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## **A Visit with the Investment Policy Committee**

*Each week our investment policy committee (Greg Donaldson, Mike Hull, and Rick Roop) meets to discuss the economy, the financial markets, and how their actions relate to our three Rising Dividend investment styles: Cornerstone (formerly Rising Income), Capital Builder (formerly Blue Chip Growth), and Income Builder.*

*With the number of crosscurrents flowing about on the world's economic scene today, we thought you might find informative our investment committee's discussion of why interest rates have been rising, why that has stalled stock prices, and why, in spite of all this, we are pleased to be in companies that continue to increase their dividends. While not verbatim, the following closely represents what we have been talking about in recent weeks.*

### **Economy and Interest Rates**

**Greg Donaldson:** Probably the biggest news moving both stocks and bonds in the last 60 days has been the unexpected rise in the yields of 10-year US Treasury bonds. Our interest rate model, which tracks interest rates versus core inflation, indicates that over the last 50 years on average there has been a 3% difference between the core CPI and long-term interest rates. With the core CPI running near 2% for the last few years, we would have expected long-term interest rates to have hovered near 5%. Except for brief spells, long-term interest rates have consistently been under that level.

Former Fed Chairman Alan Greenspan spoke of this issue a number of times and described it as a "conundrum." In the last 60 days, the conundrum has lifted as long-term rates have risen sharply from near 4.50% to just over 5%. A half percent move doesn't sound like much, but it has caused a buzz of questions on Wall Street.

**Rick Roop:** The "conundrum" was explained by many experts as the extraordinary US bond purchases by China, Russia, and India. Have these nations stopped or slowed their purchases of US Treasury Bonds?

**Greg Donaldson:** Not according to the most recent data we have, but China did recently put about three billion dollars in Blackstone, the giant private equity firm, and they have said they plan to put

more of their reserves in stocks in the future. Most experts, however, do not see any significant changes in these countries' purchasing patterns of US debt.

I don't believe the run-up in rates has much to do with these three nations' purchases of our bonds. **I think it is primarily a reaction to the rise in long-term rates around the world. The world economy is now growing modestly faster than our own, which has put upward pressure on central banks to curb inflation, by increasing short rates.** Britain, China, the European Central Bank, New Zealand, and Australia have all been hiking rates over the last year. As they have pushed their short rates higher, their longer rates have also gone higher.

**Mike Hull:** But there does not seem to be a lot of evidence to suggest that our rates should have jumped higher in recent weeks. Inflation, particularly the core CPI rate at 2%, is still close to the Fed's comfort zone and would not seem to justify an uptick in rates. GDP growth is below the optimum rate of 3%. **The move to higher rates in the face of reasonably tame data could mean that US interest rates are now being driven more by international inflation expectations than by our own trend of inflation.** That's a new thought to me. I think we all agree that, since the end of World War II, the rest of the world has taken its inflation cues from us, not the other way around, as it now appears.

**Rick Roop:** It could prove worrisome for our economy and stock market if this recent trend continues, because it would mean that Ben Bernanke and the Fed have ceded some of their ability to manage US economic growth and inflation to the international Central Banks.

## Stocks and Dividends

**Greg Donaldson:** Mr. Roop, you have just hit the jackpot. That is also the reason that our stock markets have pulled back. If foreign interest rates are now going to dictate our interest rates and if our economy is already growing at slightly under its optimum level, then it would seem to tie the Fed's hands from cutting rates anytime soon. This, of course, would put pressure on earnings growth and stock prices.

**Mike Hull:** Is that what you believe?

**Greg Donaldson:** No, it isn't. The Federal Reserve in the US has a twin obligation of maximizing economic growth and minimizing inflation. With the economy growing at a year over year rate of well under the optimum rate of 3%, I still believe the Fed will be cutting rates before the year is out.

**Rick Roop:** What if they don't?

**Mike Hull:** My guess is that the over all US stock market will tread water.

**Greg Donaldson:** I agree, but our models say that the Dow Jones Industrial Average, for instance, is already undervalued by about 7-10%, and dividend growth has been very strong over the last year, so I still believe the path of least resistance for stocks is up.

**Rick Roop:** Well, the prices may not be going up, but in recent weeks, many of the companies in our portfolios have been raising their dividends more than we had expected. Is that going on in all stocks?

