

September 2011 Alvine Newsletter

The search for yield – why dividends are now relevant

Key Issues—the summer-sell off in equity markets and corresponding rally in prime bonds have opened an anomaly.

Key recommendation---quality consumer stocks with bullet proof dividends now comfortably exceed their own bond yields. This represents great value even in a comparable Japanese style bear long term recession.

'Do you know the only thing that gives me pleasure? It's to see my dividends coming in'
John D Rockefeller (source BrainyQuote.com)

There are many ways to try and value equities, from P/E ratios to more fancy calculations of EBITA or in the case of social media user numbers. However there is something simple and comforting to follow John D Rockefeller and count exactly what you are going to receive as income. As long as this dividend is secured by earnings and cash flow a broad comparison can be made with fixed rate securities. At a time of paltry returns from bonds this lead us to pick out just how generous many current dividends can be.

Market moves—a major *quality* Bond rally

The recent turbulence in global equity and peripheral bond markets should not obscure the dramatic drop in treasury/gilt edged and bund yields. Since August 1st ten year US treasuries have rallied by 6 and half big figures defying doomsters like Bill Gross at PIMCO, even when the US lost its AAA rating. Investors saw these securities as offering a safe haven as fears of a double dip emerged. This blistering rally has been followed by the best corporate paper, with names such as Johnson and Johnson five year bonds trading at an incredible **1 1/4%** yield (JNJ 2.15 15/05/2016.)

While weaker credits have not benefitted from the flight to safety other comparable prime credits around the world such as **Procter and Gamble 2.19%** (PG 15/02/19), **Tesco 1.96%** in £ (TSCOLN 24/02/14), **Nestle 0.68%** in SWFR (NESNVX 13/2/14), these bonds all demonstrate this effect.

Uncertainty rules

At the same time, and probably as a consequence of recessionary fears, global equity markets have been on a rollercoaster ride through the summer. Investors would have been burned by following a blindly long risk strategy. There are as ever many differences of opinion as to the forward prospects for risky assets, and indeed some arguments that an ultra defensive posture via bonds is appropriate. We will return to the immediate prospects for markets towards the end of this newsletter. However even if these concerns are vindicated and we will remain in an era of low growth, PIMCO's 'new normal' how best can portfolios be allocated? ***Can investors still make money if we are turning Japanese?***

What's been the cause of the current market malaise?

The global economy had been struggling to make a meaningful recovery since the nadir of early 2009. While there had been causes for optimism in the spring of this year overall confidence was delivered a large knock by both the ongoing European debt crisis, and the brinkmanship with the US's debt ceiling. Whatever the causes, a significant new market phase has unfolded in the last few weeks. In these violent moves there can be a tendency for all 'risky' assets to be equally tarred with the same brush, and it is this phenomenon that we wish to explore.

Sector Rotation—more important than ever

Many market professionals have complained that the 'risk on-risk off' trade has become so correlated that we might all trade the S&P 500. Currencies, commodities, corporate bond, Euro zone debt, the VIX all these products have had a tendency to trade together. In moments of extreme sentiment this can throw up opportunities. It is for this reason that we are compelled to **look beyond simple asset allocation by class, and now look in more detail at sectors.**

What we don't like—Banks and Commodities

The recovery in the global economy, however inadequate as it has now become, was never going to mimic the last bull market. The last great run of 2003-2007 was based on cheap debt, leverage and the ever expansion of Bank's balance sheets. Accordingly **RBS's total balance sheet at its 31/12/07 year end was an incredible £1.9 trillion (source RBS accounts) comfortable exceeding the entire GNP of the UK!**

Profits might have appeared to be good in those go-go years, but the leverage and balance sheet required to sustain them will now not be repeated. RBS is not alone as all major Banks activities are being constrained by a variety of factors which include; regulatory demands to hold more Capital, loan quality issues and funding constraints. This leads us to believe that earnings, and hence Bank valuations will take a considerable time to recover. **It may be**

true that valuations against book may be visually cheap, but if the book size is also unravelling this becomes an illusion.

