Eidelman Virant
CAPITAL

Quarterly Letter — March 2012

April 5th, 2012

Dear Clients & Friends,

The S&P 500 and Russell 2000 stock market indices rose 12.6% and 12.4% respectively in the first quarter of 2012, the best first quarter S&P 500 performance in 14 years. The markets benefited from 24 consecutive months of private-sector job growth, increasing manufacturing, and improving fundamentals and prices in the real estate market. In Europe, the Greece bailout and the implementation of the new LTRO loan program has seemed to calm the markets and given countries time to get their finances under control. The result has been a lowering of interest rates on Italy and Spain debt and rising stock prices throughout Europe. To top it off, Chairman Bernanke just reiterated that despite clear economic improvement, he will keep monetary policy accommodative in order to keep the recovery rolling.

Eidelman Virant portfolios had a great quarter led by the success of our "year-ender" strategy and a strong recovery in financial stocks. I wrote last quarter in "The Case for Bank Stocks" that "After being the worst performing sector in 2011, we think bank shares are poised for a big rebound in 2012." Just last quarter, there were major concerns over European sovereign debt defaults, a slowdown in China, and the anemic recovery in the U.S. How quickly perceptions change! In the first quarter of 2012, financial stocks led the way with an industry average return of 22% after the Federal Reserve released their latest stress tests showing that 15 of the 19 major financial institutions could survive a dire scenario. Now, market participants including formerly bearish Jim Cramer are touting financial stocks as a great way to play the economic recovery and rebound in housing. We still believe that many bank stocks, particularly our holdings such as Citigroup (C), First Business Financial (FBIZ), and many others have a lot of upside left given their earnings potential and low price-to-book value ratios.

With two positive quarters in a row behind us, what do we see ahead for the markets? Historically, when the first quarter was up 10% or more, the S&P 500's median return over the following 9 months averaged 6%. A continued economic recovery along with accommodative fiscal and monetary policy should bode well in the short run. However, we remain cognizant of challenges lurking beneath the surface. Our biggest concern is that the current low tax rates and high government spending will need to be reversed after the election to begin chipping away at the large U.S. budget deficit. Such actions may lower economic growth and corporate profit margins. With this in mind, we are looking to not just invest in companies trading at low valuation ratios compared to the market, but also looking for companies with growing profit margins. In the event of a stock market or corporate earnings decline, such attributes should help our individual investments outperform.

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One question we often get is: “How can I get a reasonable, but safe yield?” While certificate of deposit (CD) and corporate bond rates have historically averaged 5% and 7% respectively, fixed income is now a different ballgame. CD rates are now 0.21% and intermediate corporate bond yields are around 3.5%. Low interest rates have driven investors to seek other high yielding alternatives such as high-dividend paying stocks, Real Estate Investment Trusts (REITs), and Master Limited Partnerships (MLPs). In the next section entitled “I Love Dividends, but Watch Out!,” I’ll explain that while dividends are one attractive piece to the investment puzzle, only a total return analysis can fully evaluate the true potential of an investment. In fact, many high-yielding investments can be “value traps.” In the final section, I’ll touch on why investments in REITs and MLPs need to be evaluated on their own and some concerns about investing in REITs and MLP funds as a whole.

Stepping back and looking at the big picture, investing in corporations that make our lives better and more productive has been the best way to compound wealth compared to alternatives such as cash, gold, fixed income, and real estate. We remain confident that our value-oriented investment approach of buying such companies at reasonable prices and with other characteristics that give us the highest probability of outperforming the market is the best way to capitalize on this opportunity. Thank you for your continued loyalty and I look forward to writing again next quarter.

Sincerely,

Tom Eidelman, CFA

I LOVE DIVIDENDS, BUT WATCHOUT!

BY TOM EIDELMAN

Once when I was 10 years old, my father showed me a check for $30 and said “Congratulations, you got a dividend from Middle South Utilities.” I didn’t know what a dividend was then, but I knew I wanted more of them!

Typically, a dividend is an ongoing distribution by a company to its shareholders. Many investors prefer stocks paying dividends because they can get some “income” from their investments without having to sell their stock. Most publicly traded companies that have been around for decades pay a dividend, while other faster growing industries like Technology companies and start ups tend not to pay dividends. With interest rates low and investors scrounging for yield, stocks and funds that have a high dividend yield are rapidly gaining popularity. Consider this:

1) Investors poured $31 billion into mutual funds and ETFs that invest in dividend payers last year, nearly five times the amount in 2010, according to researcher Lipper Inc. Investors withdrew $33.5 billion from equity funds overall.

2) S&P 500 stocks that paid dividends posted a 1.4% total return in 2011, while non-payers fell 7.6%.

3) Literally as I was writing this letter, I got a call from Russell Investments trying to sell their two new high-yield dividend stock funds.

