DIVIDENDS ATTRACTIVE IN MIDST OF MANY UNSETTLED ISSUES

NO SHORTAGE OF UNSETTLED ISSUES

In an effort to market their products and the guarantees that are associated with them, banks and insurers routinely refer to "these unsettled times" in their ads. While these marketing efforts ignore the obvious fact that the investment climate is *always* unsettled to at least some degree, these institutions rely upon these hollow sound bytes because they contain an undeniable emotional appeal. Although I certainly am not of the mind that investors ought to dismantle their investment portfolios in response to the current negatives, I actually do regard the current environment as being particularly unsettled. Here are a few of the issues on my radar:

- The potential impact of the impending fiscal cliff on the U.S. economy
- Spanish and Italian debt trouble
- Iranian hostility toward Israel and the West
- Instability in Syria
- The general election in the U.S.

U.S. ECONOMY AT RISK DUE TO THE IMPENDING FISCAL CLIFF

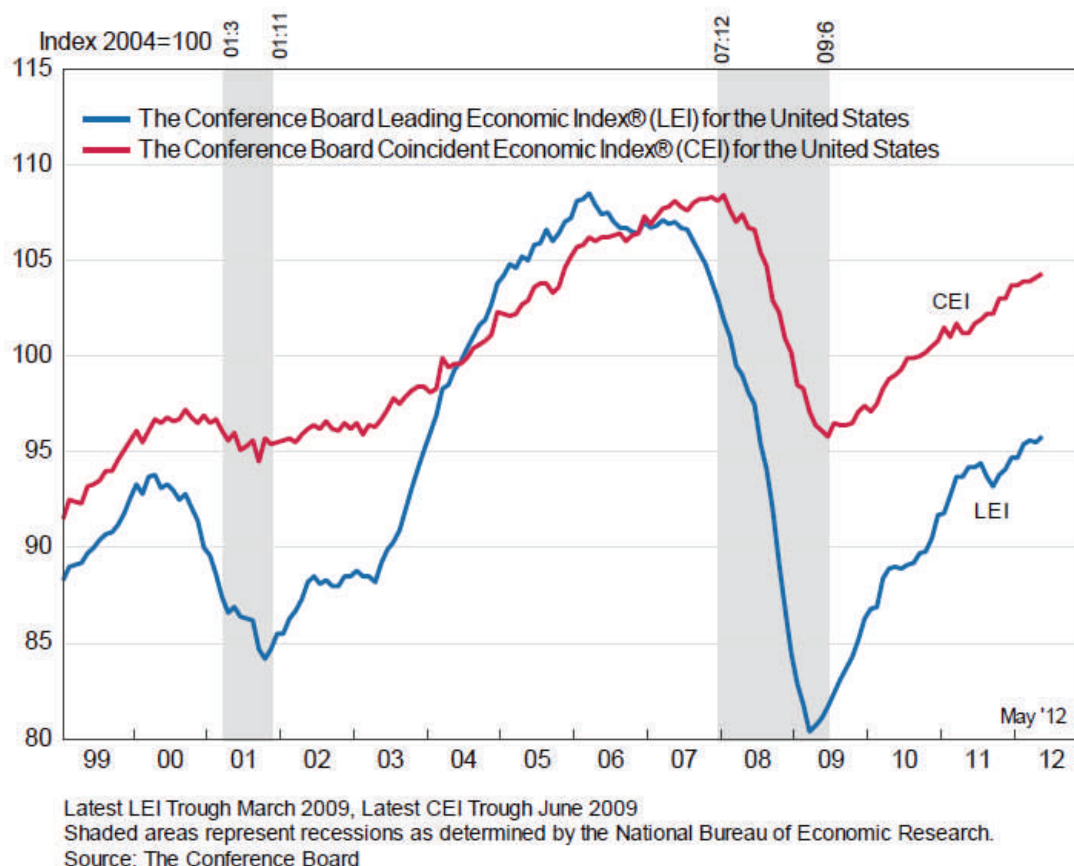
The International Monetary Fund (IMF) recently pared its 2012 growth forecast for the U.S. economy from 2.1% to 2.0% as it warned that the Obama administration might be slicing the deficit faster than the relatively fragile U.S. economy could withstand. Since the first half of 2012 is already in the books, the impact of this downward revision would necessarily impact the remaining half of the year. Consequently, this revision is actually twice as large as it may first appear.

