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RESEARCH NOTES

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More Risk Than Return- Revisited

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Recent indications that the Federal Reserve Bank has plans to "taper" its quantitative easing program in the coming twelve months has given bond investors good reason to bid interest rates meaningfully higher.

The graph below illustrates the rise in the yield of a 10-year Treasury note since May 2. Income-producing securities have experienced a sharp downward correction in value as a direct result of the rise in interest rates.

As readers of these notes know, we have been wary about portfolio exposures to securities that would be affected by an upward move in interest rates, such as long-maturity bonds and high-yield equities (especially those dividend paying stocks with poor dividend coverage and poor growth prospects). In the current interest rate environment we have expressed concerns that even a *small* upward move in interest rates could cause *large* negative price movements in the value of such securities[1]. In our view today's low income yields present far more downside risk than return potential.

The price movement of the 10-year Treasury note since May 2 illustrates how bond pricing works and makes our point. An investor who purchased this Treasury note at the beginning of May would have paid a price which resulted

[1] The mathematical term for this is **convexity**. When interest rates are low, small changes in rates cause large changes in price.

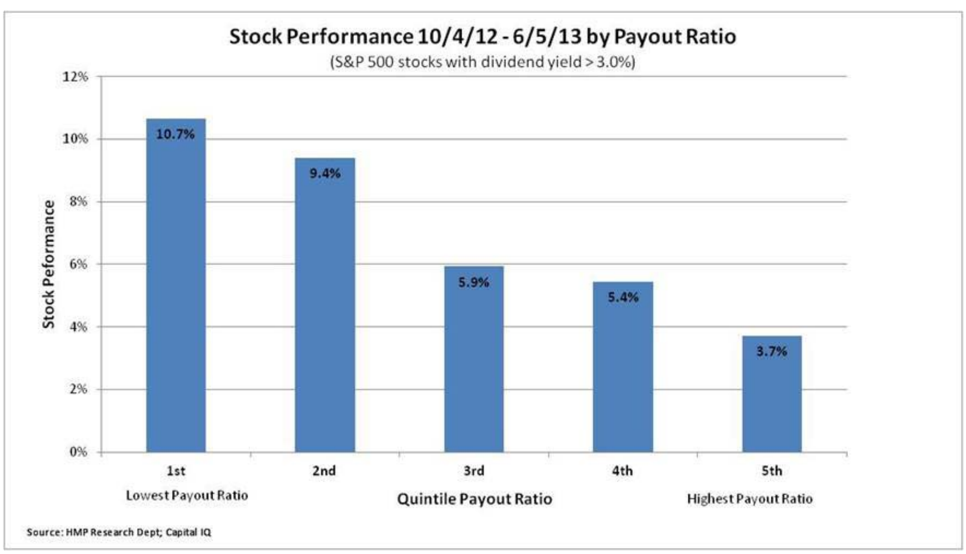
in a 1.63% yield-to-maturity. This means the investor could look forward to earning 1.63% annually over the life of the note. However, because the yield on this Treasury note rose 0.48% since he purchased it, the investor suffered nearly a 4% loss in the principal value of this security. Or, to put the loss in a slightly different perspective, this investor lost *two years* of annual return in a little over one month!

Table 1: 10 Year Treasury Bond	
	Yield
5/2/2013	1.63%
6/5/2013	2.11%
Change	0.48%
Total Return	-3.98%

Our concerns regarding rising interest rates have not been limited to bonds with long maturities. We have suggested that there may exist an unsustainable 'yield bubble' in certain segments of the equity market. We observed in our October 2012 Research Note, "Not All Dividends Are Created Equal", stocks with the highest yield commanded the richest valuations. We noted that "small increments of higher dividend yield beget much more additional risk than return." We recommended clients seeking current income be discriminating and look to high yielding stocks with well-supported dividends which, on average, were selling at discounted valuations.

In light of the rise in yields, generally, we looked at how these high-yield equities fared since we published our cautionary note. As before, we divided a list of well-capitalized U.S. stocks with dividends greater than 3% into five quintiles, based on their payout ratios (the percentage of their earnings they distribute to shareholders as a dividend). We then compared the performance of each of these five groups of stocks since our previous letter. As the graph below illustrates, the quintile of stocks with the lowest dividend payout ratio (i.e., those stocks with the best dividend coverage) *significantly* outperformed the quintile of stocks with the poorest dividend coverage.

Most of the underperformance in the high yield stocks with poor dividend coverage took place after interest rates began their recent ascent. Table 2 lists five representative stocks from the fifth quintile which we had highlighted at the end of last year and opined were



extremely overpriced and particularly vulnerable to an increase in interest rates. Certainly their recent, sharp price declines underscore our assertion that stocks valued primarily for their dividend yield were every bit as vulnerable in a rising interest rate environment as longer maturity fixed income securities, if not even more at risk. Despite their poor relative performance over the last several months, we continue to avoid longer dated bonds and stocks with poor dividend coverage and/or poor prospects of future dividend growth, trading at above-average dividend yields.

Market Log- June 18, 2013

S&P 500: 1651.81
10 year T-Note: 2.19%
Crude Oil: $97.88
Gold: $1366.00

Table 2: High Payout Ratio Equities

	5/2 Thru 6/5
AT&T	-5.03%
TECO Energy	-7.13%
Verizon	-7.02%
Altria Group	-1.20%
E.I. DuPont de Nemours	5.12%
Average	-3.05%
S&P 500	2.38%

If you have questions or comments regarding this or any other communication from us, please email us at hmpresearch@hmpayson.com.