Do we agree that a high dividend paying stock strategy is a sound way to achieve solid investment returns in the foreseeable future? Not exclusively. Dividends are only one piece to the total return puzzle. Total return on an investment is made up of two components:

Capital Gain (growth)

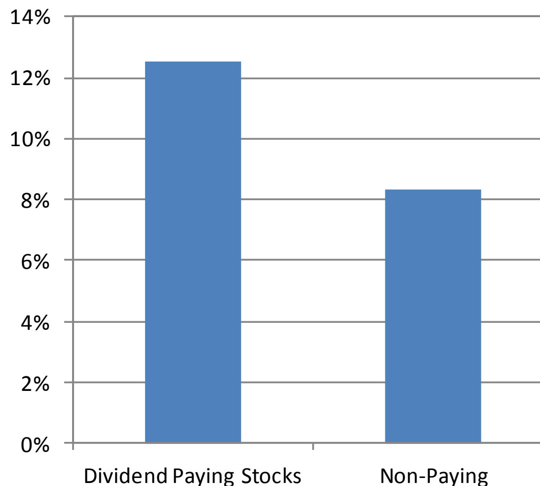
+ Dividend Yield (income)

= Total Return

Dividend Payers have Outperformed

Studies have shown that stocks that pay dividends have outperformed the market overall and outperformed non-payers (See Chart A).

Chart A: Dividend Vs Non-Payer Stocks (1980-2012)



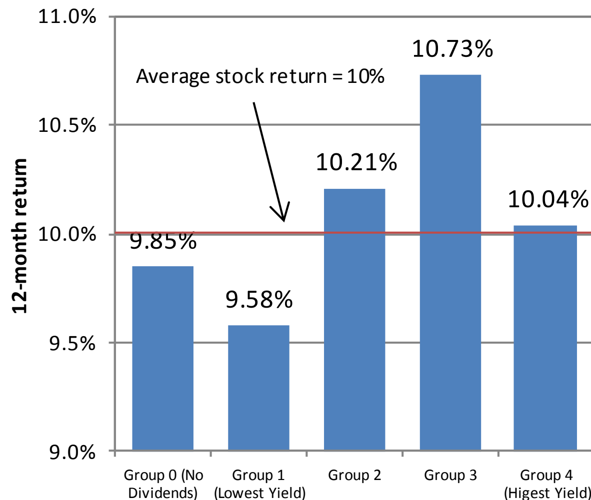
Data Source: Factset

I believe the reason dividend payers have outperformed is because in order to pay dividends, companies must earn strong and consistent cash flow over time. In other words, weak, troubled, and fledgling companies can’t afford to pay dividends and such companies have been underperforming investments over time. Also, paying a dividend applies accountability and fiscal responsibility on management teams. Management can’t just hoard cash and then use it to make unwise acquisitions. So history tells us that paying a dividend is a good thing. Does this mean that U.S. stocks that pay the *highest* dividends are the *best*? History suggests not.

Yield Trap

Stocks with the *highest* dividends do not necessarily outperform those with modest and low dividend yields (See Chart B on next page). The reason for this phenomenon has to do with the ability to maintain the dividend. If a company pays out 100% of its earnings in the form of a dividend, then they may be at risk of cutting their dividend when a downturn hits and their earnings decline.

Chart B: Highest Yield Stocks Not the Best Group (1990-2009)



Data Source: Factset

An Example: Pitney Bowes (PBI)

Pitney Bowes (PBI), with an 8% dividend yield, is the third highest yielding stock in the S&P 500 index and is the largest holding of the SPDR S&P Dividend ETF (SDY). Founded 90 years ago, Pitney Bowes' core business is in postage metering machines for traditional mail. Increased email and digital communication is eating away at this core business causing revenue declines for three consecutive years.

Although PBI has an 8% dividend yield, consensus estimates have earnings declining -7% and -4% in 2012 and 2013 respectively. All else being equal, combining +8% dividend yield with a -7% earnings decline would equate to a paltry 1% total return.

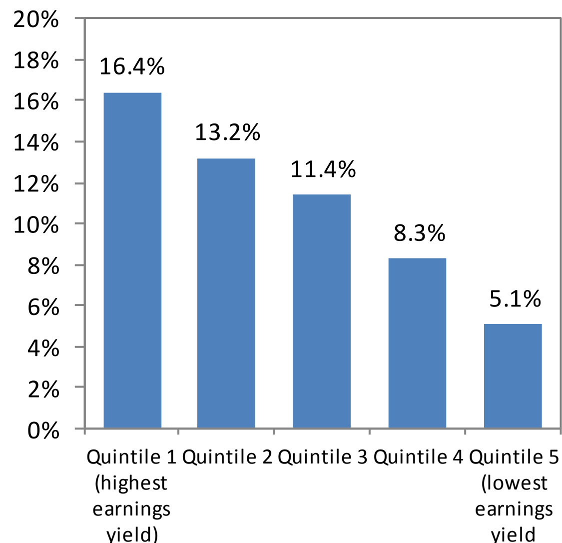
With a declining business and a high 85% of earnings going towards paying off the dividend, I believe their dividend is vulnerable to being cut. A dividend cut could be viewed unfavorably by the markets and cause the share price to decline further.