As is the case with Greece where there is concern that excessive fiscal austerity may throw that economy into a tailspin, the IMF feels that President Obama's proposed fiscal 2013 budget, which calls for slashing the nation's deficit by three percentage points to about 5.5% of gross domestic product, represents a more severe reduction in spending than the economy might be

able to withstand. The crux of the IMF's argument is that it feels that the Federal Reserve would have limited ability to offset the impending economic drag of higher tax rates and a reduced budget deficit through monetary stimulation. The IMF also noted that a worsening eurozone crisis also threatens the U.S. economy.

CONFERENCE BOARD: U.S. ECONOMY SET TO "MUDDLE THROUGH"

Despite the impending fiscal cliff and the threat of further deterioration in the eurozone, Ken Goldstein, who is an economist at The Conference Board (an independent, non-profit research organization) recently said, "Economic data in general reflect a U.S. economy that is growing modestly, neither losing nor gaining momentum. The result is more of a muddle through. Continued headwinds, both domestic and foreign, make further strengthening of the economy difficult." Despite this unexciting outlook, some investment strategists feel that the U.S. may now represent the *least worst* investment climate. For what it's worth, The Conference Boards Leading Economic Index® (LEI) is still pointing *up*.



Latest LEI Trough March 2009, Latest CEI Trough June 2009
Shaded areas represent recessions as determined by the National Bureau of Economic Research.
Source: The Conference Board

TROUBLE IN SPAIN ...

Moody's and Fitch each downgraded Spain's credit rating following its request for up to 100 billion euros worth of aid from the European Union on the notion that this aid would allow Spain to absorb the bad debts of its banking system. Predictably, the yield on 10-year Spanish debt rose to a record high 7.1%. Spain may borrow at this rate for a while, but it cannot afford to bear such a punitive rate on a continuing basis.

In psychological terms, breaching the 7% borrowing-cost threshold is important because investors have historical grounds to view it as probable confirmation that Spain will need a government bailout as did Portugal, Ireland, and Greece after the credit markets forced their borrowing costs to spike.

... AND ITALY

Italian Premier Mario Monti has not yet asked for a financial rescue or for other European countries to share Italy's debt burden, but he has become more vocal about Italy's borrowing costs, which are now over 6%, having become unsustainably high.

EUROPEAN UNION LEADERS RESPOND

Germany vehemently objects to pooling eurozone debt in any way on the grounds that doing so would lessen the incentive for debt-ridden countries to reform their fiscal imbalances, but in a decision that was viewed by many as a major concession by German Chancellor Angela Merkel, European Union leaders have nonetheless agreed in principle to allow Europe's bailout fund to attempt to drive down the borrowing costs of Spain, Italy, and other debt-ridden eurozone members by buying the government-issued debt (government bonds) of those countries in the credit markets. In exchange, those countries must comply with prescribed economic policies.

In an effort to send a positive signal to the markets and to buy time for the governments of the more debt-ridden member states to tackle the root causes of the crisis, the European Central Bank (ECB) has cut interest rates to a new record low to provide some measure of monetary stimulus. Nonetheless, ECB President Mario Draghi acknowledged that this rate cut is likely to generate

only limited positive economic effects since the rate at which banks can borrow from the ECB is already so low. To avert the impending credit crunch, the ECB also injected more than 1 trillion euros into the European banking system and has relaxed the collateral guidelines by which banks must abide when borrowing from the central bank.

All in all, Draghi commented that, “economic growth [in the eurozone] continues to remain weak with heightened uncertainty weighing on confidence." He added that, "the risks surrounding the economic outlook for the euro area continue to be on the downside." As such, he expects continued stress in sovereign debt markets and feels that any eventual recovery in the area will be gradual.

IRAN

In a continuing effort to induce Iran to curb its nuclear activity, the West has imposed a series of economic sanctions upon Iran. The intensity of those sanctions recently increased now that the European Union has placed an embargo on the purchase of Iranian crude oil. In response, Iran has warned the West that its ships in the economically sensitive Straits of Hormuz, which serves as the conduit for around one-third of the world’s seaborne oil trade, will soon be armed with missiles that it will use to attack the Persian Gulf region if it is attacked for not curbing its nuclear activity enough to suit the West. Presumably, such an attack would come from Israel, but it’s possible that the U.S. would involve itself in such an attack.

