



## **Harnessing Volatility through Dividends**

June 23, 2010

Accompanying last month's steep market decline was the return of heightened volatility. Uncertainty over the European debt crisis, a sudden intra-day market break, global tensions and the mounting economic toll of the BP oil spill resulted in plummeting equity prices and whipsawing currency markets. The euro dropped to new lows and the Chicago Board of Options Exchange Volatility Index (VIX) soared to over 30, a level not registered since March 2009.

At our annual client review meetings, we cautioned that the preconditions for a market correction were in place. We recalled the lessons learned in the 2007- 2009 period noting the impact of the deleveraging of debt burdens in financial institutions, residential housing, the American consumer and sovereign nations.

- One principle recognized is that pristine balance sheets preserve market capitalization, permit strategic acquisitions and facilitate further penetration of emerging markets. Simply stated, stalwart balance sheets are the antidote to deleveraging.
- Secondly, historic global interconnectivity permits instantaneous dissemination of news. Developments thousands of miles away often incite immediate, emotional reactions. Investors tend to act precipitously, thus amplifying uncertainty and fear which in turn drive market volatility. One needs to differentiate the fundamental from the visceral causes of volatility.
- Lastly, we recognize that robust cash balances in investment accounts buffer volatility. The fallout from oscillating markets is an opportunity to capture attractive forward yields. As the market plunge of May 6 demonstrates a dislocation can be violent and disconnected from reality. After a brief period, market equilibrium was restored. To nourish portfolios with purchases of core positions that offer solid dividend streams is a proactive approach to counteract the anxiety of unstable markets.

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In our August 2009 commentary (*Pheidippides, Dividends and Recovering Markets*) positive dividend developments were highlighted. The following table updates dividend increases in several of our top equity holdings that we added to in the recent downturn.

<b>Chevron (CVX)</b> \$74.00 Dividend Yield: 3.9%	In April Chevron declared a quarterly cash dividend of \$0.72. Chevron has posted 22 consecutive annual dividend increases and an annual dividend growth rate of 7% since 1987.
<b>IBM (IBM)</b> \$129.30 Dividend Yield: 2.0%	Reflecting strong free cash flows, IBM raised its quarterly cash dividend to \$0.65 per common share, an increase of 18% from the prior quarter – maintaining its record of dividend increases for 15 consecutive years.
<b>Novartis (NVS)</b> \$48.44 Dividend Yield: 3.4%	An FDA advisory committee has recently recommended approval for Gilenia, potentially the first oral treatment for multiple sclerosis. Since the company's creation in 1996, NVS has raised its annual dividend for 13 consecutive years.
<b>McDonald's (MCD)</b> \$68.64 Dividend Yield: 3.2%	Citing confidence in the long-term strength of the company's global business, MCD raised its September quarterly cash dividend to \$0.55. The annualized dividend of \$2.20 is quadruple the amount paid in 2004.
<b>REITS</b>  <b>Monmouth Real Estate (MNR)</b> \$7.32 Dividend Yield: 8.2%  <b>National Retail Properties (NNN)</b> \$21.49 Dividend Yield: 6.9%	<p>Recently added to the NYSE, Monmouth has sustained its cash distributions during the recent severe correction in the REIT industry. The company, which has a 96% occupancy rate, retains high quality net-leased industrial warehouse tenants such as FedEx, Coca-Cola Enterprises, Kellogg and Caterpillar.</p> <p>National Retail Properties employs a triple net long-term lease business model and has sustained 20 consecutive years of increased dividends.</p>

In addition to capturing robust forward yields with timely purchases of large-cap holdings, strategic selling of covered calls augments traditional dividends. While market volatility facilitates opportune purchases, it also enables a conservative but fruitful covered call option strategy. Generally, covered calls have been sold into market strength. In this instance exercise prices are carefully selected so as to avoid limiting unrealized gains of an advancing security. By providing distance between the current price and the exercise price, portfolio growth drivers have room for capital appreciation. This example underscores an *offensive* tactic to benefit from volatility - adding breadth to portfolio income streams, even from holdings that do not pay a dividend, i.e. Apple.

Of interest is premium income generated by selling covered calls in the energy and commodity sectors. As part of our hedging strategy, covered calls were sold in these sectors in the belief that a rising US dollar would deflate commodity prices and trigger a pullback in holdings such as BHP Billiton. In this instance, option premiums represent a *defensive* adjunct to portfolio income.

Looking ahead, fears of runaway inflation appear overstated. Excess global capacity and abundant labor supply act to restrain it. The powerful riptide of deleveraging should also keep prices in check. Despite a benign inflationary environment, debt-burdened developed nations may still face higher costs of capital. In the US with \$13 trillion in government debt poised to surpass the GDP – possibly as early as 2012 - the prospect of creeping interest rates looms on the horizon.

Competition for capital between mature, developed (debtor) countries and youthful emerging (surplus) nations will surface. The tension between servicing the sovereign debt of the US and the European Union and the thirst for capital in emerging nations is swiftly coming to a crossroads. This intersection represents a potential headwind for both equity and fixed income assets, demanding discriminating selection of durable income-generating securities.

Historically when interest rates have risen appreciably, equities undergo price/earnings (PE) contraction. Valuations fall and dividend payments are at risk. We believe an adjustment to this paradigm is necessary. The modified paradigm must integrate the reflexivity of the S&P 500 earnings with the resurgent growth in the economies of emerging nations. Our research suggests that as early as 2011, emerging nations will provide 20%-35% of US large-cap earnings.

Strong balance sheets will provide the financial muscle for industry leaders to expand international market share and further earnings momentum. Conversely, disadvantaged, leveraged, mid- and small- cap competitors will face higher cost of capital as the government competes with private borrowers. As a consequence, large-cap holdings with dominant global franchises are optimally positioned to reward their shareholders with increasing dividends that mitigate against the adverse effects of reduced PE multiple.

These cross currents point to unevenness of the global economy and extended market gyrations. Emphasis on the income component of a portfolio's total return should play a more profound role in securing long-term investment goals. By harnessing volatility and cultivating resilient income streams, investors can embrace with confidence an enduring strategy that offers a degree of certainty in an uncertain world.

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