The bottom line is that we are skeptical that companies can maintain a very high dividend yield (currently > 5%). While there may not be that many companies with a higher dividend yield than Pitney Bowes, we believe that there are many with better total return potential.

Earnings Yield – Ability to Pay Dividends

We find that the best stocks to own are those with the highest *ability* to pay dividends. These companies can choose to invest their profits back in the business, implement a share buyback, make accretive acquisitions, or even raise their dividends. The best way to spot such companies is to look at their earnings yield as a percentage of their stock price. Our studies show that a high earnings yield has been one of the best predictors of future stock market performance.

Chart C: Highest Earnings Yield Stocks Performed Best (1980-2012)



Data Source: Factset

Summary

With demand for dividend paying stocks being so high, we recommend investors look beyond dividend yield alone. We conduct thorough fundamental analysis of our investments including hundreds of metrics and construct portfolios with the highest probability of outperforming the market. In the next section, I'll dive a little deeper into some other popular assets that have interested income investors.

MLPS OR REITS AS INCOME ALTERNATIVES?

With fixed income yields at record lows, investors are looking for other alternatives. Two areas that have received high inflows of new capital are Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs). While there may be some attractive individual investments in these areas, I want to highlight some key risk factors why these areas may offer unattractive total return prospects.

Real Estate Investment Trusts (REITs)

REITs are an efficient way to invest in diversified real estate holdings such as office buildings, apartments, and industrial real estate. REITs must have most of their assets and income tied to real estate investments and distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends.

Over the past 20 years, the REIT index has accumulated a compounded return of approximately 10% per year. Such returns have come from a 7% average dividend yield plus 3% capital appreciation as rent and real estate prices have increased at the rate of inflation.

While past performance has been remarkable, Here are some key reasons future returns may not be as good:

1) Current REIT yields of 4.3% are roughly half their historical average of 7.2% due to high demand for income producing investments (See Chart D).
2) REITs valuations (based on book value, earnings, or funds from operations) are well above historical averages. I believe current valuations are likely to revert downwards and be a headwind for future returns (See Chart E).
3) Capital appreciation for REITs is likely to be low. Additional return would need to come from growth, which is hard to achieve when 90% of earnings are being paid out. The rate of real estate/rent appreciation will likely equate to the rate of inflation which is forecast by the TIPS bonds market at 2.3% per year.
4) REITs will likely underperform if interest rates rise. As interest rates rise, yields on REITs would need to rise to compete with other yielding assets causing the price of REITs to decline. In addition, the heavy use of leverage would increase the cost of operations, causing profit margins to go down.

Chart D: REIT Yields at Decade Lows (1987-2011)

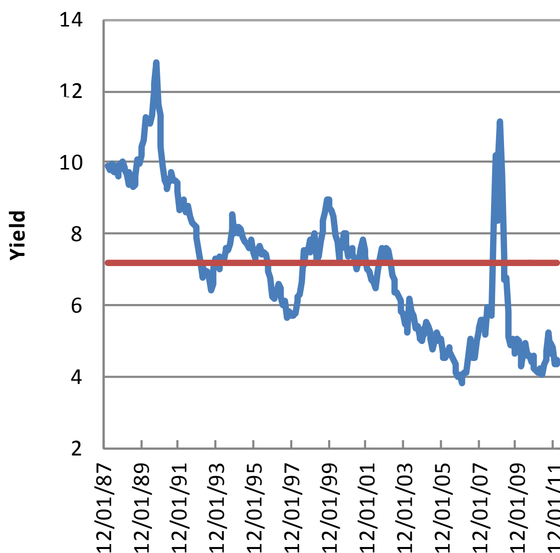
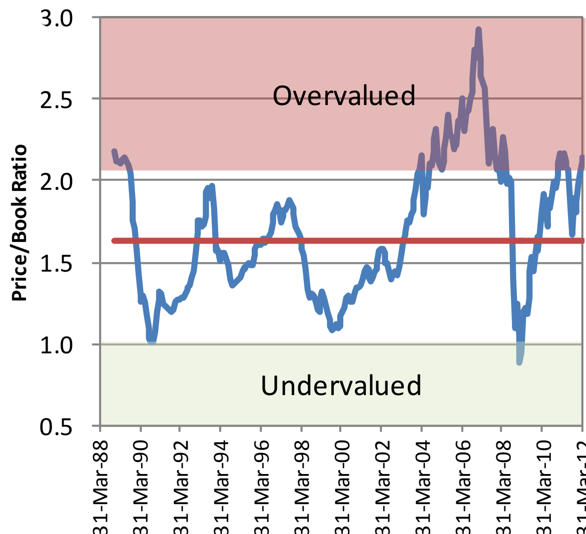


