BIAS
INVESTMENT MANAGERS - SECURITIES ANALYSTS

THE OVERLOOKED SWEETSPOT FOR INVESTING
September 2012

Central bankers have forced bond yields to such artificially and historically low levels that returns on fixed income portfolios have been disappointingly low. Further, as low interest rates persist and coupon payments remain depressed, the sensitivity of bond prices to interest rate changes increases. In other words, with low interest rates the likelihood of higher interest rates—and consequently lower bond prices--in the future increases.

During this period of disappointing bond yields, dividend paying stocks have moved into what we consider “the sweet spot” of investing. Whereas in previous decades fixed income securities were purchased for income, coupon payments are now such that blue chip companies like Royal Dutch Shell and AT&T are paying far more on dividend payments than they do on their medium term debt issuance (Exhibit A) even after taking account of tax withheld at source.

Equities for Yield

	Dividend Yield Gross	Dividend Yield Net	5 Yr US Treasury	Yield pick-up vs. Net
AstraZeneca	6.06%	4.24%	1.37%	+287bps
at&t	4.67%	3.27%	1.21%	+215bps
	4.64%	3.25%	1.09%	+355bps
intel	3.59%	2.51%	0.77%	+174bps

Exhibit A: Equities for Yield (source: Bloomberg)

So the focus at BIAS in recent years has been dividend paying stocks which have a history of maintaining and increasing income distributions to its shareholders. Fixed income securities should now be used only for capital preservation purposes, but dividend paying stocks, controlled for consistency of payment, do provide an opportunity for recovering income flow into the portfolio whilst giving potential for capital appreciation. Moreover, an investment portfolio entirely invested in fixed income securities presents some risk when one considers that in a rising rate environment, bond prices will fall.

To further illustrate the attractiveness of stocks versus bonds, consider two valuation measures that we have presented in our most recent Quarterly Market Briefing:

1. The Fed Model compares S&P 500 Index earnings yield against the US Treasury Ten-Year bond yield.
2. Credit Suisse First Boston's (CSFB) Global Risk Appetite (GRA) measure.

In the former (Exhibit B), when Ten-Year Treasury yields are well in excess of earnings yields on S&P 500 Blue Chip stocks, stocks are considered over-priced relative to US Treasures. On this basis however from 1980 to 1982 and 2011 through today, stocks were/are under-priced. Although these anomalies can persist for some time, history has shown that they provide rich opportunities when yield disparities are at their extremes.

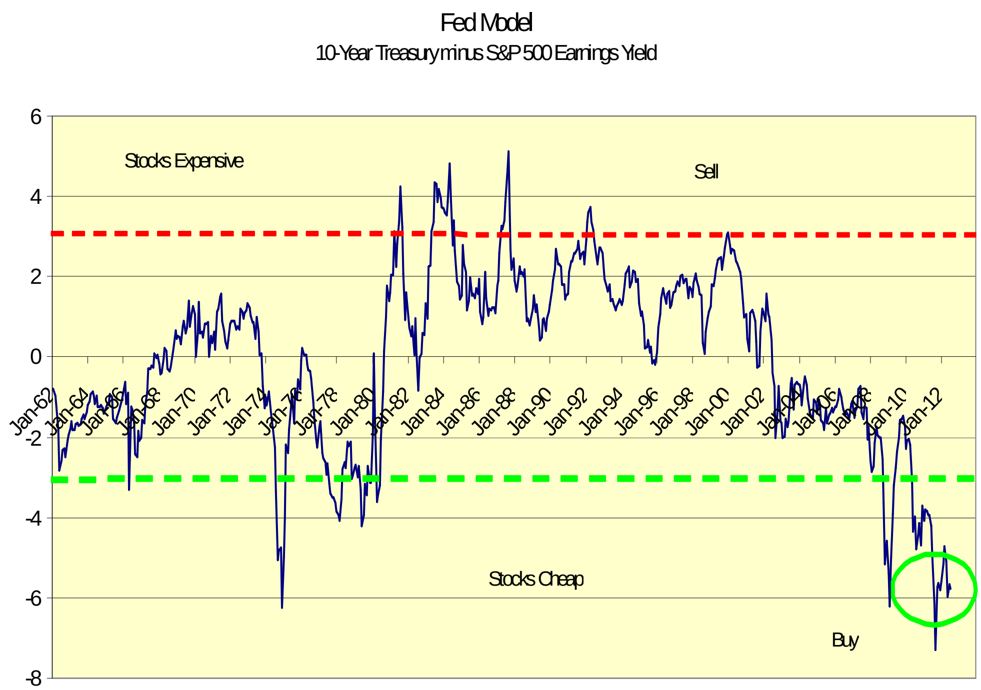

Exhibit B: The Fed Model

As to point two above, in the late 1990's CSFB initiated a study to measure extremes of investor sentiment. They discovered how these extremes signal turning points in stock market performance as indicated by the S&P 500 Index (Exhibit C). Specifically, extremely negative sentiment, as shown by a global risk appetite (GRA) score below negative 3, was followed by strong rallies in the stock market. We see this in 2002, 2008/9, and more recently in 2011.

