Eidelman Virant
CAPITAL

Quarterly Letter September 2012

Dear Clients and Friends,

When I met with a client last week he said, "The market is up a bunch, should we sell everything?" With many people skeptical of the U.S. economic recovery, government deficit spending, and aggressive monetary policy, investors are surprised by the magnitude of this year's stock market gains. The S&P 500 and Russell 2000 indices are up 16.4% and 14.2% respectively for 2012. With 10-year Treasury bonds at 1.7%, this year's gain on the S&P 500 represents ten years of bond interest! The key factors driving stocks up were 1) the announcement of quantitative easing (QE3) by the federal reserve, 2) improvements in the U.S. economy including an eye-popping increase in consumer confidence, 3) an increase in U.S. housing prices, and finally 4) low interest rates incentivizing investors to allocate toward higher returning equities in the quest for adequate investment returns. With this news behind us, can stocks continue their run going forward? Yes.

The most compelling reasons to be optimistic about the stock market are momentum and relative valuation compared to interest rates. Since 1925, there have been 31 years when the S&P 500 Index rose at least 12% during the first nine months of the year. The median gain during the fourth quarter of those years was 4.9% and was up 81% of the time. The momentum of the market has also been exceptionally strong as measured by the number of stocks hitting 52-week highs and advancers vs. decliners. According to Ned Davis Research's "Fab Five Tape Composite", the S&P 500 Index has gained 20.5% annually since 1982 when technical indicators were in the favorable zone we are in today.

The real story of why stocks could march higher for an extended period of time is that they may be one of the only traditional liquid assets capable of earning an adequate return. In other words, they are the only game in town. Even though the majority of the historical total return on stocks has come from growth, the current dividend yield on the S&P 500 Index of 2.2% now exceeds the fixed 1.7% yield of the 10-year U.S. Treasury bond. In the past, when dividend yields on stocks exceeded the real 10-year Treasury yield, the S&P 500 Index outperformed bonds by 7.5% annually. In this quarterly letter, I'm going to step back and look at the big picture. With interest rates at unsatisfactory levels, investors with an average risk tolerance will likely allocate more to higher quality, dividend paying stocks. Because there is a limited supply of high-quality stocks, this tailwind could drive such equities to much higher levels.

We remain cognizant of many challenges that could cause volatility in the equity markets. Many economists believe the economy and corporate profits are artificially boosted by U.S. deficit spending. Our biggest concern is what happens when the U.S. inevitably tightens its fiscal belt. In addition, investor sentiment has risen to elevated levels and insider selling has picked up. Despite these concerns, we believe investing in areas where we see pockets of value is the best way to protect and grow wealth over the intermediate and long term.

We will continue to work hard in the quest to earn superior investment returns. If you have any questions, please do not hesitate to contact us.

Sincerely,

Tom Eidelman, CFA
Vice President

HIGH-QUALITY STOCK SHORTAGE?

With interest rates at unsatisfactorily low levels, investors with at least an average risk tolerance should consider increasing allocations to higher-quality, dividend paying stocks. There is only a limited number of such world class companies whose earnings predictability and dividend histories create bond-like characteristics. Increased demand for income and limited supply could drive such equities to much higher levels.

Theoretically, there should never be a shortage of stocks because new businesses can be formed or private companies can go public. In the late '90s when internet stocks were given nosebleed valuations, hundreds of new companies went public with little more than a business plan to satisfy the insatiable investor demand for internet stocks. However, new high-quality stocks can't be created overnight. There is only one Coca-Cola, McDonalds, and Walmart. These companies aren't just the best in the country, in our view, they are the best in the world. As investors all over the world appreciate the value and scarcity of high-quality U.S. stocks, their share prices could go dramatically higher.

Quality Stocks are Rare

In the U.S., there are only 111 companies or $3.8 trillion in market capitalization rated "A" or better by S&P's stock ratings. There are only 133 companies or $2.9 trillion of equities that have a history of raising their dividend every year for the past 10 years. Chart A below shows a list of the 12 largest high-quality stocks as defined by 10-years of dividend increases. Because of their large size, the below list represents nearly half the high-quality market capitalization.

