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Seeking Stability in an Uncertain Market The Benefits of High Dividend Equities



A conversation with David J. Abella, CFA
Portfolio Manager and Senior Equity Research Analyst

Highlights:

- A recurring dividend stream helps to anchor the stock prices and minimize volatility of high dividend and income (HDI) equities, particularly over the long term.
- As the subprime mortgage crisis worsened in the late summer, it caused above normal volatility in high dividend equities, as credit spreads widened, liquidity dried up, and leveraged holders of illiquid mortgage portfolios were forced to sell their most liquid and higher quality assets, such as high dividend stocks.
- Rate cuts can be a powerful stimulus to the economy and to high dividend stocks specifically. We expect more cuts from the Fed going forward as the fallout from subprime mortgage crisis continues.
- Looking at the traditional HDI sectors, and given our current market and economic outlook, we recommend being overweight master limited partnerships (MLPs), slightly overweight to equal weight REITs, equal weight utilities, and underweight financials, in order to capture both dividend and capital appreciation opportunities.

The following discussion is moderated by Ted Cox, CFA, Senior Vice President of Rochdale Investment Management.

Q: The recent subprime confidence crisis and the Fed's rate cut have impacted both the fixed income and equity markets. This has led to increased volatility in the stock market. How does our high dividend and income (HDI) strategy help investors minimize volatility in their portfolios?

A: Over longer periods of time, the HDI strategy helps to minimize volatility through the high and stable dividend, which helps to anchor the underlying stock prices. In the short run, volatility can be equal to or even greater than that of the broader markets, and we certainly saw that in the month of August. Much of that had to do with the credit crisis and the subprime issue.

Q: How does the subprime crisis impact the high dividend strategy?

A: We've seen a spike in short-term price volatility. There are a few factors driving this. First, the credit crisis bubbled up slowly. By August, credit spreads began to widen as a lot of liquidity had dried up. This led to an increase in the required returns for all income oriented stocks and an increase in the capitalization rates of REITs. Some of those increases were temporary spikes and are not necessarily what the steady-state required return will be going forward. For example, if you thought a utility should be yielding 5% in a normal market, and if investors want a utility to yield 6%, the stock price has to fall for it to yield 6%. It doesn't necessarily mean that 6% is now the new required return on utilities, but certainly that was the case in August. It is a matter of the increased credit spreads weighing on individual income stocks to the point where the stocks had to fall to find equilibrium.

Secondly, there is the factor of real borrowing costs rising. Many companies have to borrow money to expand operations. If a company wants to buy a new office building, they typically would have to use approximately 50% leverage to buy that office building, and there was concern that there would be no liquidity. That was extremely overstated and turned out not to be the case. That is an example of a worst-case scenario.

Thirdly, there was some technical selling by hedge funds and long/short funds as they saw large write-downs in their illiquid mortgage portfolios. In order to meet margin calls, they were forced to sell liquid investments, which included a lot of income oriented stocks. For example, in looking at the carry trade, someone might be borrowing at a low rate to purchase a basket of income oriented stocks. Some of the trading that occurred was in order to unwind those deals, and that translated into selling the stocks.

Q: How did the Fed rate cut impact your strategy and your stocks?

A: The Fed rate cut allowed cooler heads to prevail. Some of the panic in the market was caused by investors bidding very low for assets with higher intrinsic value. The Fed signaled their intent to watch conditions closely and allowed investors to be a little more sensible, and that was a huge factor. Going forward, rate cuts can be a powerful stimulus to the economy. We are at that stage where growth has slowed, so lower rates could be very beneficial to the economy as a whole and HDI stocks specifically.

Q: What is your expectation for the Fed for the rest of the year?

A: There will likely be more cuts. The evidence behind this can be found in the housing sector, which remains overvalued in many areas of the country. There still are going to be defaults in subprime mortgages, especially in mortgages with resetting adjustable rates. This will continue to be somewhat of a negative drag on the economy, and the Fed will attempt to manage that by cutting rates. Unless the housing market were to stabilize and the economy were to grow, I would expect more Fed rate cuts.

Q: How will your HDI strategy perform in a declining interest rate environment?

A: Generally speaking, the HDI strategy is designed for any market. The strategy focuses on strong cash flow stocks at good valuations with good yields. While this is attractive under any economic condition, a declining rate environment is probably the most beneficial over time, and certainly a lower rate environment is better than a higher rate environment, all else being equal.

Q: Within your HDI strategy, you have REITs, MLPs, utilities, and financial companies. How attractive are REITs right now?

A: Because of their successful dividend-paying histories, REITs are a strong cornerstone investment for most investors' dividend portfolios. They have excellent cash flows that really stand through thick and thin. However, the REIT stocks themselves can be one of the more volatile areas of the overall HDI strategy. Generally speaking, the cash flows associated with the commercial real estate sector are strong and still growing.



In terms of valuation, REITs have been beaten up after peaking in January and February of this year. Equity Office Properties was purchased by the Blackstone Group (BX, \$24.58), and that drove up valuations in the sector. While we did not own those stocks, our holdings experienced a contagion effect. Since then, REITs have come down quite significantly, and they were trading at a 16% discount to net asset value (NAV) by the end of August.

Historically, one of the best ways to invest in the sector is to buy REITs at a discount to NAV. Since the low of August 16th, the REIT universe has rallied 14% and is up almost 8% in September and into October. I still think there are some good values available in the REIT universe, and we are selective in how and what we purchase. For example, when REITs were hitting highs in late January and early February, we weren't buying a lot of the names.