The recent downgrade by Moody's of several key US banks makes interesting reading **'Today's announcement by Moody's solely reflects a change in their assumption regarding systemic support in the light of the provisions of Dodd-Frank'** (source CNBC.com 21/9/11) In other words the new tighter regulatory environment. If you then consider the Vickers report in the UK and the extra Capital that this will require then you will see how profits will be harder to come by.

Two main themes have powered interest in commodities , EM and in particular China's explosive growth and as an apparent hedge against aggressive monetary printing. The China story is a long term one, and investors should caution themselves not to get too stuck on such simplistic hype. The Chinese authorities, along with many other EM central bankers, have been tightening policy all year. Our biggest concern with this trade is just how long investors are as the Bank of Japan put it "The entry of new financial investors has paved the way for the financialisation of commodities. Consequently, global commodity markets have become more sensitive to portfolio rebalancing by financial investors, which has made commodity markets more correlated to other asset markets' (source Simon Hunt Strategic Services, June 2011.)

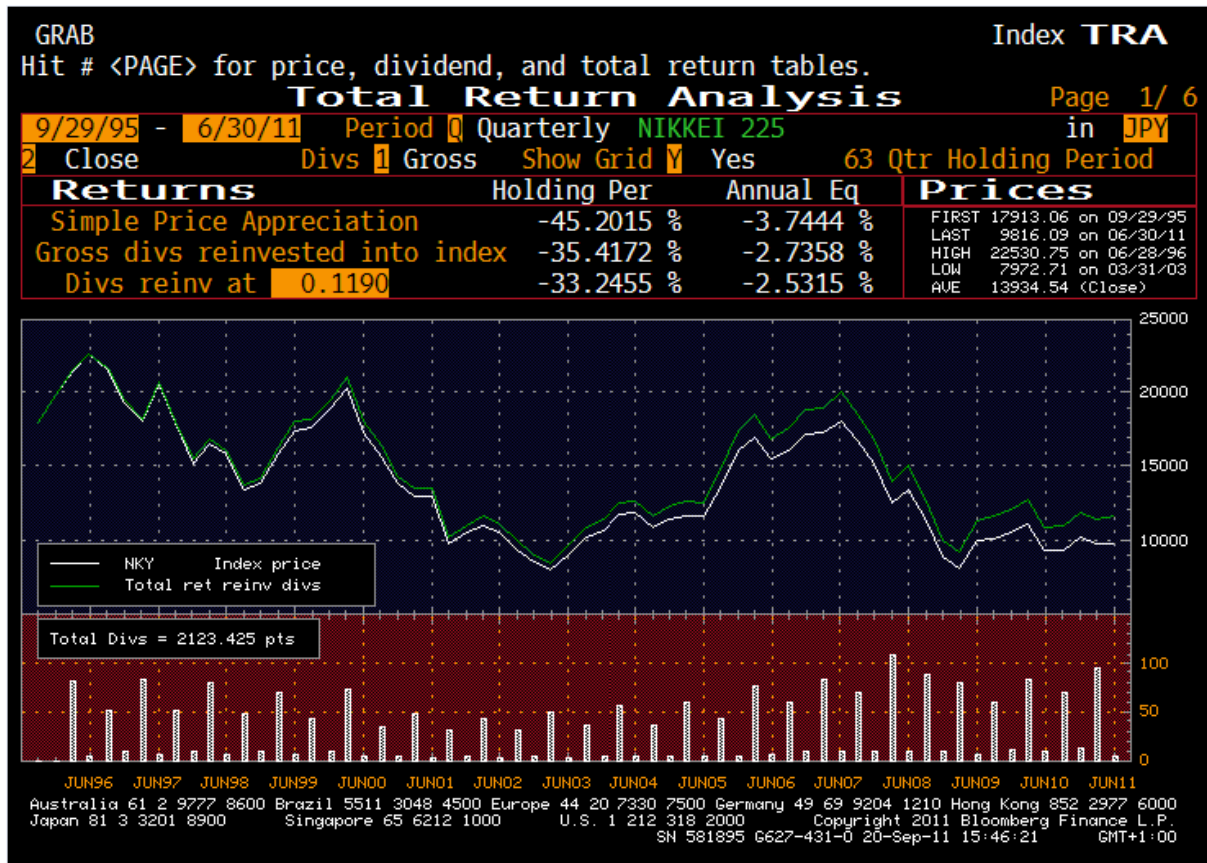
In essence Commodity investment has become a leveraged play on global growth, with many players already involved with growth faltering prospects are for a proper shake out.