**Greg Donaldson:** No. S&P just reported that positive dividend increases for the second quarter were down slightly from recent quarters. They cite slower earnings growth as the main culprit for the dividend shortfall. However, among the companies we own, in the most recent quarter, I cannot think of a single company that did not beat our dividend hike target.

**Mike Hull:** And, that's been going on for quite a while. I'd say every year for at least the last five, dividend growth for our portfolios has exceeded expectations. I agree with Rick that recent news has been surprisingly good, but, in some cases, the market has ignored it. That would imply that the market does not believe it is sustainable. Pepsi, for example, raised its dividend 25%, but the stock has fallen since the announcement. I cannot find any news that would justify the fall in Pepsi's price. The argument could be made that perhaps some of the big dividend hikes we have been seeing lately are paying for the past as opposed to signaling the future.

**Greg Donaldson:** Michael, that is always the worry isn't it? Before dividend investing became popular, I think we had a lot more confidence that dividend actions were more of a signal about the future than a payback for the past. Now that a lot more people are watching dividend growth and boards of directors are under pressure to grow dividends, we have to make more tough calls on what the meaning of a dividend hike really is.

**Rick Roop:** Pepsi's recent softness in the face of a big dividend increase is in contrast to W.W. Grainger, who made a surprising 20% dividend increase and was rewarded with a sharp increase in its stock price. Mike and Greg, I'm right with you on this point. We are entering the most important quarter of the year for dividend hikes. Let's not only watch the dividend actions of our companies against themselves and our projections, but let's also watch their dividend actions compared to the other companies in their industry.

I think the banks are one area where that is really important. Greg, you recently wrote a blog about Wells Fargo's dividend actions in recent years. I believe you said their next dividend announcement is due the week of July 24. That ought to give us an interesting glimpse of what they think about the mortgage and real estate business.

**Mike Hull:** I have some comments on real estate, but before we get to that, let's look at the dividend yield and growth for our portfolios.

Let's focus first on the Cornerstone Portfolio. It currently consists of 27 companies. The portfolio's current dividend yield is 3.2% and its dividend has grown by 12.1% over the past 12 months. Interestingly, its 5-year dividend growth is 11.8%, which is about the same as the last twelve months and proves how consistent the dividend hikes are at many of these companies.

<b>Investment Style</b>	<b>Current Dividend Yield</b>	<b>Last 12 Month's Dividend Growth</b>	<b>Annualized 5 - Year Dividend Growth</b>
<b>Cornerstone</b>	<b>3.2%</b>	<b>12.1%</b>	<b>11.8%</b>
<b>Capital Builder</b>	<b>2.2%</b>	<b>14.9%</b>	<b>13.4%</b>
<b>Income Builder</b>	<b>5.0%</b>	<b>7.9%</b>	<b>7.6%</b>

You'll notice a new column on your portfolio report this quarter, showing the "Annual % Dividend Growth - Last Five Years" for each stock. Over the next few quarters, we hope to continue altering the reports so that you can begin to evaluate the dividend performance in the same way we do.

**Greg Donaldson:** As a side note, I did an extensive study of the 27 stocks that are currently in the portfolio, and I found four important results:

- 1. Over the past 15 years, their average annual dividend growth has been about 9.0%, much higher than the S&P average growth of 6.7%;**
- 2. Dividends for the portfolio, as we would expect, grew every year, as opposed to the S&P, which saw dividends fall four of the 15 years; and**
- 3. The average annual dividend yield was near 3.4%, as compared to the S&P average annual yield of 1.5%.**
- 4. During this time, the stocks now in the portfolio outpaced the S&P 500 on a total return basis an average of nearly 2% per year.**

The consistency of dividend growth is reflected in the near 90% correlation between the current portfolio's dividend growth and its annual price growth over the last 15 years.

**Rick Roop:** Since its inception, I know that Cornerstone has outperformed the S&P 500 in about any measure you want to use, but recently it has run into some headwinds. I think I know the reason, but what's your take on why the excellent dividend growth is being ignored by the market.

**Mike Hull:** Let me take a shot at that. I tell people all the time that even though Cornerstone has done very well over time, it has taken a very different route when compared to the S&P 500. Take for instance in 2000 when the S&P 500 fell by more than 10%, Cornerstone actually grew by more than 13%.

