WILLIS INVESTMENT COUNSEL
Principled Investing

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PORTFOLIO STRATEGY FOR A STRUGGLING ECONOMY AND A MARKET DOMINATED BY NEGATIVISM

PURPOSE OF MEMO AND RECOMMENDATION

This memo focuses on negative macro issues and suggests a portfolio strategy that should be better positioned to reflect a struggling global economy, housing and unemployment mired in quicksand, lack of leadership in government, the potential long-lasting affect of de-leveraging, and the pervasive negative sentiment of investors. An effective way to understand the other side of a debate is to argue that other side. Therefore, herein we put aside our tendency to rely on and believe in the resiliency of democracy and capitalism, in mean reversion, in the long-run trend of equities out-performing most other asset classes, and we put aside all valuation arguments. Purposefully then, this memo will not spend time on how deep pessimism often precedes strong equity market rallies or how all the negatives listed herein are well known and thus are likely already reflected in stock prices. Instead, this memo will present arguments for a U.S. economy that will be mired for years in the aftermath of the leverage/housing/financial crisis; and a market that will be dominated by the pessimism that now heavily influences the decision-making of many investors.

This memo will conclude that the more one embraces the macro views discussed herein the more one might want to consider allocating a substantial portion of the portfolio to *WIC's Managed Volatility and Income Strategy* (MVIS).

DISCUSSION

There is a significant probability that the following could characterize the global economic landscape, and the mindset of investors, for the next three-to-five years:

- Unresolved sovereign debt issues in Europe
- Actual or threat of dissolution of European Union
- Possible unraveling of real estate over-development in China
- China and India continue to grow, but at a slower pace that is insufficient to carry the rest of the world's GDP

- Social unrest in Europe, the U.S. and in China (which could undermine sound policy and positive sentiment)
- Housing in the U.S. takes years to significantly recover
- U.S. unemployment stays entrenched at 8-9%
- De-leveraging and its attendant austerity (households, governments and companies) restrains spending and investment; GDP struggles to grow
- America's debt and deficit issues, and lack of political will to seriously deal with the root causes, prevent a re-emergence of risk-taking ("animal spirits")
- Obama re-elected casting a deeper pall over business

The above macro trends could lead to weak operational performance of companies, or to a negative perception of their operational performance potential. Fundamentally, the following earnings growth headwinds could lead to a continued and prolonged negative perception by investors:

- Struggling U.S. exports to a weakened Europe and a slower growing China
- Lackluster spending by disillusioned U.S. consumers
- Delayed capex by CFOs who mistrust Washington and expect another recession

Inconsistent and unconvincing earnings growth, along with continued investor disillusionment, will likely cause continued low earnings multiples thereby constraining stock price growth – another reason stock returns could languish.

<u>The most important factor may be crowd psychology</u>. The longer the current environment persists, the more mistrusting investors will become; the more each hopeful rally is retraced due to concern over yet another "crisis", the more skeptical investors will become of the ability of the world to recover. Traditional valuation metrics could matter little (or almost be ignored) for a long time. In the same way over-valuation can last longer than one would think (remember the late 90s), under-valuation can as well. With each passing month, there are yet more ways for the public to be saturated with news. The volume is louder and louder and most people are unable (human nature) to turn on the mute button – they just absorb the flood of negative news. They see "for sale" signs everywhere in their daily comings and goings, and their brokerage statements are once again a dreadful reminder of the pain of just a few years ago. All of this doom and gloom could keep valuation multiples irrationally low for at least a few years. Low valuation multiples together with sluggish earnings growth could limit equity markets to low single digit total returns.

If one believes the above macro and market environment is as likely as a more positive backdrop, and therefore believes portfolio strategy should reflect such an uncertain environment, <u>WIC believes more emphasis should be placed on cash flow and yield than on appreciation</u>. Consider:

- In the above macro environment, the Fed could keep rates near their current level for several years (the Fed has announced as much) resulting in money market yields remaining under 0.25%.