What we like—global consumer companies

'There will soon be seven billion people on the planet. By 2045 global population is projected to reach nine billion' (source National Geographic January 2011.) This is more than a story.

It is not just by numbers, the world is now vastly more connected, and westernised than ever before. Hence the demand for western styled consumer products will continue to burgeon. These are the staples of family life; food, hygiene, cleaning products etc. It is a real security that demand can be sustained throughout an economic cycle.

What happened in Japan—a case study



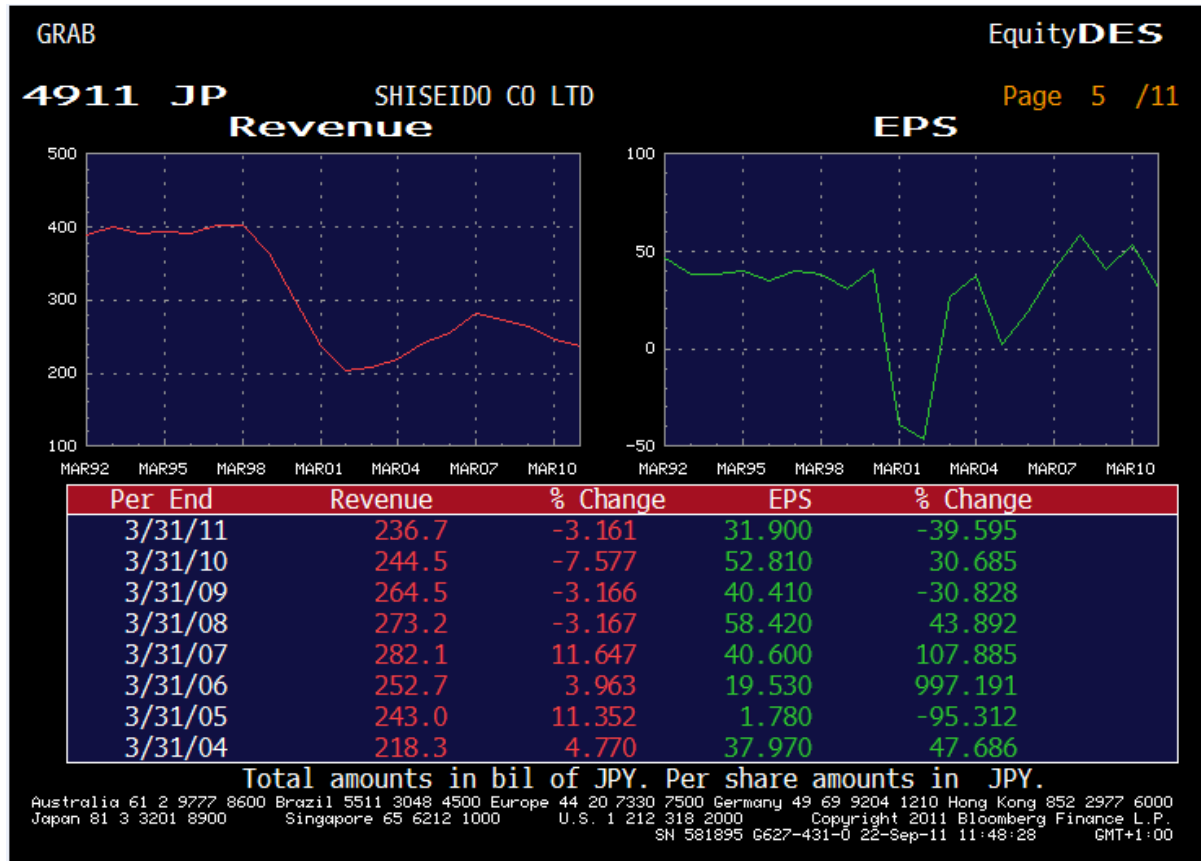
Nikkei 15 years (source Bloomberg)

This is the stark reality of just how badly the broad Japanese index has done over the last 15 years. Even taking into consideration dividend reinvestment the total return has been seriously negative.

