Zemenick & Walker *Perspectives*

An Independent Investment Advisory Firm - Since 1987 **January 2012**

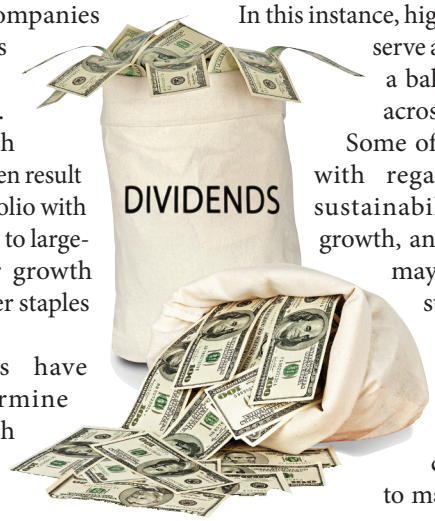
The Allure of High Dividend Yields

With dividend yields for many stocks currently outpacing yields on investment grade bonds, the attractive combination of higher current income and potential share price appreciation has made investing in high dividend equities one of the most widely discussed strategies today. While on the surface this may seem to be a good option for generating additional income, investors should be cautious of pursuing an investment strategy based solely on dividends, keeping in mind that dividend yield is only part of the total return equation.

A stock's total return has two components, the stream of dividend payments received and change in share price. However, for many, "A bird in the hand is worth two in the bush." Proponents of high dividend investing demonstrate a preference for cash in hand over share price appreciation and imagine the cash flow stream offers a defense against market declines. We believe this philosophy to be flawed.

Financial theory states that dividend policy should have no impact on a stock's total return. It may seem counterintuitive that a firm's decision to raise its dividend will not result in an increased return to shareholders. However, the price of a stock is theoretically expected to drop by the amount of the announced payment. While many financial professionals subscribe to this theory, others claim a firm's decision to increase its dividend sends a positive signal to the market about its outlook, leading to an increase in stock price. The reality is that dividend policy is a capital budgeting issue. Firms that are able to reinvest earnings in projects with a positive net present value should do so, while those that cannot should return cash to shareholders in the form of dividends and share buy-backs. For this reason, many mature companies pay out a high percentage of their earnings in dividends, while companies still in the growth stages elect to reinvest earnings in their operations. Consequently, a high dividend strategy will often result in a less diversified portfolio with an overweight allocation to large-cap equities in slower growth sectors such as consumer staples and utilities.

Numerous studies have attempted to determine whether or not high dividend stocks are superior investments. Over the last half century, high dividend stocks have generated a slightly higher return than low dividend stocks. However, returns from investing in high dividend stocks versus low dividend stocks in various sub-periods varied widely, making the determination inconclusive that high dividend stocks are superior. In addition, there is little evidence to conclude that high dividend stocks are more defensive investments in bear markets.



Looks good at first glance, but dividends are only part of the total return equation.

For example, during the last major market decline from October 9, 2007 to March 9, 2009, the S&P High Dividend Aristocrats Index declined 52.8% while the S&P 500 declined 55.3%. While the High Dividend Index did perform slightly better than the S&P 500, few would argue that this represented material downside protection. In this instance, high dividend stocks did not serve as a superior substitute for a balanced portfolio strategy across various asset classes.

Some of the key considerations with regard to dividends are sustainability, lower earnings growth, and taxes. While investors may look to high dividend stocks as a substitute for bonds, there is a key difference between bond coupons and dividends. Bond issuers have a contractual obligation to make coupon payments to bondholders, which cannot be arbitrarily suspended or reduced, short of outright default.

Conversely, a company is not obligated to maintain its dividend and may reduce or suspend it at any time. A company that does not generate adequate free cash flow to support its dividend may be forced to reduce or suspend it. Shares of companies that reduce or suspend their dividend are

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often severely penalized by the market, as witnessed by the sharp decline of many financial stocks in 2008 and early 2009.

When a company increases its dividend, it has decided to reinvest less of its earnings back into its operations, which may eventually translate into lower growth for the firm. In fact, the long-term sustainable growth rate of a company's earnings is a function of its payout ratio and its return-on-equity. Investors in a high dividend strategy must accept this trade-off and assume a lower expected return from share price appreciation.

Dividends are often considered an inefficient form of return to shareholders due to the fact that taxation is incurred by both the corporation and shareholders. Until recently, dividends were taxed to shareholders as ordinary income at a rate much higher than long-term capital gains. Consequently, the payment of dividends created a tax disadvantage for investors, negatively impacting after-tax returns. In 2003, the tax code was changed to provide for qualified dividends to be taxed at the same rate as long-term capital gains, currently 15%. However, any future change to this policy may adversely impact the prices of high dividend stocks.