EXHIBIT C: CSFB's Global Risk Appetite and the S&P 500 Index

At present GRA hovers slightly above the panic stage which tells us that stocks are reasonably valued (because sentiment remains only 'somewhat' negative) and that any deterioration in sentiment near term could result in a strong upward movement in the broad stock indices thereafter. Many stocks in the S&P 500 Index do not pay dividends and those that do tend to fare better in good and bad times. All of this leads us at BIAS to believe that the place to be during times of negative GRA is in stocks that have a discipline of regularly returning capital to investors in the form of dividends. This is reinforced by a review of the performance of our Dividend Income Strategy for various periods up to June 30, 2012. The outperformance relative to the S&P Global 1200 Index has been substantial. Indeed in assessing BIAS' own dividend income strategy, performance well exceeded that of the broad stock indices as indicated below (Exhibit D)

Performance					
Performance*	YTD	1-Year	2 - Years	3 -Years	5 -Years
31-Aug-12			Cumulative	Cumulative	Cumulative
Dividend Strategy	12.92%	17.41%	40.76%	69.20%	45.70%
S&P Global 1200 Index	10.31%	8.95%	24.74%	27.96%	-5.10%

EXHIBIT D: BIAS Global Dividend Income Strategy vs. S&P Global 1200
(Performance shown is current dividend income strategy back valued 5 years, rebalanced annually. Past performance is no guarantee of future results).

In addition to the greater potential return benefits, dividend income strategies have provided a lower level of risk than the broad stock indices as shown in Exhibit E. All this argues for a higher allocation to equities in investment portfolios subject to equities exposure being focused on stocks that have consistently maintained or increased dividends over an extended period of time.

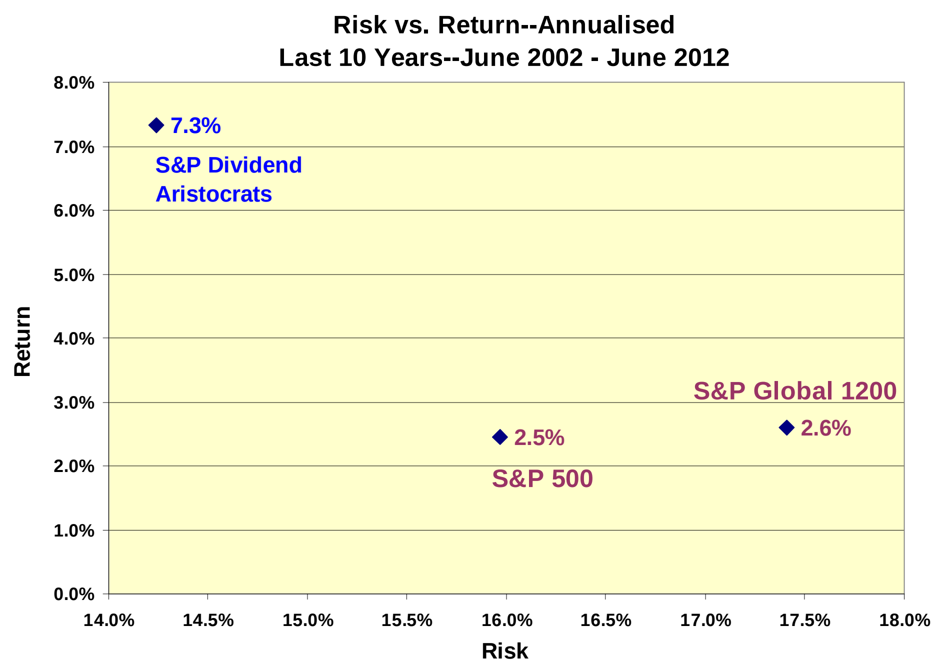

EXHIBIT E: Risk Return Comparisons of Stock Indices (source: BIAS, Bloomberg, Standard & Poors)

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