This goes a long way to explain why JGBs have attracted such a loyal following.

However if we take our favourite theme and look at how Japanese consumer stocks have performed over the same period a very different performance can be seen.

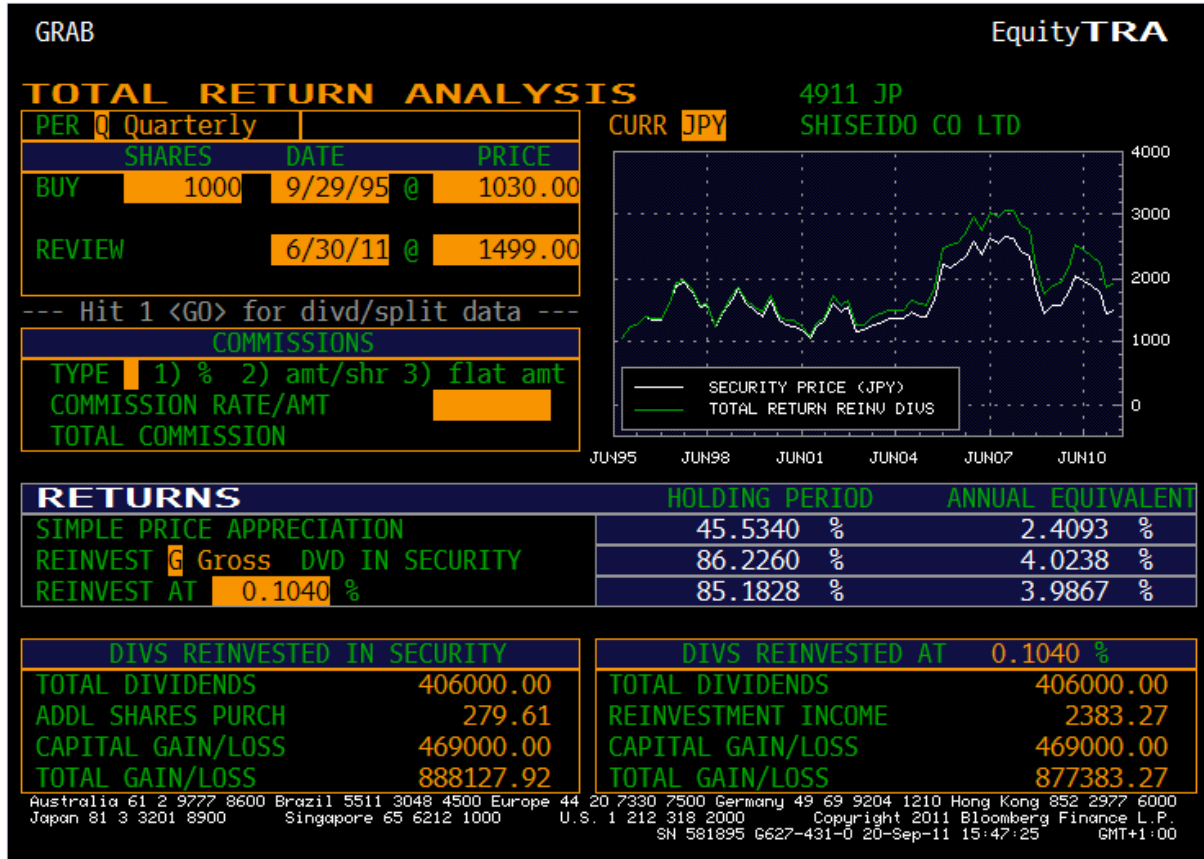
Shiseido is one of Japan's leading consumer companies producing a range of cosmetics. As such it is the sort of stable company we like.