Additionally, while capital gains taxes are deferred until realized, dividends are taxed in the period received. Thus, a high dividend strategy results in less flexibility to manage one's tax liability.

In summary, investors should be wary of embarking on an investment strategy based solely on dividends and should not consider such a strategy to be an adequate substitute for a portfolio that is well-allocated across various asset classes.

Investing Through Volatility

Wild fluctuations in the stock market seem to be a daily occurrence of late. And while there are numerous methods of calculating volatility, when measuring the absolute change in value of the S&P 500 over short time periods, the volatility we have seen recently is not unprecedented.

The graph below illustrates the historical volatility of the S&P 500 since 1927. Specifically, the red line represents the 3-month moving average of the absolute change in the index, with the black line illustrating the average change of 3.9%. In comparison, the blue line represents a logarithmic scale of the price of the S&P 500.

The graph shows clearly that, on several occasions since the 1930's, volatility has spiked to levels greater than what we are seeing now. Not surprisingly, each of the spikes corresponded to a marked drop in the S&P 500. Conversely, in every instance the market rebounded, including after the most recent spike in 2008. Obviously, past results cannot guarantee the future and we have long discounted trend analysis when making investment decisions. That said, the graph shows that investors who did not panic during prior periods of volatility were ultimately rewarded for their fortitude.

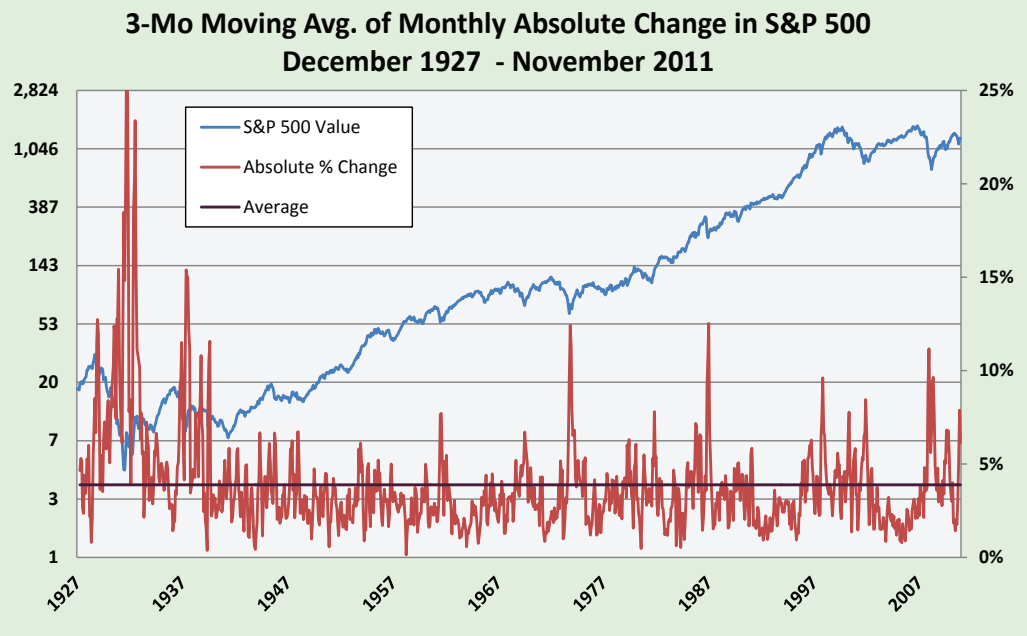
The graph also indicates that each of the major volatility spikes corresponded to a significant macro event. The early spikes paralleled the stock market crash of 1929 and the Great Depression. More recently, we can see the spikes resulting from the Mideast oil embargo of 1973, Black Monday in 1987, the Asian financial crisis of 1997, and our own financial crisis of 2008.

In keeping with history, we are again seeing volatility rise as world events capture our attention. In particular, investors seem to be focused on two problems plaguing global markets. First and foremost, Europe is tackling a financial crisis which has brought the future of the European Union into question. While most economists agree that this crisis has had little economic impact on the US, global financial markets have reacted violently to any news out of Europe recently.

On the home front, investors are caught in the cross-fire of growing partisanship in Washington. While political gridlock can often be a positive for the market, investors recognize that our leaders must address some serious questions vital to our nation's long-term solvency. Of critical concern is how Washington will juggle the need to reduce our debt burden with efforts to spur economic and job growth. This type of uncertainty, as in the past, adds tremendous volatility to the market.

Complicating these external worries, many analysts are pondering the effects of two changes in the marketplace that have taken root over the last decade - high-frequency trading and growing use of leverage.