You have to remember that Cornerstone has always consisted of high quality companies with very consistent earnings and dividend growth. It tends to out-perform the S&P 500 in the bad times and under-perform in the good times. The reason for this is two fold: its higher than average quality, which makes its companies' fundamentals a bit more consistent and a bit more transparent than the average stock. And, its higher than average dividend yield makes it more sensitive to rising interest rates than the average stock.

As we all know, quality on Wall Street comes in and out of style. During the tech bubble, nobody wanted high quality, consistently growing companies. They only wanted companies with "tech" in their name, which sold something that none of us had ever heard of before. If you remember, in 1999, at the height of the tech bubble, Cornerstone actually fell by nearly 3%, even though its dividends grew by 12%. In that same year, the tech-heavy S&P was up nearly 29%. But, it was hot air, pure hot air.

**Greg Donaldson:** 1999 was a big lesson for you, wasn't it?

**Mike Hull:** Just like 1987 was for you. You never get over times that teach you something. So much of what we think we know about investing is really just what somebody else knows and we take for our own. But, every once in a while, an event comes along that shouts at you, "Hey, you've got it wrong; you're looking in the wrong direction. Look over here. The answer is over here." That is what happened in 1999 for me.

It was then that I became convinced that the market was nuts. Stock prices were not reflecting intrinsic value, as the textbooks had been arguing for so long they were pricing in the-sky's-the-limit. I remember, at the time, our models were showing that every single stock in the Cornerstone portfolio was undervalued and that the whole portfolio was undervalued nearly 20%.

In 1999, I finally saw that investors were looking in the wrong direction and there was a day of reckoning coming, when they would realize just how little they knew or cared about the true value of a stock.

**Rick Roop:** I think I heard the same voice in 2005. Our Cornerstone portfolio had a terrific year from the standpoint of growth of earnings and dividends. As I recall, the portfolio had an average dividend yield near 3.5%, dividends grew by nearly 12%, and yet the actual performance of the portfolio was barely positive. I remember I had several clients who wanted to abandon our Cornerstone strategy and get into small caps and mid caps, which were hot at the time. I reminded them that our Cornerstone investment style was not a one-year wonder. It was based on a long-term strategy that had a proven history of working. Indeed, it worked best when the stakes were the highest.

During the bear market of 2000-2002, it had lost only about 8.5% of its value at a time when the S&P 500 had fallen nearly 45%. Thank goodness not many of them switched because most of them simply could not have withstood the volatility of the small and mid cap markets.

**Greg Donaldson:** I know we are all fans of Cornerstone, but we have two other styles that meet the needs of many of our clients, Capital Builder (formerly Blue Chip Growth) and Income Builder. Let's look at Capital Builder first. The portfolio currently contains 30 stocks, some of which overlap with Cornerstone. The current dividend yield of the portfolio is 2.2% and dividends have grown over the past 12 months by nearly 15%. As you know, over the years, Capital Builder has performed a bit better than the S&P 500 with about the same volatility. In recent months, it has been performing well as a result of its holdings in oil, retail, and financial management stocks.

Even though Capital Builder has always had a good track record, I think its management style is becoming much more understandable to our clients as a result of the new quantitative filters we are using. A simple description of what we look for in the Capital Builder portfolio are companies whose dividends are growing at double-digits, are undervalued in our models, and whose stock prices have closely followed their dividend growth in the long term.

**Rick Roop:** Capital Builder has been a great investment style for many of our clients during the phase of their lives when they were accumulating retirement assets. **Now that so many clients are nearing or in retirement, they need those assets to produce a living income.**

I see from the table that Income Builder has a 5% current dividend yield. Beyond that, its dividends have grown by 7.9% over the past 12 months. That is remarkable. Do we expect that kind of dividend growth from such high-yielding stocks over the next three to five years?

**Greg Donaldson:** I have been saying lately that I expect Income Builder's dividends will grow in the 5%-7% range.

**Mike Hull:** I have had many people asking about Income Builder. Its high and growing dividend yield is becoming a precious commodity for people nearing or in retirement. What is your level of confidence in the predictability of the business prospects for its companies? The reason I ask this is that the other two styles have long track records, are both diversified across at least six industry sectors, and emphasize companies that provide essential products and services. In addition, the credit quality of the Cornerstone and Capital Builder are, as Rick said earlier, very high. We worked on the Income Builder for over a year before we introduced it, but it does have a bit of a different makeup than the other two.