Chart E: REIT Valuations above Historical Levels



Data: Factset

Assuming no decrease in the price/book value, the expected return on such an index would equate to yield (4.3%) plus growth (2.3%) for an expected total return of 6.6% on the REIT index. Given the operating risks, interest rate risks, market volatility (the REIT index fell 60% in the crash of 2008-2009), and overvaluation risk, I don't find the risk-reward potential to be particularly attractive.

Master Limited Partnerships (MLPs)

Another hot investment area due to its high industry average yield of 6% are Master Limited Partnerships (MLPs). MLPs are tax-efficient vehicles, mostly pertaining to natural resources like oil and gas transportation, that trade like stocks. They must generate 90% of their income from such qualifying sources. Some MLPs are considered low-risk businesses because a high portion of their revenues come from long-term contracts with built-in price escalators. Is this too good be true?

Since 2003, MLPs as an asset class have grown from $30bn in investment to $250bn today, and have also been one of the best performing asset classes in the world over the last 10 years. The two largest MLPs, Kinder Morgan Energy Partners L.P. (KMP) and Enterprise Products L.P. (EPD), have grown their dividends approximately 8% compounded over the past 10-years, quite a remarkable feat after paying out 7% in annual distributions. Can they keep it up? Possibly. But similar to REITs, future yields and growth will likely be lower.

Total Return Potential

The current yield on the MLP index is approximately 6%. In addition, the two largest MLPs have forecasted 5-to-6% of annual dividend growth. Assuming valuations stay the same, such expectation could accomplish a total return of 11%. This would be a best case scenario.

The Risks

MLPs are fraught with complications and risk. These key risks include:

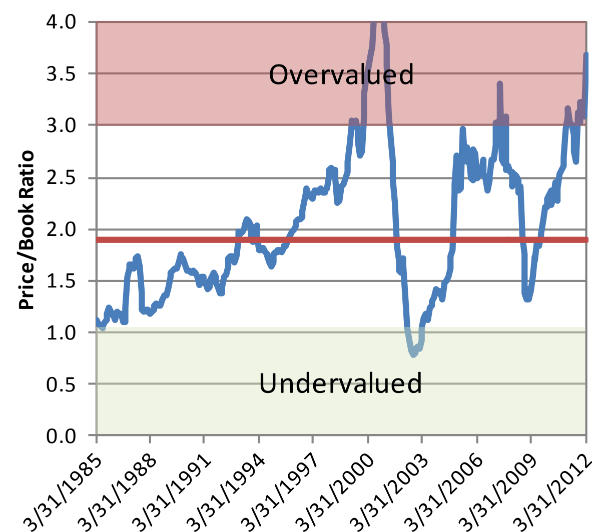
1) Commodity Risk—Big midstream pipeline MLPs flourish in a stable commodity environment since they just transport oil and gas. If energy *rises* too high (like oil in 2008), demand will fall and less energy will be used. If energy prices *fall* too far (like natural gas and coal currently), it may be uneconomical for companies to produce it and therefore will need less quantities transported.

2) Regulatory Risk— A key benefit is their tax benefit allowing them to avoid corporate income tax. In 2006, Canada enacted the "Tax Fairness Plan," which eliminated the tax benefit. As a result, the Canadian Income Trusts (similar to MLPs here) dropped 25% in a week. In an effort to raise U.S. government revenue, similar actions could be taken in the U.S.

3) Interest Rate Risk—Similar to REITs, MLPs will likely underperform if interest rates rise. As interest rates rise, MLP yields would need to rise to compete with other yielding assets causing MLP stock prices to decline. In addition, the heavy use of leverage would increase the cost of operations, causing profit margins to go down.

4) Overvaluation Risk—Perhaps my biggest concern about MLPs is their overvaluation risk. MLPs are priced for perfection and any hiccup in their business could send their high valuations back toward historical levels, which is roughly 40% below current levels (See Chart F below).

Chart F: Oil & Pipeline MLPs High Valuations



Note: Data used was the "oil & gas pipelines" industry sector from factset.

Summary

The bottom line is that no investment is "good" just because it has a high current yield. As I've outlined, REITs and MLPs are two popular high-yielding asset classes that may not deliver satisfactory future returns. While we would not recommend owning REIT or MLP index funds, there may be some specific stocks within these funds that are good values right now. We are constantly evaluating companies on their individual merits on a total return basis to attempt to achieve the best risk-adjusted return possible.

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