In the case of high-frequency trading,



specialized firms use powerful computers and algorithms to spot trends in stock prices. The computers then execute trades rapidly, in some cases buying thousands of shares only to offload them less than a second later. In many cases, the trades produce gains of no more than a tenth of a penny per share. Such trading techniques have existed since the advent of computers, but thanks to faster computers and more sophisticated algorithms, high-frequency trading is growing as a percentage of total market activity. Amazingly, high-frequency trading now accounts for nearly 70% of all stock trades, versus 30% just five years ago. And the average holding period for stocks has dropped from roughly eight years in 1960 to just three to four months now.

Like high-frequency trading, leverage has also been a tool long used to enhance returns. Historically, leverage was most often used by large sophisticated investors through vehicles such as hedge funds or derivatives. With the introduction of the first leveraged ETFs in 2006, however, the power of leverage was released to the masses. Now, smaller less sophisticated investors can buy and sell leveraged ETFs as easily and quickly as stock. Using leverage, such ETFs attempt to achieve returns 2x or 3x a selected index. The problem with leveraged ETFs is that in order to maintain the correct leverage ratio, the fund may need to buy or sell large quantities of shares at the end of each day, increasing market volume. It has been speculated that both high-frequency trading and/or leveraged ETFs were the primary cause of the May 2010 Flash Crash.

With all of these factors adding to volatility, how can investors possibly hope to achieve their long-term goals? Actually, the answer resides in the question. With the exception of the 1930's, high volatility has historically been a short-term event with periods of subdued volatility and growth following. While we cannot guarantee this pattern will continue, we do believe that commitment to a well thought out long-term investment strategy is the best advice available. Roger Ibbotson, Professor of Finance at Yale School of Management agrees. When asked recently about volatility, he responded "the individual should ride through these things, buy and hold. If they do react, usually what's happening is that their emotions work against them".

Commitment to a long-term strategy that incorporates equity investing will undoubtedly subject a portfolio to wild rides over short periods. The key is maintaining the psychological fortitude to march on, because history has proven that macro crises work themselves out over time. Even now, we are seeing signs that at least one macro concern is improving. As Washington squabbles, local and state governments have begun making some tough decisions. Through combinations of service cuts, payroll reductions, and in some cases raising taxes, state and municipal governments are making real commitments to balance their budgets and reduce their long-term debt burdens. And with consumers de-leveraging also, Washington just needs to follow suit.

Protecting Your Financial Security

Malicious online attacks numbered roughly 150 million in 2010 and were believed to result in the theft of $100-$200 million in the US alone. Scamming predators use both obvious and clandestine methods to secure proprietary information from unwary victims. These methods include: stopping and forwarding a target's mail to a different address, eliciting credit card information with phone calls, sending false wire transfer requests to financial institutions, and fraudulent emails to coax one into sharing financial information.

There has been a sharp increase in fraud targeting the financial industry, so much so that it now represents 92.4% of all online attacks. In response, custodians are taking a heightened approach to safeguarding client assets. For example, signatures on wire transfer forms are scrutinized even more to ensure that they are not fraudulent. In some cases, custodians are also starting to follow up with clients and advisors through a phone call to verify that the wire transfer is legitimate. Consequently, it is essential for clients to make sure their signatures on official paperwork are consistent with the original signature cards.

Zemenick & Walker is also taking proactive approaches to protecting client data. For paper documents, theft is deterred by regularly shredding documents with sensitive information. On the digital side we

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Z&W Welcomes Krystal West

After a lengthy search we are pleased to announce the recent hiring of Krystal West as an assistant portfolio manager and analyst.

Krystal is from Highland, Illinois, where she was valedictorian of her high school class. She then attended Saint Louis University, graduating in May 2011 with a double major - mathematics and business with a concentration in economics. While at SLU Krystal was active in a number of organizations and served on her sorority's executive committee.

She is a dedicated Cardinals fan, a good fit at a firm full of them. Though we all hoped for the best in the playoffs this year, Krystal deserves credit for her unwavering confidence from day one that they would win the World Series.

Other interests include reading, cooking, and running. She recently competed in a half marathon at the inaugural St. Louis Rock 'n' Roll event and is currently training for her next race in Nashville in April.

At Zemenick & Walker she is training in several primary areas including research, equity and fixed income transactions, and portfolio management. We are excited to have her as part of our team.

New Reality for Bond Investors

Investors must adjust their bond return expectations in the current landscape

Over the past several decades investors in high quality bonds have become accustomed to consistent returns well in excess of historical averages. This made it possible to earn attractive total portfolio returns while maintaining conservative allocations to risky assets. Unfortunately, since bond returns are likely to be below average for the immediate future, those days appear to be at an end.

