Absolute Total Return – Shawn Blau   Q3 2011

The New Dividend-investors of Graham and Doddsville

Back in 1984, Warren Buffett gave a talk at his alma mater, Columbia Business School, in honor of Buffett's old professor and mentor at Columbia, Benjamin Graham. Ironically, Columbia had been Buffett's "safety school" – his first choice had been Harvard. But, as with many things in life, Columbia eventually turned out for the best. Buffett discovered his true calling at Columbia in 1951 when he took Ben Graham's course on Security Analysis and was bitten by the "value bug". The rest, as they say, is history.

Buffett gave his 1984 speech to commemorate the 50th anniversary of the publication of Ben Graham's greatest book, "Security Analysis", co-authored in 1934 with David L. Dodd. Buffett titled his speech "The Superinvestors of Graham and Doddsville." In his speech Buffett proceeded to completely demolish the "Efficient Market Hypothesis" (EMH) that had dominated academic finance since the early 1960's. EMH held that it was impossible for stock investors to do better than the stock market itself because the market "discounted" available information.

Despite Buffett's common sense rebuttal, the "Efficient Market Hypothesis" held sway in academic finance for another decade. During that time Buffett and Ben Graham's other students proceeded to make billions, doing what the academics still insisted was impossible in the first place.

Flash-forward to 2011 and modern dividend-investors face a similar opportunity. The 3rd quarter of 2011 saw major retrenchments in all broad equity indices. The S&P 500 Index was down roughly 14% in the quarter. The broader-market Russell 3000 Index did even worse by losing 15.7% during the quarter.

At the same time, correlation among US stocks – represented by the KCJ Implied Correlation Index – was on a steady rise from July 7 onward. KCJ closed at 54.13 on July 7, and then proceeded to skyrocket during the quarter to hit a dramatic high of 90.28 on September 30. This demonstrated that equity investors were literally "throwing out the baby with the bathwater" during the 3rd quarter.

All this retrenchment opened up remarkable opportunities for the discerning dividend investor. Dividend investors, including ourselves, look for stocks that "act like bonds," but are better than bonds because they also grow like equities. We search out companies that have the ability and motivation to pay high and growing dividends and cash distributions to their shareholders.

Our fundamental strategy is to look for high current yield on a risk-adjusted basis, plus high projected growth in cash distributions over the succeeding 12-24 months also on a risk-adjusted basis.

It turns out that dividends were the hidden beneficiaries of market corrections like we saw in the 3rd quarter. Dividend-stocks often sell off temporarily with the rest of the market in broad corrections like this. HOWEVER THEY STILL RETAIN THE CASH TO PAY THEIR SHAREHOLDERS. They also continue to command adequate cash-flow to grow their dividends. This allows dividend investors to LOCK-IN solid and growing streams of dividends at bargain prices.

For example, the Dow Jones Utility Index was down only 0.023% in the 3rd quarter and has a total-return of +10.49% for the first 3 quarters of 2011 as relatively robust cash distributions of utility stocks become more attractive in a period of declining bond yields.

Likewise, our core dividend portfolios of high-dividend stocks, Master Limited Partnerships, and closed-end funds continue to represent superb values in our view. We are currently able to achieve high current yields (often 5-7% currently), along with strong projected distribution growth over the coming 12 months (often 1 – 1.5% growth in cash distributions per quarter). Since our companies have retained strong cash levels, along with comfortable cash-flows, the risk of dividend cuts is low overall.

MLP's, represented by the AMZ Index, declined 8.4% in unit-price during the 3rd quarter. However, they continued to RAISE their distributions even more rapidly than they had done in 2010. In addition, they continue to be able to borrow at exceptionally inexpensive rates. Thus, we see them as core holdings in today's market.

The Dow Jones Select Dividend Index, which tracks the 100 leading US dividend-paying companies, declined only 8.9% for the quarter outperforming the market. The Dividend Index was UP a total of 6.3% for the first 3 quarters of 2011, compared to a LOSS for the S&P of over 8% for the first 3 quarters. Thus, the Dividend Index outperformed the S&P by over 14 percentage points.

At this point stock dividends are relatively attractive compared to the yield on comparable bonds. In addition, large-cap US corporations continue to sit on large hoards of cash. Their projected return if they use this cash for CAPEX remains low due to weak projected demand in the overall economy. Thus, many have strong incentives to raise dividends. Thus, they have strong incentives to return cash to shareholders in the current environment.

The Herzfeld Closed-end Fund Index was down 7.23% YTD for the first 3 quarters of 2011, compared to a loss of 8.9% for the S&P 500. In addition closed end funds often benefit from tax-loss dislocations in the upcoming 4th quarter. This occurs when investors sell closed-end funds that have lost money during the year in order to "harvest" tax losses. This causes closed-end funds to sell at a wider discount to net-asset values, so we anticipate abundant opportunities.

For bond funds, tax-exempt municipal bonds rose 3 percent during the quarter benefiting from the "flight to quality." Taxable municipal bonds, the so-called "Build America Bonds" (BAB's), were up over 12% during the quarter, benefiting from the same phenomenon.

Finally, the sharp rise in the CBOE "VIX" Index, which tracks volatility in the S&P 500, skyrocketed from 16.52 on June 30 to 42.96 on September 30. This also opened up attractive opportunities for aggressive dividend investors. The price of "put" options goes up in tandem with the VIX, since puts are worth more when volatility is higher. Therefore, an aggressive dividend investor can now sell "naked puts" on high –dividends stocks, in order to lower their effective cost basis by around 2 percentage points, thus increasing projected return even more.

We did raise cash last quarter by selling several important categories:

We sold our Business Development Companies (BDC's) despite high current yields, because we project that they may lack liquidity to expand and may be unable to grow their dividends in the coming quarters.

We also sold our mortgage-reit's (MREIT's) because they are highly leveraged, and they hold residential mortgage-securities that may be vulnerable in the current environment, thus making it difficult to grow dividends.

However, overall we like the current environment for dividend investors. Historically, dividends have provided over 40% of the total return of large US stocks. In "range-bound" markets, like the one we are experiencing now, the contribution of dividends has been even larger.

The current environment is unique because it provides the following opportunities:

1) Very high current yields from dividends which exceed the current yields from comparable bonds
2) Retained cash which enables company managements to maintain the current distributions
3) High cash-flow which allows company managements to grow their current distributions; and finally
4) The strong motivation for wise company managements to reward their shareholders with cash distributions and to treat loyal shareholders as long term partners