- In the above environment, bond yields will likely stay near their historical lows where 3-5 year Treasuries only yield 0.40% - 0.90%, and comparable maturity investment grade bonds only yield 1.10% - 1.75%.

- Stock price appreciation could languish and average only 3-5% per year; and together with a 2% dividend yield, provide only a 5-7% total return. Few expect stock market returns to average more than 8-10% per year over the next 3-5 years.

- Compared to the foregoing possible low yields and returns, WIC's MVIS (combining above-average dividend yields and covered call option premiums) should generate a cash flow stream of 7-9% over a given 12-24 month timeframe, <u>excluding</u> price appreciation/depreciation, thereby providing:

  - A foundation for superior total returns in a low return environment
  - A means to secure a greater yield than with bonds
  - A more defensive means to own equities and capture dividends
  - A total return equal to or greater than most alternatives, and with less risk than many of those alternatives
  - A reasoned basis to stay invested and not carry "excess" cash

The crux of the matter is cash reserves provide no yield; bonds provide a very low yield and an inadequate return for the inflation and bond price depreciation risk; and traditional equities may only provide low single digit returns given the negative macro and market environment. Or worse, traditional equities may endure another severe decline. The following outlines why we believe WIC's MVIS effectively addresses this dilemma and, for many, provides the best alternative for an allocation out of cash and bonds (each scenario assumes a 12-24 month timeframe):

- <u>In a negative return environment</u>, the MVIS has a high probability of out-performing because of its higher cash flow (vis-à-vis the S&P 500 and EAFE) and defensive attributes (lower beta holdings and option-adjusted net exposure)

- <u>In a zero to 10% total return environment</u>, this strategy's higher cash flow and upside potential (covered calls leave meaningful upside potential) should enable the MVIS to outperform (or at least be competitive with) the broad equity indices

- <u>In a 10-15% total return environment</u>, the MVIS should perform similarly to the broad equity indices (e.g., a dividend yield of ~4% plus an option premium and underlying stock return of ~ 9-10%, limited by the option contracts, should provide a total return of ~ 12-14%)

- <u>In a >15% total return environment</u>, the MVIS will probably under-perform equity indices due to the upside being capped by the covered call options.

With the exception of an environment when the equity markets return more than 15%, we believe the cash flow advantage of the MVIS (dividends and option premiums), along with its defensive low beta and option structure, should position the MVIS to out-perform broad equity indices in most other market environments.[1]

Although the MVIS is clearly an equity portfolio, it is somewhat of a hybrid with some bond-like defensive elements – high cash flow, relatively low beta, and less net exposure to the equity market with the option structure.

In closing, some pundits believe macro issues are overwhelming fundamental company profitability and valuation issues. Valuation multiple-wise, they may be right; but a company's fundamental financial strength, profitability, dividend-paying ability, and valuation still matter. For 33 years, we have performed fundamental financial statement analysis on companies in our clients' portfolios; and for our MVIS holdings, we perform the same analysis, including evaluating the probability of the historical dividend trend of those MVIS companies continuing. Among the factors we evaluate:

- Five and ten year dividend history, looking for a history of growing dividends
- Payout ratio trends looking for sustainability of dividends; not just as a percentage of earnings but of cash flow as well
- Debt levels, upcoming maturities, and coverage ratios
- Investment grade metrics, our own evaluation in addition to S&P and Moodys
- Valuation using our long-standing dividend discount models and discounted cash flow models along with traditional P/E and P/B multiples

Whether as a relatively defensive way to own equities, a bond hedge against low yields or rising rates, or simply additional diversification, an allocation to WIC's MVIS should enhance most portfolios' risk/reward profile.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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[1] The cash flow and returns described herein are *expected* outcomes, not historical or guaranteed outcomes, nor modeled results. See our website for performance information and regulatory disclosures.