Iran has also threatened to close the Straits of Hormuz if Western sanctions prevent it from exporting its crude oil. A point in fact is that the oil embargo that’s now in force does not actually prevent Iran from exporting its crude oil. Instead, it reduces demand for Iranian oil by limiting the number of buyers. This distinction notwithstanding, a blockade by means of mining, airstrikes or sabotage is well within Iran’s military capabilities.

The U.S. has suggested that American warships would intervene, if necessary, and the Obama administration has explicitly warned that interference with commerce through the Straits of Hormuz

would constitute a red line that would provoke an American response. The U.S. now has significant military assets in the region intended to deter the Iranian military from shutting the strait.

Although Iran has recently increased its anti-West rhetoric, it's not entirely clear to me whether the odds of military conflict have increased or decreased. Either way, even a relatively minor conflict in this sensitive region could send oil prices soaring and that, by itself, would represent a material economic negative.

SYRIA

This past April, the Assad government agreed to a six-point peace plan that laid out a framework for a cease-fire, but that plan has not been implemented even though it allowed President Assad to remain in power. More recently, an *Action Group* of nine world powers convened in Geneva to find a way to end the bloodshed that began last March. Seven of those world powers favored calling for President Assad's ouster, but China and Russia opposed the measure. This group then agreed on a watered-down plan to form a National Unity government that would oversee the drafting of a new constitution and elections. Since the great majority of Syrians are Sunni Muslims who oppose Assad, it's difficult to see why Assad, who is an Alawite, would agree to draft a new constitution or to hold elections that are certain to result in his replacement.

In June, the United Nations sent 300 cease-fire observers to Syria, but the mission was suspended after evidence of yet another mass attrocity was uncovered. Violence in Syria has now reached unprecedented levels and President Assad now seems less inclined to ease the crackdown on protesters, so it appears unlikely that the U.N.'s unarmed observers will resume their mission in Syria anytime soon. Whether the eventual result is direct military conflict in the region or escalating tensions between the West and Russia and China, the unrest in Syria poses a significant negative to the capital markets.

INVESTMENT POSTURE

For quite a while now, we have been favoring the equities of large, dividend-paying companies that possess sound balance sheets. While these companies do not necessarily posses the growth potential of smaller, more embryonic companies, we favor them for the following reasons:

- Dividends provide regular income and lessen the need to sell at unfavorable prices.
- The existence of a dividend has tended to quell price volatility.
- Many dividend-paying companies have records of increasing their dividend regularly.
- Many dividend-paying companies have records of increasing their dividends at rates that are far superior to the rate of inflation. This translates into income increases that can outpace increases in the cost of living.
- A steadily rising dividend often results in a rising stock price the same way raising the rent of a commercial building increases its market value. Therefore, a steadily rising dividend sets the stage for an increasing income *and* portfolio appreciation.
- Commiting to a dividend imposes a degree of cash flow discipline on management teams. Since companies have committed to paying out a certain portion of their cash flow, I believe they tend to exercise better stewardship over the remaining cash.

To see how owning a basket of dividend-paying companies may translate into a steadily rising income, the table on the following two pages shows how dividend payments have changed over a 10-year period on many of the stocks we hold. We've included data on every company we oversee for which Value Line had 10 full years worth of data. We didn't cherry-pick the results in any way, so there are a few stinkers in that table, too.

I hope you had a nice 4th of July.