**Greg Donaldson:** I believe the question you are asking is: Does the Income Builder portfolio have more risk than Cornerstone or Capital Builder? If you look at Income Builder from a ratings standpoint, it has as good a financial strength as either of the other two styles. As you know, we insisted that that be the case when we assembled it. The bottom line is I don't think it has more real risk than the other two. It just has a different kind of risk.

The reason is that the companies in the Income Builder style pay out a much higher percentage of their earnings in dividends than the other two styles. Because their dividend payout ratio is so high, the real risk is that they will be able to maintain enough earnings to cover their current dividends. On the other hand, because they are mostly big, slower-growing companies, our expectations for their dividend growth are much lower, and therefore, much easier to attain.

Conversely, the margin of safety for maintaining current dividends in Cornerstone and Capital Builder is higher because they have much lower dividend payout ratios. This gives them more room for error. Their risk, however, is in attaining the much higher growth targets that we have set for them. With Income Builder, as I said earlier, we are expecting mid single-digit dividend growth over the next decade, whereas, with Cornerstone and Capital Builder we are expecting near double-digit growth.

I know we have all been thinking about this a lot because **Income Builder really is a wonderful product for these times, and I guess my bottom line is that the risk is about the same as our other two styles. It's just different.**

**Rick Roop:** When the differences in our three investment styles are not clear to our clients, I tell them to remember it like this: Capital Builder is a **Growth** and income style of investing, with the accent on Growth. Income Builder is an **Income** and growth style, and Cornerstone is a **Growth** and **Income** style.

When they see it like that, they understand why we added Income Builder in the last few years. It offers bond-like yields with income growth and modest capital appreciation, whereas bonds do not offer any income growth or capital growth.

## Wrap Up

**Mike Hull:** Let's wrap what we've discussed. I think our view of the economy is the same as it was in September of 2006. We see continued sub-par growth in US GDP with a continued slowing in inflation. We do not see any near-term recession. We believe corporate earnings and dividends will continue to surprise to the upside, resulting from strong international growth. We believe the next move from the Fed will be to lower rates. By my calculation, all of our portfolios are undervalued between 7% and 15%, so the path of least resistance, as Greg says, is up. **I see no reason to believe that stocks in general won't make double-digit returns over the next twelve months, unless interest rates move sharply higher.** The rise in interest rates seems a bit overdone to me, so bonds are probably a good buy.

**Greg Donaldson:** In a nutshell, I think you've got it. There are all kinds of things to worry about, but, then, there always has been and always will be. Interestingly, the recent terrorist's attempts in Britain did not have a material effect on the world's stock markets, and even if the bombs would have gone off, I don't think the markets would have taken much notice. **I believe investors worldwide have come to the conclusion that terrorism is not going away anytime soon but is not a threat to the worldwide economic order of things.** In this regard, terrorism has failed because its most damaging effects have fallen mostly back on the very people who are fomenting the carnage.

**Mike Hull:** We can't end without touching on real estate. I think we all have a different perspective about the true extent of the risks to the economy from the weakness in real estate. I have a bit of an unusual perspective. Except in just a few parts of the country, I believe real estate may be closer to bottoming than we had been thinking. **Having said this, I do not think we will see a brief bottom and an up-turn as we are accustomed to in stocks. I think we may see real estate bottom out and just sit there for the next few years.**

My reason for this is the matter of supply. As prices fall, the current oversupply of housing will find buyers and stability will return, but the fall in prices will create a class of negative worth homes throughout the US. These are homes whose true selling value is less than the owner's outstanding mortgage on the property. People in this kind of situation are under no obligation to cut bait, take a loss, and move on like they do in stocks. They can say to themselves, look I bought this house to live in. So, its not worth what I paid for it or what I owe; it doesn't make any difference. As long as I can make the payments, I'm staying.

The amazing thing about the real estate mess is that the unemployment data hardly show any effects from it. Unemployment is only 4.5%. That is remarkable and shows that the real estate defaults are not spilling over into the broader economy.

Blessings from the Investment Policy Committee,

Greg Donaldson      Mike Hull      Rick Roop