September 1, 2011

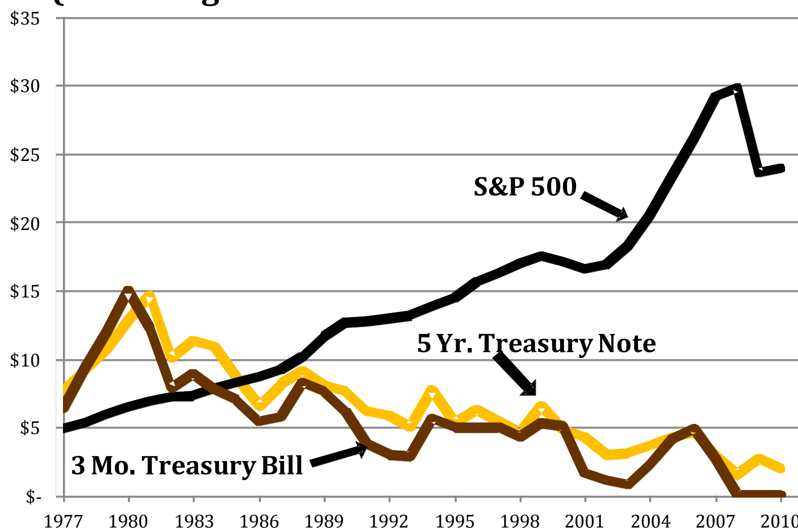
Rising Dividends Equity Investment Strategy

"The Committee currently anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

The Federal Reserve Open Market Committee – August 9, 2011

The above statement was unwelcome news for income-oriented investors. With it, investors' hope that Federal Reserve policy would allow for higher yields on high-quality bonds, bank savings accounts, and money market funds was put on hold for two more years. As yields on many short-term savings vehicles are at all-time lows, the Federal Reserve was in effect telling investors that they will need to look elsewhere to receive a reasonable income return on their savings and investments.

One place we think longer-term, income-oriented investors should turn to is dividend-paying common stocks. Contrary to conventional wisdom, history shows that a diversified portfolio of stocks can effectively provide a more reliable stream of income - with greater protection from inflation - than bonds and other fixed income securities. To illustrate this fact, we calculated the income from separate $100 investments made on January 1, 1977 in the Standard and Poor's 500 Index (S&P 500), the 3-month U.S. Treasury Bill (T-Bill), and the 5-year U.S Treasury Note (T-Note). In our analysis, we did not reinvest dividends or interest payments, as we were interested in comparing the income generated by these investments. This approach is equivalent to that of an investor spending the income generated by his or her portfolio as it is received, much as a typical retiree might. We also did not adjust for inflation. The results of our research are displayed below in Figure 1.



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Preserving And Growing Capital Since 1969

As Figure 1 illustrates, the effect of investment choice on income level is dramatic. At the end of 2010, 34 years after the initial investment, annual income from the S&P 500 investment is nearly 5 times greater than in 1977. Most notably, the annual income from the T-Bill investment is 98% less and from the T-Note investment 74% less than in 1977. Also, the annual growth rate of income from the S&P 500 over this period was a positive 4.77%, compared to a ***negative*** 3.90% annual growth rate of income from the T-Note investment and a ***negative*** 11.05% annual growth rate of income from the T-Bill investment. This is despite the S&P 500 experiencing its largest dividend decline in its 53-year history in 2009. The overall positive income performance of the S&P 500 during this period is largely explained by the fact that throughout these 34 years, there were only three years when income from the S&P 500 investment decreased, while the T-Bill and the T-Note investments each experienced nineteen years of decreases in income. ***For an investor seeking reliable and growing income, stocks have been significantly better than the safest bonds.***

Although we have illustrated that the S&P 500 has provided a more reliable income stream than both Treasury Bills and Notes, the S&P 500 is actually characterized by a lack of focus on dividends which makes it a sub-optimal portfolio choice for those investors seeking income. This is because included within the S&P 500 are numerous stocks that pay no dividend at all. In fact, 112 of the 500 stocks in the index as of July 2011 paid no dividends.ii These non-dividend-paying stocks do not help income- oriented investors achieve their goals and a well defined, income-oriented portfolio would be well served to exclude them. Furthermore, changes in the stocks that comprise the S&P 500 have at times detracted from the dividend income that investments in this index provide to investors. For example, the number of non-dividend-paying stocks within the index increased from 64 to 149 companies from 1994 to 2002.iii Indeed, these types of adverse income changes are not unique to the S&P 500. Today, most professionally managed stock portfolios, mutual funds, and indices are constructed with little concern for dividends or changes in the level of dividend income provided to investors.

Capturing the benefits of investing in an income-oriented stock portfolio requires a unique attitude towards the short-term price fluctuations of equity holdings. As an income-oriented investor, your goal is to receive reliable and rising income over time, not fast profit from buying and selling stocks. Therefore, your focus should be on the dividends paid by the stocks you own and on the ability of the underlying companies to maintain and grow their dividends. Certainly, price movements become more relevant should the need to sell a given stock arise, but most of the time a constant eye on share price leads to unwarranted elation or desperation. A focus on short-term price changes, when these are negative, can lead to unnecessary worry and poor selling decisions. Focusing on positive short-term price changes can also be detrimental, leading to overconfidence and poor purchasing decisions. Keeping a focus on growing your income and preserving capital, while allowing opportunity for long- term capital appreciation, should provide the lasting results you seek.

