, while an incorrect name could result in assets being paid to the wrong person if no supporting documentation is given.

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