Chart A: Largest High-Quality Stocks as of 9/30/12

Security Name	Ticker	YTD %Chg	Weight	PE	Yield
Wal-Mart Stores Inc.	WMT	23.9%	4.8	15.2	2.1
Coca-Cola Co.	KO	9.7%	4.8	19.1	2.7
Exxon Mobil Corp.	XOM	8.3%	4.7	11.7	2.5
Johnson & Johnson	JNJ	5.4%	4.6	13.7	3.5
Chevron Corp.	CVX	10.2%	4.6	9.1	3.1
Procter & Gamble Co.	PG	4.1%	4.5	17.8	3.2
PepsiCo Inc.	PEP	6.5%	4.1	17.4	3.0
Abbott Laboratories	ABT	22.9%	4.0	14.0	2.9
Intel Corp.	INTC	-6.2%	3.6	10.4	4.0
McDonald's Corp.	MCD	-8.3%	3.5	16.8	3.4
Average		**7.7%**	**43.0**	**14.6**	**3.1**
S&P 500				*15.5*	*2.2%*
Russell 2000				*17.2*	*1.4%*
Value Line Universe				*15.9*	*2.4%*

Note: Chart A shows the top holdings of the Schwab Dividend ETF (SCHD), which is a fund of stocks having 10-years of consecutive dividend increases.

$3.8 trillion of high quality stocks may sound like a big number, but this represents only 5% of U.S. household assets and only 2% of the world's assets (See Chart B below). In fact, if you compare the U.S. high quality stock market value to the $10 trillion value of all the gold in the world, U.S. high quality stocks are more than twice as rare as gold.

Chart B: U.S. Household Asset Allocation

As of June 30, 2012

Asset	Amt (Bil $)	%
Bank Accts	$ 9,250	13%
Bonds	$ 14,667	20%
Stocks	$ 15,083	21%
High Quality Stocks	*$ 3,766*	*5%*
Other Equities	*$ 11,317*	*16%*
Real Estate	$ 18,000	25%
Durable Goods	$ 5,000	7%
Private Biz	$ 7,000	10%
Other	$ 3,000	4%
Avg. U.S. Household	$ 72,000	**100%**

Source: Federal Reserve Flow of Funds 6/30/12

Shortage Could Lead to Big Upside

A fundamental law of economics is that profits and value go to those resources which are both scarce and useful. The value of those things that are scarce and in demand will tend to rise, relative to the value of those things which are abundant and less desired.

There were two different times in recent history when a subset of the S&P 500 was in vogue and valuations were driven up to 2-3x their historical averages. The "nifty fifty" group of premier growth stocks such as Xerox, IBM, and Coca-Cola rose to 42x earnings in 1972 due to their high and stable growth rates, more than double the valuation of the S&P 500 Index. In the late '90s, technology stocks rose in excitement surrounding the internet to a P/E ratio of over 60x, or 3x the value of the S&P 500 Index.

With a dearth of income opportunities in the market today, similar excitement could swoon over companies with the ability to consistently pay and grow dividend yields. The fact that these stocks trade at a P/E valuation below the market as a whole gives these shares tremendous appreciation potential.

BOND DISAPPOINTMENT

Interest rates are at pathetic levels across all time horizons and credit levels. In fact, short-term yields are approaching zero. For many individual investors, pension funds, and insurance companies, such low rates are making it nearly impossible to achieve their income needs. Chart C below shows that current rates are roughly 65% below their historical averages. Chart D shows just how low the current bond yields-to-maturity are across various quality and time horizons.

Chart C: Historical Bond Yields (3-Month CDs, Moody's Aaa, Moody's Baa Corporate Bonds) 1972-2012.