— Glenn Wessel

Dividend Study: 2001 - 2011

Data from Value Line

Company	Recent Yield	Per-Share $ Distributions		Total % Change	Average Annual % Change	10 Years Later: $1 Worth of Income Became
		2001	2011			
Citigroup (C)	0.1%	$6.00	$0.03	-100%	**-41.1%**	$0.01
Lincoln National (LNC)	1.5%	1.22	0.20	-84%	**-16.5%**	0.16
Pennsylvania REIT (PEI)	4.2%	2.04	0.60	-71%	**-11.5%**	0.29
Lifetime Brands (LCUT)	0.8%	0.25	0.08	-68%	**-10.8%**	0.32
Hartford (HIG)	2.3%	1.01	0.40	-60%	**-8.8%**	0.40
Altria Group (MO)	4.7%	2.22	1.58	-29%	**-3.3%**	0.71
JP Morgan Chase (JPM)	3.3%	1.36	1.00	-26%	**-3.0%**	0.74
General Electric (GE)	3.3%	0.64	0.61	-5%	**-0.5%**	0.95
Merck (MRK)	4.0%	1.37	1.52	11%	**1.0%**	$1.11
Williams Companies (WMB)	4.1%	0.68	0.78	15%	**1.4%**	1.15
BP (BP)	4.7%	1.43	1.68	17%	**1.6%**	1.17
Heinz (HNZ)	3.8%	1.60	1.92	20%	**1.8%**	1.20
Average Annual 10-Year Change: CPI (Urban Areas)					**2.4%**	**$0.79**
Ingersoll Rand (IR)	1.5%	0.34	0.43	26%	**2.4%**	1.26
Verizon Communications (VZ)	4.5%	1.54	1.96	27%	**2.4%**	1.27
Baker Hughes (BHI)	1.4%	0.46	0.60	30%	**2.7%**	1.30
Southern Company (SO)	4.2%	1.34	1.87	40%	**3.4%**	1.40
Travelers Companies (TRV)	2.9%	1.11	1.64	48%	**4.0%**	1.48
Piedmont Natural Gas (PNY)	3.7%	0.76	1.15	51%	**4.2%**	1.51
Genuine Parts Corp. (GPC)	3.3%	1.14	1.76	54%	**4.4%**	1.54
Kellogg (K)	3.5%	1.01	1.67	65%	**5.2%**	1.65
At&T (T)	4.9%	1.02	1.72	69%	**5.4%**	1.69
Helmerich & Payne (HP)	0.6%	0.15	0.26	73%	**5.7%**	1.73
State Street Corp. (STT)	2.1%	0.41	0.72	76%	**5.8%**	1.76
Emerson Electric (EMR)	3.5%	0.77	1.38	79%	**6.0%**	1.79
Met Pro (MPR)	3.0%	0.15	0.27	80%	**6.1%**	1.80
Pfizer (PFE)	3.9%	0.44	0.80	82%	**6.2%**	1.82
3M (MMM)	2.6%	1.20	2.20	83%	**6.2%**	1.83
Disney (DIS)	1.2%	0.21	0.40	90%	**6.7%**	1.90
Nextera Energy (NEE)	3.5%	1.12	2.20	96%	**7.0%**	1.96
Movado Group (MOV)	0.8%	0.06	0.12	100%	**7.2%**	2.00
Exxon Mobil (XOM)	2.6%	0.91	1.85	103%	**7.4%**	2.03
General Mills (GIS)	3.4%	0.55	1.12	104%	**7.4%**	2.04
Aqua America (WTR)	2.6%	0.30	0.62	107%	**7.5%**	2.07
Baxter International (BAX)	2.5%	0.58	1.27	119%	**8.2%**	2.19
Kinder Morgan Energy Partners (KMP)	6.0%	2.08	4.58	120%	**8.2%**	2.20
Chubb (CB)	2.2%	0.68	1.54	126%	**8.5%**	2.26
Abbott Labs (ABT)	3.2%	0.82	1.88	129%	**8.7%**	2.29
Chevron (CVX)	3.4%	1.33	3.09	132%	**8.8%**	2.32
Kimberly Clark (KMB)	3.5%	1.12	2.76	146%	**9.4%**	2.46
Schlumberger (SLB)	1.6%	0.38	0.96	153%	**9.7%**	2.53
Caterpillar (CAT)	2.4%	0.70	1.82	160%	**10.0%**	2.60
Coca Cola (KO)	2.6%	0.72	1.88	161%	**10.1%**	2.61
Clorox (CLX)	3.5%	0.84	2.25	168%	**10.4%**	2.68

