



Investment Advisors, Inc.

The Pendulum Swings

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The price of any security today (stocks, bonds, real estate investment trusts, options etc.) is simply the present value of cash flows that an investor expects to gain over the life time of that security. In the case of a 3 year 5% bond for example, an investor expects two different kinds of cash flows. First, for every \$1,000 invested, they expect to receive \$50 of interest every year over the next 3 years. Secondly, they expect to receive \$1,000 of the original investment back at the end of those 3 years. In case of equities, an investor expects two very different kinds of future cash flows.

The first expected cash flow is the form of appreciation of stock prices, i.e. the company they are investing in will increase its earnings over time and the value of the company will increase in time. Think of a company like Costco; at the end of 2004 Costco had total worldwide revenues of approximately \$45 billion. By contrast the company is expected to report revenues of over \$100 billion in 2013. The second cash flow investors rely on is the expected dividend payments received from the companies that they are shareholders of. Costco currently pays an annual dividend of approximately \$1.24 a share (paid quarterly) – it paid \$0.40 a share in 2004. A combination of higher revenues and increased dividends has helped Costco share price increase from around \$40 in 2004 to over \$100 currently. An investment in Costco over that time frame would have equated to price appreciation of about 150% and a dividend return around 35%, adding to an approximate total return of 185%.

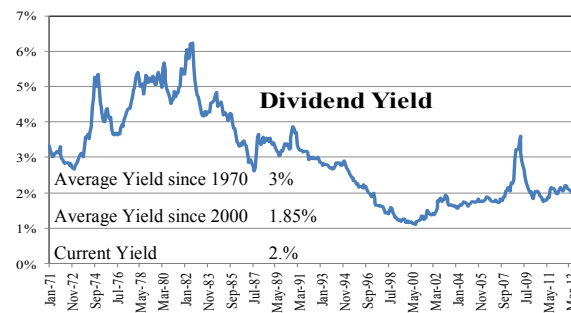


Figure 1

In recent times investors have focused mostly on stock price gains and dividends seem to have been an afterthought (see Figure 1). Unfortunately, for many investors that time has coincided with relatively poor equity index returns. Data over the past century suggests that a rising tide lifts most stocks, i.e. in a bull market it's easy to hit those high notes, the more difficult part is managing downside risk (Figure 2)*.

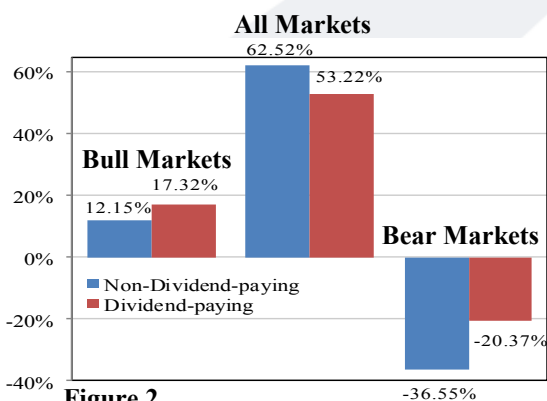


Figure 2

investors in the past and a similar future strategy is unlikely to fair any better.

The same investor strategy is unlikely to work for all investors. By having representation in many different investments (value stocks, corporate bonds, sovereign debt etc.) an investor is in a position to weather periods of high volatility. History suggests that portfolio performance depends largely on investor consistency and risk management. An emphasis on high-quality, dividend paying stocks may not win under all circumstances, however over the long-term such a strategy has resulted in above average risk adjusted returns.

* <http://dx.doi.org/10.1016/j.jcorpfin.2011.01.001>

Over the past two decades, investor emphasis on stock price appreciation has resulted in many portfolios overemphasizing growth (the high flyers) over value equities (high quality) in hopes of continuously hitting homeruns. On average, approximately 40% of the equity market's long-term total return has been as a result of dividends, the rest has been contributed by capital appreciation. Consequently the performance of these divergent strategies has been quite predictable with low valuation, high quality securities outpacing their fast growing peers (Figure 3). Overemphasizing a key component of total return has hurt many in-

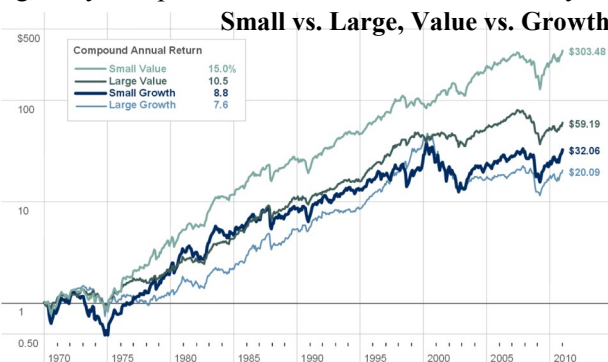


Figure 3