Q: What are your thoughts on MLPs?

A: The MLP universe has been a bit steadier. Although MLPs were off their highs in August, they had rallied quite a bit earlier in the year. They have proven to be a great sector as they have provided a steady, consistent income stream. The two natural gas pipeline and rural propane heating companies in our portfolio are two examples of MLPs which have supplied a stable cash flow with a good yield.

Q: Can you speak briefly on utilities?

A: Utilities can be divided into two segments: regulated and unregulated. Regulated utilities would include an electric company whose rates are regulated by the individual state, while unregulated utilities sell power to the market. Unregulated utilities are the higher growth business of the two. However, regulated utilities have little risk in their cash flows.

The regulated utilities, which are the higher dividend utilities, are the ones we have purchased for our strategy. They were beaten up unfairly as they too were hit in the credit crunch of August. Utilities definitely have come back, but it is actually the non-regulated utilities that are leading the day higher. I think the regulated utilities, however, are steady and a good defensive play, and I like that sector more than I have in the past, as the valuations make more sense.

Q: What about financials?

A: Aside from regional banks, we currently have a low weight in financials, relative to both our own historical allocation as well as to peer dividend strategies. Our current model weight for this sector is around 14%, and we may dip even lower than that. A lot of the financials are actually now up year-to-date, but there are several notable exceptions. Generally speaking, the Fed's reducing of short-term rates is a huge positive for banks, because it steepens the yield curve and it increases the net interest margin, which determines how profitable a bank can be. On the other hand, banks will be feeling the negative effects from the increasing defaults in mortgages and the slowing of the economy. Selectively, we could buy some attractively valued financials, but it is not a sector that we would overweight.

Q: Are there any other sectors you would like to mention?

A: As far as some of the miscellaneous stocks are concerned, I still think some of the tanker companies are interesting plays. In particular, the tankers have proven to be steady cash businesses with attractive yields. Other recession resistant sectors we tend to favor include rural telecom companies and select food companies. You have to go stock by stock though and look at the valuation and also look at how this company may perform in a slowing growth environment. Overall, we see opportunity in different miscellaneous sectors.

Q: Could you select one stock in particular and provide us with some insight on that stock?

A: Centerplate (CVP, \$17.80) is a catering company which provides services at sporting events such as minor league baseball games, major league baseball games, football games, and hockey games. They also provide services for the Rose Bowl, the San Diego Zoo, and the Javits Center here in New York. They are considered a strong, solid company and have a wide spectrum of business. Centerplate has been a core HDI holding in our miscellaneous sector. Generally



speaking, this is a strong stock for long-term buyers as it pays a monthly dividend with a yield of roughly 10%. But, the stock has been somewhat volatile as of late, particularly in August. It has since recovered nearly all of that lost ground and is trading back near where it had been earlier in the year.

Q: If you were to rank your categories – banks, REITs, MLPs, and utilities – which category would you be overweighting at this point?

A: We would probably overweight MLPs and equal or slightly overweight REITs. Had this been a month ago, when REITs were trading at a 14% discount to NAV, I would have overweighted them. REITs have recovered and are still an attractive valuation, but I would say MLPs might be a relatively better valuation at this point in time. Utilities would receive our equal or standard weight, while financials would be underweighted. I would also overweight the miscellaneous businesses such as tanker companies.

Q: What is your take on Canadian income trusts, and how do you see them fitting into your portfolio?

A: We started to take an interest in Canadian income trusts about a year ago. If you remember Halloween of 2006, the Canadian government said, "We're going to tax these at the corporate level beginning four years out." Generally speaking, the aspect of taxation at the corporate level is troubling, but the market is aware of the threat and stocks have made the necessary adjustments. Even with that risk of taxation in mind, there is still opportunity in those Canadian income trusts if investors look for a name with a steady cash flow that will pay a high dividend. Investing in companies which have the ability to support the dividend can prove to be extremely valuable and rewarding.

Arctic Glacier Ice (AGUNF, \$12.71) is a Canadian income trust that will be relatively unaffected by the tax issue. They are the second-largest producer of packaged ice in North America. They are a Canadian company, but 95% of their business is in the U.S. Reddy Ice (FRZ, \$26.54) is the number one ice packaging company, and we own that as well. They are subject to a potential takeover, and we are hearing some noise involved in the trading there. Those two companies actually go head to head in one small market in eastern Texas. In reality, it is a recession-resistant business. The reason Arctic Ice will not be subject to paying Canadian taxes is because they already pay U.S. corporate taxes. In using that as tax credit, they will not be subject to any additional Canadian taxes, and we should see a strong yield of close to 8%.

Another holding we have, Jazz Air (JAARF, \$7.72), might scare people at first because it is an airline. As a regional Canadian airline and a spin-off of Air Canada (AC/A, C\$14.80), the company does not have the same competition that one would see in the U.S. domestic market. It is a very stable business in Canada, and they provide a strong yield of 12.5%. They will be subject to paying Canadian taxes, but at that point we expect them to have enough growth to support the dividend at the current level.

Stock prices shown are the closing prices of 10/4/07 (Source: Bloomberg). The Rochdale Dividend & Income Portfolio holds the following positions as of 8/31/07: CVP, 1.52%; AGUNF, 0.03%; FRZ, 0.60%; JAARF, 0.55%. All opinions constitute Rochdale's opinion and are subject to change without notice. Rochdale Investment Management, its affiliated companies, or their respective shareholders, directors, officers, and/or employees may have long or short positions in the securities discussed herein.

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