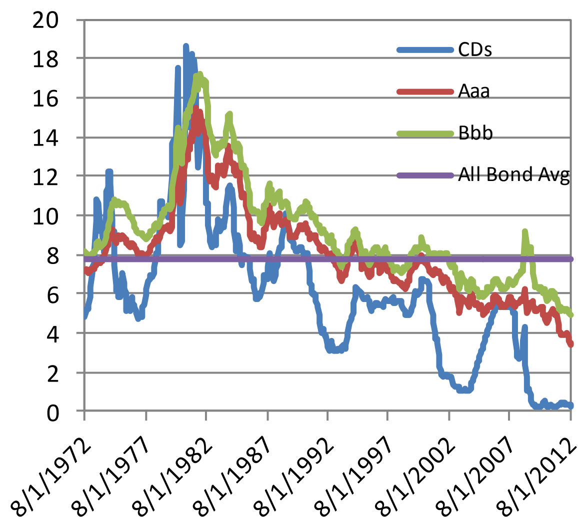


Chart D: Fixed Income Yields as of 9/30/12

	Yield-to-Maturity	Avg. Years
Money Market Rates	0.1%	0.0
Avg 6-month CD	0.2%	0.5
Short Term Corporate Bonds	1.6%	3.0
Intermediate US. Govt Bonds	0.8%	5.6
Intermediate Corp Bonds	2.9%	7.4
Long Term Govt Bonds	2.4%	24.0
Long-term Corp Bonds	4.4%	24.5
High Yield Corp Bonds	5.6%	4.5
Average	**2.3%**	**8.7**
Total Bond Market Index	1.7%	6.9

Note: While the average of the above assets is 2.3%, the weighted-average yield-to-maturity on the entire bond market based on Vanguard's Total Bond Market Index is actually 1.7% because of its high weighting to Govt/Agency bonds (44%).

Pension Plans Can't Earn Required Returns

Defined benefit plans in the U.S. currently have a target 7.8% return requirement to pay their stated benefits to retirees. The current defined benefit fixed income allocation has risen over the past decade to 42%. Using the average yield-to-maturity of the bonds listed in chart D, these funds would only receive 2.3% return from their bond portfolios, leaving a required 12% return from the rest of their portfolio (which is currently 38% equities and 20% "other" assets). In our opinion, current bond allocations will result in pension funds failing to achieve their return objectives.

Individuals Forced to Dip into Principal

Retired individuals face a similar income shortage problem. Among the retired population, the median annual spending is roughly $31,000. After accounting for the average $12,000 in after-tax social security benefits, the average retiree still needs $19,000 to live on. The goal of many investors is to live off the interest of their savings and leave their principal intact to insure retirement security and eventually pass on to their spouse, children, or charity.

Current interest rates make such a task a virtual impossibly using the average asset allocation of U.S. households older than 65 (37% cash, 31% fixed income, 27% stocks, 5% other). Historically, the median family would have earned an average return of 7.8% and needed just $304,000 to generate $19k after taxes in income without dipping into principal. At the current blended (cash, bonds, equities) expected return rate of 3.3%, a family would need $715,000 to earn the desired $19k in yearly after-tax income without dipping into the principal. Unfortunately, the median household does not have $715,000 in savings. Unless retirees save a lot more or allocate more to higher expected return assets, they will likely have to use up their savings to meet their spending needs and live in fear of exhausting their savings.

Investors Should Look Elsewhere for Return

The bottom line is that pension funds and individuals are either going to have to cut spending or look outside of fixed income to achieve their financial goals. In the next section, we'll talk about an area that we believe offers attractive risk-adjusted returns and in our view, makes the most sense to act as a substitute for bonds.

THE BEST INCOME SUBSTITUTE

We believe investors should and will allocate more assets to high-quality dividend paying stocks as an income substitute for bonds. Investors have already begun to search for yield in certain income-rich areas such as utility equities, real estate investment trusts (REITs), and Master Limited Partnerships (MLPs). While these areas have risen dramatically due to increased demand for yield, one area that remains a good alternative based on current risk/reward attributes are high-quality, dividend paying stocks.