Beating inflation

Dividend Study: 2001 - 2011

Data from Value Line

Company	Recent Yield	Per-Share $ Distributions 2001	2011	Total % Change	**Average Annual % Change**	10 Years Later: $1 Worth of Income Became
Procter & Gamble (PG)	3.7%	0.70	1.97	181%	**10.9%**	2.81
Toyota Motor (TM)	1.5%	0.42	1.27	202%	**11.7%**	3.02
McKesson (MCK)	0.8%	0.24	0.76	217%	**12.2%**	3.17
Johnson & Johnson (JNJ)	3.6%	0.70	2.25	221%	**12.4%**	3.21
New York Community Bancorp (NYB)	7.9%	0.30	1.00	233%	**12.8%**	3.33
Colgate Palmolive (CL)	2.4%	0.68	2.27	234%	**12.8%**	3.34
Deere & Co (DE)	2.3%	0.44	1.52	245%	**13.2%**	3.45
CSX (CSX)	2.5%	0.13	0.45	246%	**13.2%**	3.46
PepsiCo (PEP)	3.0%	0.58	2.03	250%	**13.3%**	3.50
Occidental Petroleum (OXY)	2.5%	0.50	1.76	252%	**13.4%**	3.52
Apache (APA)	0.8%	0.17	0.60	253%	**13.4%**	3.53
Automatic Data Processing (ADP)	2.8%	0.40	1.42	255%	**13.5%**	3.55
Franklin Resources (BEN)	1.0%	0.26	0.97	273%	**14.1%**	3.73
News Corp. - A (NWSA)	0.8%	0.04	0.15	275%	**14.1%**	3.75
Conoco Phillips (COP)	4.7%	0.70	2.64	277%	**14.2%**	3.77
T. Rowe Price Group (TROW)	2.2%	0.31	1.24	300%	**14.9%**	4.00
United Technologies (UTX)	2.8%	0.45	1.87	316%	**15.3%**	4.16
Becton Dickinson (BDX)	2.4%	0.38	1.64	332%	**15.7%**	4.32
Medtronic (MDT)	2.7%	0.22	0.97	341%	**16.0%**	4.41
Cummins (CMI)	1.6%	0.30	1.33	343%	**16.1%**	4.43
Total S A (TOT)	5.4%	0.70	3.11	344%	**16.1%**	4.44
Paccar (PCAR)	2.1%	0.29	1.30	348%	**16.2%**	4.48
Potash Corp. (POT)	1.2%	0.06	0.28	367%	**16.7%**	4.67
CA Inc. (CA)	3.7%	0.08	0.40	400%	**17.5%**	5.00
Target Corp. (TGT)	2.5%	0.22	1.10	400%	**17.5%**	5.00
IBM (IBM)	1.7%	0.55	2.90	427%	**18.1%**	5.27
Walmart (WMT)	2.3%	0.27	1.46	441%	**18.4%**	5.41
Walgreen (WAG)	3.7%	0.14	0.80	471%	**19.0%**	5.71
Texas Instruments (TXN)	2.4%	0.09	0.56	522%	**20.1%**	6.22
AFLAC (AFL)	3.0%	0.19	1.23	547%	**20.5%**	6.47
Norfolk Southern (NSC)	2.6%	0.24	1.66	592%	**21.3%**	6.92
Lockheed Martin (LMT)	4.6%	0.44	3.25	639%	**22.1%**	7.39
EOG Resources (EOG)	0.7%	0.08	0.64	700%	**23.1%**	8.00
Nucor (NUE)	3.8%	0.17	1.45	753%	**23.9%**	8.53
Cardinal Health (CAH)	2.2%	0.09	0.82	811%	**24.7%**	9.11
Hasbro (HAS)	4.3%	0.12	1.15	858%	**25.4%**	9.58
Intel (INTC)	3.1%	0.08	0.78	875%	**25.6%**	9.75
Expeditors International (EXPD)	1.4%	0.05	0.50	900%	**25.9%**	10.00
Noble Energy (NBL)	1.0%	0.08	0.80	900%	**25.9%**	10.00
McDonalds (MCD)	3.2%	0.23	2.53	1000%	**27.1%**	11.00
Teva Pharmaceuticals (TEVA)	1.9%	0.07	0.89	1171%	**29.0%**	12.71
Lowes (LOW)	2.3%	0.04	0.53	1225%	**29.5%**	13.25
Infosys (INFY)	1.4%	0.04	0.70	1650%	**33.1%**	17.50
Stryker (SYK)	1.6%	0.04	0.72	1700%	**33.5%**	18.00
America Movil (AMX)	1.1%	0.01	0.26	2500%	**43.6%**	26.00
Southern Copper (SCCO)	6.4%	0.06	2.46	4000%	**45.0%**	41.00
Waste Management (WM)	4.3%	0.01	1.36	13500%	**63.4%**	136.00
Average	**2.8%**					