Shiseido revenue and earnings (source Bloomberg)

The company has essentially trod water in what has been a static marketplace. However the return to investors has been more interesting with an attractive dividend yield of 3.47%, of course in Yen.

This has given a positive long turn total return *without* any growth in earnings



Dividends matter---some good examples for the future

For any stock to be considered in such an uncertain world we need to be sure of the security of the payout. This is known as dividend cover.

Here are some examples;

Nestle 2010 dividend 5.44 CHF covered by earning per share of 16.19 CHF

Tesco 2010 dividend 13.05 p covered by earnings per share of 29.19p

Danone 2010 dividend 1.2 e covered by earnings per share of 3.04e

Not only are these companies in solid consumer territory, but their earnings exceed comfortably likely future payouts.

Conclusion—in a low growth low interest rate environment dividends should form part of the investment decision making

As part of the SEC filing following LINKEDIN's IPO this statement was made 'we have never declared or paid, and do not anticipate declaring or paying, any cash dividends' (source Edgar.online.com) It's not the right place to give a demolition of the pricing of Social media companies, but merely an interesting reminder of who pays and who does not pay dividends.

There are many ways of valuing equities and ultimately common stock depends on what someone else is prepared to pay for it when you want to sell, these are undated securities unlike most fixed income that have a defined maturity. However, **if you are receiving a good steady income that surpasses the alternatives there is a material interest for you to retain and value that asset even in a long term bear market.**

Model portfolio and general comments on markets

Readers of this newsletter will know that we have followed a general bullish line since we first put pen to paper in July 2010. Needless to say we are disappointed in the price action since the dog days of August and must re-assess this view promptly.

We had based our view on two important beliefs firstly that the recovery since the 2009 low would be normal and that the market had not taken proper consideration to this cyclical boost, and secondly that the politicians and Central banks would continue to boost demand if the economy faltered.

Cyclical factors, our timing may have been correct in 2010 and the early part of 2011 but it is equally obvious that this impetus has now run out of steam. **We now face a short turn spiral of inventory unload and consumer retrenchment, these are not conducive to positive stock market returns.**

But what of our other saving grace the Central Banks and politicians?

In an open letter to Ben Bernanke the Republican leadership expressed a new dimension urging the Central bank to '**resist further extraordinary intervention in the US economy**' (source FT.com 21/9/11.) As the FT went on to comment 'the highly unusual political message to the independent central bank shows how unconventional monetary policy is creating risks for the Fed as an institution.'

With less than 15 months to the next Presidential election there is a real danger that for perceived party political advantage, the Republican party will take an 'opposition' style position attempting to circumvent the executive and monetary stimulation processes to re-start the economy.

For whatever reason this makes our long held view, as expounded by Bernanke himself, that with sufficient monetary creation an economy could be righted and a Japanese style long term recession averted. This analysis has now to be modified.

'Laws are like sausages, it is better not to see them being made' Otto von Bismarck (source Brainy.quote.com). This aphorism has been used by Chancellor Kohl to describe the European Union's decision making, and never more than now it is a useful means of understanding what is going on.

The markets have been pushing the politicians for a comprehensive resolution to the Euro zone peripheral debt problems, but nothing is in sight. It is our opinion that a forceful move to a fiscal union and the issuance of euro-bonds will not come to pass. **If you see the difficulties in getting the EFSF passed by the national parliaments, a requirement under treaty law, then the prospects for another phase of unification look sparse.**

But what of the ECB? Here the picture is more interesting as the bond buying programme of Italian and Spanish debt continues quietly, under the radar. This is significant.

With Juergen Stark gone there is an argument that this leaves no further internal obstacle to the policy of effectively monetising the debt.

Conclusion—we need to rein risk back.

While we are perennial optimists and the time will come again to go full on with our equity strategy, however the current cyclical position of the global economy together with the loss of the Federal Reserve's put means we need to move to a balanced approach and we will scale back to a neutral weighting.

There will be a better level to resume an overweight exposure to equities, which we believe will be at least 20% below current levels.

What this space!

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