Defining High-Quality

A high-quality company has 1) high returns on capital 2) stability of earnings 3) low leverage and 4) long history of paying and growing dividends. A key to achieving the above criteria is maintaining a competitive advantage. This advantage is often referred to as a "moat" because it keeps intruders from capturing the company's crown jewels (profits). This advantage could be due to large scale (Wal-Mart), patents (Pfizer), or powerful branding (Coca-Cola).

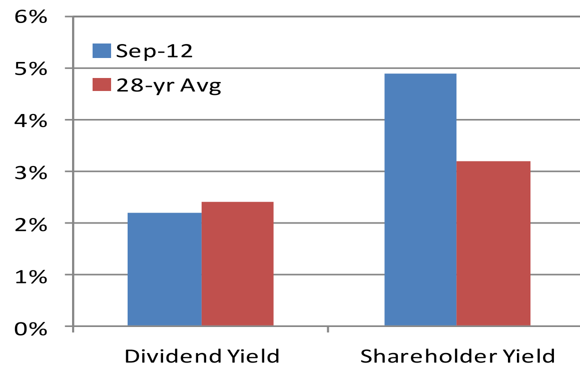
Stability of Income

The attractiveness of high quality stocks as an income substitute lies in their stable earnings power and shareholder friendly capital allocation policies of buying back stock or paying out cash dividends. For example, in 2011, IBM took their free cash flow and paid out a 2% dividend yield and took the rest of it and bought back 6% of the company's outstanding shares for a total shareholder yield of 8%. The typical high-quality company has earnings which are more than double its current dividend. Predictable and stable earnings combined with a consistent capital allocation policy gives higher quality stocks characteristics similar to bonds.

Hidden Yield

While the average dividend yield on the S&P 500 Index is currently 2.2%, the actual "shareholder yield" including stock buybacks is much higher. Because dividends are currently taxed at 15% and often reinvested back into the company by shareholders, corporations often buy back their own shares directly to defer the tax consequence. Paying a dividend and buying back stock provide similar rewards to investors except that the latter defers the return until the stock is sold and recognized as a capital gain. While dividend yields on stocks are historically low, the total "shareholder yield" (dividends plus buybacks), is currently 4.9%, a yield higher than its 25-year average. See Chart E.

Chart E: Dividend & Shareholder Yields on Stocks



Source: Ned Davis Research

Although many investors have searched for extra yield in longer-term corporate bonds and lower-credit junk bonds, we think high-quality equities are a better value. We estimate that high-quality stocks will have a higher return than junk bonds over the next seven years while their historical risk profile (standard deviation) has been nearly the same. See Chart F below.

Chart F: Stock Market Risk and Expected Returns (Estimated 2013-2020)

Asset	Bonds		Stocks	
Asset Risk	Low		High	
Sub Asset	Corp.	Junk Bonds	High-Quality	S&P 500
Sub-Asset Risk	Avg	High	Low	Avg
5-yr Hist Std Dev.	11%	16%	18%	22%
Expected Returns	3%	6%	8%	7%

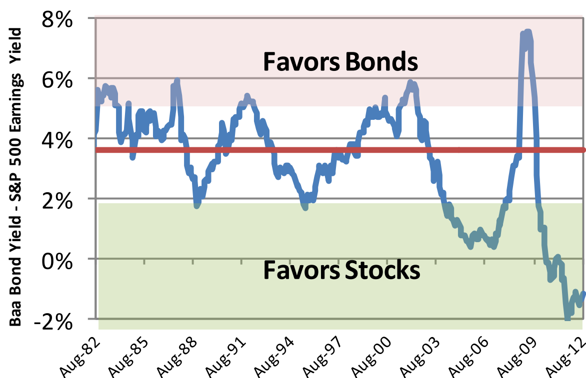
Note: Bond Market expected returns and 5-year historical standard deviations come from yield-to maturity (YTM) and standard deviations from the following funds: Corporate bonds use iShares iBoxx Investment Grade Corporate Bond Fund (LQD) and junk bonds use SPDR Barclay's Capital High Yield Bond ETF (JNK). High-quality and S&P 500 historical standard deviations come from Vanguard Dividend Appreciation Fund (VIG) for high-quality and S&P 500 Index. S&P 500 expected return comes from Schwab forecasts. High-quality return forecasts come from internally developed proprietary models. Past performance is not indicative of future results.