To illustrate how fortunate investors have been, the Merrill Lynch 7-10 Year US Treasury Index produced annualized returns of 8.39% for five years and 7.63% for 25 years as of November 30th. Since 1990 the Index has returned greater than 10% in twelve different calendar years!

Looking back, it is easy to see why bond investors have had it so easy. In 1981, the 10-year US Treasury Note was issued with a 14 ⅝% coupon at roughly par. This income return alone was enough to produce fantastic returns over the next decade.

Moreover, though there have been bumps along the way, the long-term trend for yields has been downward ever since. The US Treasury issued 10-Year Notes on 11/9/11 at a yield of roughly 2.00% (these have subsequently traded on the secondary market with a yield as low as 1.88%). Falling interest rates further enhance total returns because of their impact on bond prices. At the time of its issuance in 1981, the 14 ⅝% Note had a duration of roughly 5.5, meaning that for a 1.00% drop in interest rates it was expected to increase in price by about 5.5%.

Today's bond math certainly seems to put a ceiling on potential returns. Obviously, locking in a 10-year Treasury at 2.00% guarantees a paltry income return. Additionally, the decades long decline in yields appears to be nearing an end. Unless yields *approach zero or go negative,* there simply is no room for falling yields to continue to add meaningfully to total return.

And, of course, the real concern is that the opposite might happen and rates begin to move upward. One of the determinants of a bond's duration is its coupon. The higher a bond's coupon the lower its duration and the less sensitive its price is to changes in interest rates. With a 2.00% coupon, the most recently issued 10-year Treasury Note had an original duration of 8.9, making it much more sensitive to changes in interest rates than bonds issued in higher interest rate environments. Because the low coupon provides little cushion to absorb price declines, relatively small changes in rates could quickly take total returns negative.

This is <u>not</u> to say investors should avoid the bond market, rather that they must make prudent decisions and have realistic return expectations given the interest rate landscape. The yield curve remains steep, thus moving out on the curve brings rewards, as long as total portfolio duration remains reasonably controlled. Moreover, securities like munis, corporates, and CDs offer substantial yield premiums over Treasurys. By capitalizing on the yield curve and securities with yield premiums, investors can improve returns, but there is no escaping the reality that investment grade bonds are likely to produce low returns for the foreseeable future. Perhaps the most important consideration is to maintain portfolio risk controls and avoid the temptation to replace bond allocations with riskier cash flow producing assets.

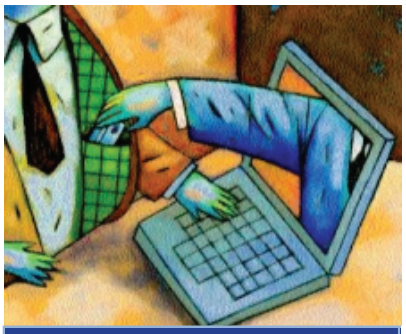
Security *Continued*

have introduced a new platform for file sharing. This allows us to securely share files with clients through a password protected website, which can be accessed securely from any device with internet connectivity. This provides a safe way to access and share sensitive documents with clients while avoiding the security risks inherent in exchanging these documents via email.

Individuals can also take steps to safeguard their own information. A few suggestions for doing so are as follows: Keep antivirus software up-to-date and firewalls enabled to protect against harmful websites. Always log out of websites after shopping or banking online. By staying logged in, financial details are available to others.

Never open emails from unknown senders; specifically do not open attachments, click links, or reply to ambiguous emails. Contest and sweepstakes emails often come from fraudulent sources asking for sensitive material that should never be divulged.

Moreover, it is critical to change passwords every 60 days to ensure that they remain effective. A strong password consists of a variety of lower and uppercase letters, along with numbers and symbols. One way to develop such a password, that may be easy to remember, is by using a cliché such as, "A penny saved is a penny earned", and using the first letter of each word to make the password. With this example, the password would be "apsiape", which can then be followed by a combination of numbers and symbols. Also, refrain from using the same password for multiple websites. Finally, monitor bank and credit card accounts weekly to help stop fraudulent activity quickly. By following these tips individuals will be more secure online and can better protect their financial security.



Most Hacked Passwords	
1. 123456	11. Nicole
2. 12345	12. Daniel
3. 123456789	13. babygirl
4. password	14. monkey
5. iloveyou	15. Jessica
6. princess	16. Lovely
7. rockyou	17. michael
8. 1234657	18. Ashley
9. 12345678	19. 654321
10. abc123	20. Qwerty

Source: Imperva