With this in mind, six years ago Goelzer created the **Goelzer Rising Dividends Portfolio,** an income- oriented stock portfolio that seeks to provide the benefits of a rising income stream coupled with the opportunity for capital appreciation.

The **Goelzer Rising Dividends Portfolio** has been designed as a broadly diversified portfolio that includes companies from each of the major industry sectors. We seek firms that have historically generated strong cash flow in excess of the amount needed to fund and grow their

businesses and which have used this excess cash to pay shareholders a regular and growing dividend. The Portfolio specifically excludes non-dividend paying stocks. Among companies that meet these criteria, we purchase stocks that are attractively priced. The result is a well diversified portfolio with a significantly higher dividend yield than the overall market and which comprises companies with strong balance sheets, growing cash flow, and a demonstrated commitment to paying dividends.

As of August 31, 2011, the projected annual dividend yield for the **Goelzer Rising Dividends Portfolio** stood at 3.8%. This compares favorably to the projected dividend yield of 2.1% for the S&P 500 Index, the 2.2% yield-to-maturity for 10-Year U.S. Treasury Bonds, and the approximately 0% yield for many money market funds. Further, the dividends paid by the common stocks held in the **Goelzer Rising Dividends Portfolio** have been growing at rates above inflation over the past year. Specifically, of the forty-nine stocks currently included in the Portfolio, forty-two have increased their dividends during the past 12 months, with an average increase of 9% and a median increase of 7%.

Here are the companies that provided the largest dividend increases within the Portfolio over the past year:

1. Intel Corporation, the world's leading semiconductor company, increased its dividend twice during the past year for a total increase of 33%. The current annual dividend rate of $0.84 per share equates to a yield of 4.1% on the stock's current price of $20.26. Since 2006, the company has more than doubled the amount of its dividend. With projected 2011 earnings per share of $2.37, the current dividend represents just 35% of earnings – leaving ample room for additional dividend increases in the future. The company's cash and short-term investments balance of $11.5 billion, versus long-term debt of $2.1 billion, also positions it well for further dividend increases.
2. Microsoft raised its dividend by 23% to $0.64 per share late last year. The company, which is often the victim of unfair criticism, has grown its sales by 11% annually over the past five years while growing its earnings per share by nearly 16% per year. This strong growth rate has allowed the company to double the amount of its annual dividends since 2005. The company currently has an incredible $52.7 billion of cash and short-term investments on its balance sheet against $11.9 billion of long-term debt. We believe the company is well positioned for another significant dividend increase later this year. The current dividend yield is 2.5%.
3. Stanley Black & Decker provided investors with a 20.7% dividend increase this past year. Coming off the 2010 merger of Stanley Works and Black & Decker, the maker of tools and entry systems was able to cut costs while sales rebounded as the world economy entered a second year of growth. The past year's dividend increase was a significant jump after several prior years of 3% growth. The current payout ratio, at 31% of expected 2011 earnings, however, is still modest and leaves room for future increases. The current dividend yield is 2.7%.
4. ConocoPhillips, which grew rapidly over the past decade thanks to rising oil prices and a string of acquisitions, has recently changed its strategy. The past year's 20% dividend increase along with a $10 billion stock repurchase program represent management's new plan to distribute money to the shareholders. The company has recently been selling non-core properties and plans to spin-off its refining operations. These changes should reduce

capital expenditures and free-up cash for additional dividend increases as long as oil prices do not decline significantly. The stock's current dividend yield is 4.1%.

5. Norfolk Southern, the large East Coast railroad, raised its dividend twice during the past year for a total increase of 19.4%. Over the past five years the company's dividend has grown by a tremendous 169%. The rapid growth of intermodal containers (cargo containers that go from ship to train to truck), rising imports from Asia, and more efficient train engines that provide a competitive advantage versus long-haul trucks have all led to a resurgence in the railroad business. While the company is certainly subject to economic cycles, its current low dividend payout ratio provides a cushion should the economy slow, thereby allowing the company to continue its uninterrupted streak of 29 years of dividends. Norfolk Southern's current dividend yield is 2.6%.

We are quite proud of the results achieved on behalf of our income-oriented clients since the inception of our Rising Dividends Equity Portfolio. In this era of historically low yields on traditional income- oriented investments such as bonds and money market funds, a well diversified portfolio of high- quality companies with a demonstrated commitment and capacity to pay increasing dividends over time can be a solid choice. If you would like to learn more about our Rising Dividends Portfolio, please call us at 317-264-2685, or visit our website at www.goelzerinc.com.

Goelzer Investment Management is a leading investment advisory/portfolio management firm in the Midwest and one of the largest Registered Investment Advisor firms in the country, with more than $1.2 billion in assets under advisement for approximately 400 clients throughout the United States and Europe. We are an independent, fee-based firm providing comprehensive investment planning, advice, and portfolio management services. Since our firm was founded in 1969 our client base has grown to include affluent individuals and families and institutional investors.

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