Stocks over Corporate Bonds

The most compelling display of the relative value in stocks vs. bonds compares S&P 500 earnings yield to the average Moody's Baa corporate bond yield. Historically, Baa-rated bonds yielded about 3.5% more than stocks because stocks also had growth. However, the earnings yield on stocks now exceeds that of the fixed Baa-rated bond yield.

Historically, when this earnings spread favored stocks, the S&P 500 returned 14% and outperformed bonds by 4% annually (See Chart G below).

Chart G: Bond Yield vs. Stock Earnings Yield



Source Data: Federal Reserve Board, Yale Shiller Data

Growth Matters

While dividends are important, another key return driver for equities is growth. Using 5-year rolling periods since 1940, dividends have represented just 42% of the total return on stocks. Earnings growth in the S&P 500 has averaged an additional 6.5% over the past 50 years. While future growth may be slower due to a mature economy, high government debt, and lower inflation, we believe that corporate earnings should grow commensurate with world productivity, inflation, and population growth.

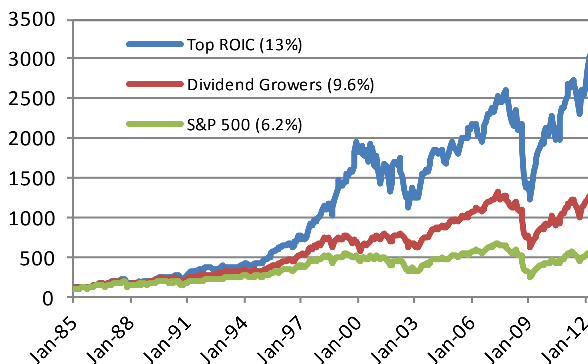
Quality Stocks Have Outperformed

Since finance theory teaches that higher returns require higher risk, one might expect high-quality stocks to earn *lower* returns than those of lower quality. However, just the opposite has been true. Since December 1985, an equal-weighted portfolio of high-quality stocks (as defined by dividend growers or highest return on invested capital) would have outperformed the market handily, earning a total return of over 9.5% per year vs. the S&P 500's return of 6% (See Chart H).

Added Benefits

High-quality stocks have many positive attributes that are beyond the scope of my key points in this letter, but are too important to leave out. They have historically performed better than their lower quality peers during down markets and periods of inflation due to stable earnings from internationally diverse businesses and ability to raise prices to their customers.

Chart H: Dividend Growers & High Profitability Stocks vs. S&P 500. (1985-2012)



Ned Davis Research

Specific Funds & Stocks

Two of the most popular and lowest cost ETFs for high quality dividend paying stocks are the Vanguard Dividend Appreciation fund (VIG) and the Schwab U.S. Dividend Equity ETF (SCHD). The SCHD has an expense ratio of just .07% and waives commission fees for Schwab clients. The largest holdings of the SCHD are listed back on Chart A. In our view, these funds are a great way to take advantage of the opportunity we see in some of the world's greatest companies.

Conclusion

For investors with at least an average risk tolerance, we believe high-quality stocks will be a key way to grow and protect wealth on an inflation adjusted basis in the long run. With implied after-tax yields on CDs and U.S. government bonds below the expected rate of inflation, fixed income investors have committed themselves to a loss of purchasing power over time. As investors increasingly recognize the growth, dividends, and scarcity of high-quality U.S. stocks, their share prices could appreciate dramatically higher.

Disclosures

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